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Supreme Court Bankruptcy Thoughts: Scope of Safe Harbor and Appellate Review

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The Supreme Court recently addressed two bankruptcy issues. In its *Merit Management* opinion, the Court resolved a circuit split regarding the breadth of the safe harbor provision which protects certain transfers by financial institutions in connection with a securities contract. In *Village at Lakeridge*, the Court weighed in on the scope of appellate review and whether a bankruptcy court's factual determination should be reviewed for clear error or *de novo*. These decisions are notable because they provide guidance on previously murky issues of bankruptcy law.

Merit Management Group, LP v. FTI Consulting, Inc.

In *Merit Management*, the Supreme Court held that Section 546(e) of the Bankruptcy Code does not protect transfers by financial institutions in connection with a securities contract if the financial institution is only a conduit for the transfer.

Merit Management concerned a Chapter 11 bankruptcy case filed by Valley View Downs, LP ("Valley View"). Prior to filing, Valley View agreed to purchase the stock of Bedford Downs Management Corp. ("Bedford"), a company it had competed against for the last available harness-racing license in Pennsylvania. The exchange took place through an escrow agent, and Valley View borrowed money from another bank and other lenders to pay for the shares. Valley View filed for bankruptcy when it failed to secure the requisite gaming license.

After plan confirmation, the trustee sued Merit Management Group, LP ("Merit"), a former shareholder of Bedford, seeking to recover $16.5 million that Merit received in exchange for its shares as a constructive fraudulent transfer. Merit sought dismissal, arguing that the transfers were made by or to the type of financial institutions covered by the safe harbor provision of Section 546(e). The safe harbor provision provides an exception to the bankruptcy trustee's power to avoid certain transfers, specifically those made "by or to (or for the benefit of)" certain entities, including financial institutions "in connection with a securities contract." While it is undisputed that the escrow agent and bank were enumerated entities within this provision, the Court analyzed whether the language "made by or to" pertained to institutions that act as "mere conduits" in a transaction, such as here.

In making its determination, the Court considered approaches taken by the different circuits. The Seventh and Eleventh Circuits have interpreted the safe harbor provision to not provide protection to transfers that pass through a covered entity, where the entity only acts as a conduit and has no beneficial interest in the property transferred. The Second, Third, Sixth, Eighth, and Tenth Circuits have historically held to the contrary.

The Court analyzed the specific language of the safe harbor exception, as well as the entire statutory structure. It concluded that the relevant transfer for purposes of the safe harbor is the same transfer that the trustee seeks to avoid. In this case, the trustee sought to avoid the transfer between Valley View and Merit, not the transfers of the escrow agent and bank. Because neither Valley View nor Merit were covered by the safe harbor provision, the provision did not apply to the transfer. Therefore, the safe harbor provision does not apply when an entity covered by the exception is only a "conduit" for the transfer at issue.

This holding resolves a circuit split by favoring a narrow view of the safe harbor provision.

U.S. Bank, N.A. v. Village at Lakeridge, LLC

In *Village at Lakeridge*, the Supreme Court addressed whether a bankruptcy court's determination that a set of facts demonstrated an arms-length transaction should be reviewed for clear error or *de novo.*

In 2011, The Village at Lakeridge, LLC (“Lakeridge”) attempted to reorganize under Chapter 11 of the Bankruptcy Code. Lakeridge’s proposed plan of reorganization purported to impair the interests of two of its substantial creditors: U.S. Bank, N.A. (“U.S. Bank”) and MBP Equity Partners (“MBP”), which owned Lakeridge. U.S. Bank refused the proposal, which consequently blocked Lakeridge’s option to reorganize through a fully consensual plan. *See* 11 U.S.C. § 1129(a)(8).

Lakeridge then opted to use a “cramdown” plan, which impairs the interests of a non-consenting class of creditors. For the court to approve a “cramdown” plan, another impaired class of creditors must consent to the plan. However, if a creditor is an “insider” of the debtor, the Bankruptcy Code does not factor that creditor’s consent in this determination. While the Bankruptcy Code defines “insider” as any director, officer, or “person in control” of the entity, courts (including the Ninth Circuit) have devised tests to identify “non-statutory” insiders. The crux of these tests is whether an individual’s transaction with the debtor was at arm’s length.

Because of its “insider” status, MBP could not provide the consent required for a cramdown plan. It instead sold its claim for $5,000 to a retired surgeon who was romantically involved with an MBP board member/Lakeridge officer. Thereafter, the surgeon consented to Lakeridge’s proposed reorganization. U.S. Bank objected, arguing that the surgeon was a “non-statutory” insider because the transaction was not at arm’s length. Based on the facts provided, the Bankruptcy Court rejected U.S. Bank’s argument and found that the transaction was conducted at arm’s length. The Ninth Circuit affirmed, holding that the finding was entitled to clear-error review.

The Supreme Court affirmed the Ninth Circuit’s holding. It stated that at the case involved a “mixed question” of law and fact. When a case requires appellate courts to expound on the law, the case should be reviewed *de novo*. However, when a case immerses the courts in case-specific factual issues, the case should be reviewed with deference. In this case, the Court boiled the mixed question down, asking: Given all the basic facts found, was the surgeon’s purchase of MBP’s claim conducted as if the two were strangers to each other? The Court stated that “this is as factual sounding as any mixed question gets” and reasoned that the Bankruptcy Court had presided over presentation of evidence, heard all the witnesses, and had the deepest understanding of the record. It further stated that very little legal work was required to apply the arm’s-length test. For these reasons, the Court determined that the issue primarily rests with the Bankruptcy Court, subject only to appellate review for clear error.

Village at Lakeridge clarifies the correct standard of review – clearly erroneous – in the narrow circumstances it addresses. However, in reaching this decision, the Court expressly declined to review questions related to “insider” status and whether the Ninth Circuit test is appropriate to make this determination.

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