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Business Reorganizations, Bankruptcy,
and Creditors' Rights

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Supreme Court Limits Safe Harbor in Fraudulent Transfer Litigation

Resolving a Circuit split, on February 27 the U.S. Supreme Court issued its unanimous opinion in *Merit Management Group, LP v. FTI Consulting, Inc.* (No. 16-784), holding that the safe harbor provided in Section 546(e) of the Bankruptcy Code does not protect the ultimate recipient of a potentially fraudulent transfer, because that recipient is not a “financial institution.”

The litigation concerns payments made by a Chapter 11 debtor prior to its bankruptcy to close a transaction in which it purchased all of the shares of another corporation. The plaintiff, a plan trustee appointed pursuant to the debtor’s confirmed Chapter 11 plan, asserted that the debtor was insolvent when the payments were made and that the debtor overpaid for the shares. The defendants, who were the shareholders of the acquired corporation, and the ultimate recipients of the purchase price from the debtor, defended on the basis that Section 546(e) prevents the avoidance of the payments they received, on the basis that the funds were settlement payments made to or for the benefit of a financial institution, because the money flowed through two banks that provided the financing for the acquisition and the closing escrow.

The Court unanimously rejected the defendants’ arguments, instead concluding that the particular transfer that the trustee sought to avoid in the litigation must be the focus of the safe harbor analysis. The transfer to be scrutinized was the transfer to the shareholders who received the payment, not the intervening transfers to the financial institutions that handled the funds on their way from the debtor to the shareholders of the acquired corporation. In so holding, the Court construed the language of the statute, the statutory context, and the broader statutory structure.

As the Court succinctly put it: “Because the parties do not contend that either [the debtor] or [the shareholder] is a “financial institution” or other covered entity, the transfer falls outside of the §546(e) safe harbor.” Therefore, fraudulent transfer defendants who are not themselves “financial institutions” will no longer be able to claim the protection of the safe harbor of Section 546(e), and will need to find another defense to avoid judgment in such cases.

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