# Supreme Court Closes Safe Harbor Loophole in Fraudulent Conveyance Litigation

In a much anticipated decision, *Merit Management Group, LP v. FTI Consulting, Inc.*, the Supreme Court has paved the way for bankruptcy estates, through litigation, to claw back value from shareholders and other participants that benefitted from pre-bankruptcy leveraged buyouts and other transactions, eliminating a safe harbor that formerly stifled such litigation.

Section 548 of the Bankruptcy Code allows trustees and debtors-in-possession to undo certain pre-bankruptcy transfers – known as “constructive fraudulent conveyances” – for which the debtor received less than a “reasonably equivalent value” and which were made when the debtor was insolvent. Participants in leveraged buyouts and other transactions were previously able to escape the threat of clawback under Section 548 by virtue of Section 546(e) of the Bankruptcy Code, which prescribes a safe harbor exception shielding transfers that were “made by or to (or for the benefit of) a . . . financial institution.” The majority of Courts of Appeals – including the Second and Third Circuits – had held that Section 546(e) covered transactions where a financial institution, such as a bank, acted as a “mere conduit” in the transaction. Accordingly, shareholders and other parties were able to participate in leveraged buyouts with impunity, relying on the fact that financial institutions would typically act as an intermediaries in the transactions – for example, by facilitating the transfer of funds from the new to the old owners of the company.

The Supreme Court has now foreclosed this expansive interpretation of Section 546(e), dramatically changing the landscape of bankruptcy and creditors’ rights law and opening up additional opportunities for an estate and its constituents to recapture lost value.[1] *Merit* involved Valley View, an aspiring racetrack casino that bought out shareholders of rival racetrack Bedford Downs in return for Bedford’s withdrawal from a competition for a harness-racing license. Despite having obtained the license, Valley View’s business subsequently failed, and the company filed for Chapter 11 bankruptcy. The trustee of Valley View’s litigation trust sued Merit – one of Bedford’s former shareholders – seeking to avoid the transfer of $16.5 million from Valley View to Merit in exchange for Bedford’s stock. The trustee claimed that Valley View was insolvent when it purchased Bedford and “significantly overpaid” for Bedford’s stock. In its motion to dismiss the lawsuit, Merit argued that the transfer at issue was protected under Section 546(e) because two financial institutions – Credit Suisse and Citizens Bank – facilitated the transfer of funds between Valley View and Bedford’s shareholders. The district court granted Merit’s motion, but the Seventh Circuit reversed, holding that Section 546(e) did not protect Merit from the reach of Section 548.

In a unanimous decision, the Supreme Court affirmed the Seventh Circuit’s decision and held that “the plain meaning of Section 546(e) dictates that the only relevant transfer for purposes of the safe harbor is the transfer that the trustee seeks to avoid.” Because the only transfer the trustee sought to avoid was that between Valley View and Merit, the high court reasoned, the banks’ involvement as conduits in the transaction did not immunize the transfer from scrutiny as a fraudulent conveyance under Section 548.

---

[1] The decision is available at https://www.supremecourt.gov/opinions/17pdf/16-784_gdhk.pdf.

The Supreme Court's decision in *Merit* is likely to have significant implications. Transactions that leave companies with a significant amount of new debt while inequitably benefitting their old shareholders will no longer be shielded from avoidance simply because a bank is an intermediary in the transaction. Furthermore, we anticipate a flurry of bankruptcy-related litigation attacking pre-petition leveraged buyouts and other transactions that, before *Merit*, were shielded in most circuits. The decision reopens what had been a highly valuable avenue for fiduciaries and creditors to augment available assets for distribution and will require investors throughout the capital structure to reevaluate the risks and opportunities of current and future investments. Tranches of debt that were considered immune from avoidance risk now must be viewed more cautiously; conversely, unsecured or subordinated tranches of debt that will benefit from successful avoidance litigation will be presented with new opportunities for enhanced recoveries.

Kasowitz Benson Torres LLP's bankruptcy litigation and restructuring practice group has been at the forefront of many of the most notable fraudulent conveyance actions over the past two decades, including:

- **Tribune Company**. We represent the trustee for the senior notes in the Chapter 11 cases of Tribune. Focusing on fraudulent conveyance claims related to the $11 billion leveraged buyout of Tribune, we have prosecuted numerous claims against recipients, including CalPERs, of fraudulently conveyed assets, against which we have successfully defeated numerous defenses.

- **Refco**. We represent the Official Committee of Unsecured Creditors and several other key creditor parties in the wind-down of Refco's Chapter 11 estates. We successfully handled the prosecution and settlement of claims relating to a $1.4 billion leveraged recapitalization.

- **Adelphia Communications**. We represented the Official Committee of Unsecured Creditors and Adelphia Recovery Trust in the prosecution of numerous actions, including for intentional and constructive fraudulent conveyances, against commercial banks and their investment bank affiliates, resulting in hundreds of millions of dollars in recoveries.

**Contact Information**


**Adam L. Shiff**
Partner
ashiff@kasowitz.com

**Matthew B. Stein**
Partner
mstein@kasowitz.com

**Shai Schmidt**
Associate
sschmidt@kasowitz.com