Dodging the Issue: The Supreme Court "Weighs" In On Bankruptcy Law

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The Supreme Court has been unusually busy in addressing bankruptcy-related matters by issuing two recent opinions – Merit Management Group, L.P. v. FTI Consulting, Inc. ("Merit") and U.S. Bank, N.A., as Trustee v. Village at Lakeridge, LLC ("Lakeridge"). As discussed below, both decisions discuss nuanced areas of bankruptcy law but do not go far enough to change the landscape for practitioners. Indeed, the decisions are more notable for the questions that they do not answer than the questions that they do.

The Merit Case

In the Merit case, the Court reviewed a decision by the Seventh Circuit reversing the District Court’s determination that the “safe harbor” provided by Section 546(e) of the Bankruptcy Code did not protect the avoidance of a specific transfer. The issue involved whether FTI Consulting, Inc., as litigation trustee ("FTI") of Valley Views Downs, LP (the "Debtor"), could avoid and recover a transfer of approximately $16.5 million made from the Debtor to Merit Management Group ("Merit"), a shareholder of Bedford Downs Management Corp. ("Bedford"). Specifically, the Debtor and Bedford entered into an agreement whereby the Debtor would acquire the stock of Bedford for $55 million. Credit Suisse provided the financing to the Debtor and Citizens Bank of Pennsylvania acted as an escrow agent, holding the funds that were ultimately distributed to Bedford’s shareholders, including Merit, which received $16.5 million from the transaction. The Debtor could not operate its proposed business and ultimately commenced a chapter 11 case. FTI was appointed as litigation trustee after confirmation of a plan. In that role, FTI commenced an action to avoid the $16.5 million payment to Merit as a fraudulent transfer under Section 548 of the Bankruptcy Code.

Merit moved for judgement on the pleadings under Rule 12(c) of the Federal Rules of Civil Procedure by asserting that the transfer is not avoidable because it is protected under the provisions of Section 546(e). That section exempts from avoidance certain transfers that were, among other things, made as a settlement payment by a financial institution. The District Court agreed with Merit’s arguments and granted its motion. The Seventh Circuit reversed, finding that Section 546(e) does not apply when the financial institution is acting a mere conduit. Here, the Seventh Circuit found that the financial institutions involved merely moved the funds through the transaction and did not benefit from the transfers.

The Supreme Court heard the case to resolve the circuit split regarding the application of Section 546(e). Merit argued to the Court that when a transfer is challenged, a court should examine all the component parts and, if one part is protected by Section 546(e) because it involved a “financial institution” (as defined in the Bankruptcy Code), then the transfer as a whole cannot be avoided. FTI argued the contrary, that the courts should look at the substance of transfer as a whole, which here is the transfer from the Debtor to Merit, and since that transfer was not made to or for the benefit of a financial institution, Section 546(e) is inapplicable.

The Court agreed with FTI’s argument and stated that courts must look holistically at the transfer that is being avoided. In so holding, the Court began with a textual analysis of Section 546(e). That section provides, among other things, that transfers to or for the benefit of financial institutions in connection with settlement payments cannot be avoided under the avoidance provisions of the Bankruptcy Code. The Court noted that since Section 546(e) operates as an exception to the avoiding powers, courts must first look to the transfer that is the subject of the suit. Since the plain language of Section 546(e) only applies to payments made in connection with the enumerated transactions, transfers that do not fall within those categories are not protected. Indeed, the Court noted that the statute does not say “a transfer that involves” or “a transfer that comprises” financial institutions is exempted.

In addition, the Court focused on the fact that the characterization of the transaction that is subject to avoidance (i.e. what is the plaintiff actually seeking to avoid – the transfer to Merit or the transfers made to the intermediary financial institutions) is important. And, since Merit did not challenge the characterization of the subject transfer, the court did not need to focus on the component parts of the transfer. Rather, the court needed to look at the transfer as a whole and stated that “[t]ransfers ‘through’ a covered entity . . . appear nowhere in the statute.” Thus, where the financial institutions were only involved as intermediaries that moved the money, rather than direct beneficiaries of the money, the protections of Section 546(e) were inapplicable.

The Court noted in a footnote that since the parties did not ask it to determine if the transfer at issue was a “settlement payment” or made in connection with a “securities contract,” the Court would not decide that issue. Instead, the decision rests on FTI’s unchallenged characterization of the transaction and the subsequent statutory analysis of Section 546(e). Without answering whether transfers “through” financial institutions could be considered settlement payments or payments made in connection with securities contracts, the Court left the door open for additional litigation and uncertainty. While it is understandable that the Court does not answer unpresented questions, it may have missed the rare opportunity to provide beneficial interpretation of important terms contained in Section 546(e).

The Lakeridge Case

In Lakeridge, the Court did not answer specific questions because the issues were not raised in the lower courts. In contrast, in Lakeridge, the Court specifically narrowed the issue to avoid answering a larger question that was likewise ripe for review. In that case, the Court looked to settle the issue of what is the proper standard of review that appellate courts should apply when examining determinations of non-statutory insider status.

Lakeridge, LLC ("Lakeridge") was a wholly-owned subsidiary of MBP Equity Partners ("MBP"). It owed $10 million to U.S. Bank, N.A. (the "Bank") and
$2.76 million to MBP. In Lakeridge’s chapter 11 case, the Bank rejected a proposed plan of reorganization and, as a result of MBP’s insider status and disqualified vote, the plan could not be confirmed. To circumvent the Bank’s rejecting vote, a member of MBP’s board and an officer of Lakeridge, Kathleen Bartlett, negotiated the sale of MBP’s claim to a buyer, who also happened have been in a romantic relationship with Ms. Bartlett. The total price paid for the claim was $5,000. Given that Lakeridge now had an accepting, non-insider creditor class, it could attempt to cram-down the Bank. The Bank objected, asserting that the buyer was a non-statutory insider. The Bankruptcy Court disagreed, finding that under the applicable Ninth Circuit test to determine if a person is a non-statutory insider, the buyer would not qualify because the claim purchase was negotiated at arms’-length. In order to make this determination, the Bankruptcy Court relied on the facts that the buyer and Ms. Bartlett maintained separate residences and finances and that the buyer made the purchase as a speculative investment. The Ninth Circuit affirmed, finding that the Bankruptcy Court’s findings were entitled to deference and reviewed under a clear error standard.

The Supreme Court accepted review solely to determine the appropriate standard for reviewing lower court decisions on whether a party is a non-statutory insider. The Court held that the proper standard of review is the clearly erroneous standard and, thus, affirmed the Ninth Circuit. The Lakeridge Court reached this holding by recognizing that a determination as to non-statutory insider status requires a court to examine three kinds of issues – one, a question of law, one, a question of fact and one, a mixed question of law and fact. The question of law is what is the appropriate test for determining whether a party is a non-statutory insider? The Court did not answer or review that issue but simply accepted that the test applied by the lower courts was appropriate in this circumstance. The question of fact relates to who did what and when such as examining the particulars of the relationship at issue. Again, the Court did not review or question the lower courts’ findings. The final issue (the mixed question of law and fact) was the issue actually before the Court – were the facts properly applied to the legal standard? The Bank argued that this question relies heavily on legal interpretation and, thus, should be reviewed de novo, while Lakeridge argued that the determination was highly factual and should be reviewed for clear error.

The Supreme Court started this analysis by asking a basic question – “What is the nature of the mixed question here and which kind of court (bankruptcy or appellate) is better suited to resolve it?” Since mixed questions are not all alike, the standard of review depends on whether the question requires more legal analysis (as the Bank urged) or immersion in the facts (as Lakeridge argued). The Court found that in applying the Ninth Circuit test for non-statutory insiders, the central inquiry came down to whether the transaction was an arms’-length transaction. Given that an arms’-length transaction is generally defined as a transaction conducted as though the two parties were strangers, the Court determined that such an inquiry was highly factual in nature. Thus, the proper standard of review was clear error.

In reaching this decision, the Court expressly declined to review questions such as whether a claim purchaser steps into the shoes of original claimant so that the buyer would be considered an insider because he bought the claim from an insider. Nor did the Court review or examine the appropriate standard to determine if a party is a “non-statutory” insider. Indeed, Justice Sotomayor filed a concurring opinion questioning whether the Ninth Circuit test to determine non-statutory insider status was the right test. Rather than answer that question, she merely raises the issue that this case presented the Court with an opportunity to weigh in on what is the appropriate test and resolve somewhat disparate law on that issue.

Take-Aways

These two Supreme Court decisions, while notable for actually addressing issues of bankruptcy law, do not significantly alter the application or interpretation of that law. Rather, the decisions merely focus and clarify narrow issues while carefully sidestepping larger questions that could actually impact the interpretation of applicable bankruptcy law. Thus, it is hard to set forth concrete lessons because the larger issues that impact matter resolution were not finally settled. But, one important lesson here is that parties should take particular care in framing the issues before the trial court and appellate courts. For example, if Merit had challenged the characterization of the transaction at issue and questioned whether the payments were, for example, on account of a securities contract, the result may have been different.