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U.S. Court of Appeals for the Second Circuit Rules That Bankruptcy Code's "Safe Harbor" Provision Preempts State Law Fraudulent Transfer Claims

By Robert Klyman and Gregory Juell*

The authors of this article discuss a U.S. Court of Appeals for the Second Circuit summary order in which the court held that the "safe harbor" provision of Section 546(e) of the Bankruptcy Code preempted a bankruptcy trustee's state law fraudulent conveyance claims."

The U.S. Court of Appeals for the Second Circuit has issued a summary order in which it held that the "safe harbor" provision of Section 546(e) of the Bankruptcy Code preempted a bankruptcy trustee's state law fraudulent conveyance claims.[1]

In so doing, the Second Circuit clarified the protection that the Bankruptcy Code affords certain parties who receive payments from companies in leveraged buyouts and recapitalizations that might otherwise be avoidable under applicable state law when the applicable company commences a bankruptcy case.

FACTUAL BACKGROUND

Boston Generating LLC (BosGen), together with its holding company EBG Holdings LLC (EBG) and various subsidiaries, comprised a wholesale power generation company that owned and operated several power facilities in the Boston metropolitan area.

In October 2006, EBG implemented a leveraged recapitalization transaction, which included a tender offer and distribution in which EBG's members received cash distributions in exchange for their membership interests in EBG.

To effectuate the recapitalization transaction, BosGen's lenders distributed loan proceeds to a BosGen account at US Bank. Thereafter, BosGen transferred approximately $708 million to EBG's Bank of America account (the BosGen Transfer).

EBG then transferred the proceeds to Bank of New York (BNY), as trustee, to execute the leveraged recapitalization transaction, which funded a $925

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[1] Holliday v. Credit Suisse Securities (USA) LLC, et al., 21-2543-br.

million tender offer (the Tender Offer) and a $35 million distribution (the Distribution) to EBG's members in exchange for their equity interests in EBG.

PROCEDURAL HISTORY

Several years after the Tender Offer and the Distribution, BosGen, EBG, and several of their affiliates filed voluntary Chapter 11 petitions in the U.S. Bankruptcy Court for the Southern District of New York.

During the bankruptcy case, the debtors sold substantially all of their assets to a third-party buyer and confirmed a liquidating plan. Pursuant to the plan, the debtors appointed a liquidating trustee to pursue various causes of action on behalf of the debtors' estates, including actions to avoid and recover the BosGen Transfer and the Distribution as fraudulent transfers under New York law.

In response to the trustee's fraudulent conveyance claims, the defendants argued that the "safe harbor" provision included in Section 546(e) of the Bankruptcy Code shielded the transfers from the trustee's avoidance powers under state law. Under that section, "notwithstanding the substantive avoidance powers set forth in [the Bankruptcy Code], the trustee may not avoid a transfer that is a . . . settlement payment . . . or . . . transfer made by or to (or for the benefit of) a . . . financial institution . . . in connection with a securities contract."[2]

The bankruptcy court agreed with the defendants and held that the safe harbor provision in Section 546(e) applied to both the Tender Offer and the Dividend.[3]

In so doing, the bankruptcy court held that each of the Tender Offer and the Dividend (a) constituted a settlement payment made to complete a securities transaction, and (b) was made in connection with a securities transaction, as the Tender Offer and Dividend were both securities transactions. It also found that BosGen qualified as a financial institution with respect to the BosGen Transfer, and that BNY was a financial institution with respect to the Dividend. It therefore held that both the BosGen Transfer and Dividend were protected by the safe harbor and dismissed the trustee's claims.

The district court affirmed the bankruptcy court's ruling that the safe harbor preempted the trustee's fraudulent conveyance claims.[4] With respect to the

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[2] 11 U.S.C. § 546(e).

[3] In re Boston Generating LLC, 617 B.R. 442 (Bankr. S.D.N.Y. June 18, 2020).

[4] Holliday v. Credit Suisse Securities (USA) LLC, No. 20-cv-5404 (S.D.N.Y. Sept. 13, 2021).

BosGen Transfer, the district court also analyzed in detail whether the bankruptcy court had considered the correct transfer in finding that the safe harbor applied. The trustee contended that the transfer from BosGen's account at US Bank to EBG's Bank of America account constituted the relevant transfer – such that no financial institution acted as an agent, as required under Section 546(e) – and that the bankruptcy court should not have included the transfer to BNY as part of the analysis.

In rejecting this transfer-by-transfer analysis, the district court applied the U.S. Supreme Court's holding in *Merit Management Group, LP v. FTI Consulting, Inc.*,[5] where the Supreme Court found that the transfer at issue in a Section 546(e) analysis is the overarching end-to-end transfer, as opposed to any component part of that end-to-end transfer. The district court therefore determined that the relevant transfer was the transfer of BosGen's loan proceeds from its loan facilities to the funding of the Tender Offer, and that the trustee's components-based analysis could not withstand application of *Merit Management*.

SECOND CIRCUIT RULING

The Second Circuit affirmed the district court, finding that the BosGen Transfer was protected by the safe harbor of Section 546(e) of the Bankruptcy Code.

First, the Second Circuit found that the bankruptcy court did not err in finding that the BosGen Transfer was executed in connection with a securities contract. BosGen's facility agreements expressly contemplated that the loan proceeds would be used to fund the Distribution and Tender Offer and that BosGen would then transfer the proceeds to EBG for that purpose.

In addition, per the holding in *Merit Management*, the Second Circuit held that Section 546(e) applied to the overarching transfer the trustee sought to avoid – namely, the transfer of BosGen's loan proceeds from its loan facilities to the funding of the Tender Offer. In so doing, the Second Circuit rejected the trustee's argument that the "elements of the safe harbor provision should be analyzed independently with respect to each 'component part'" of the BosGen Transfer.

The Second Circuit then rejected the trustee's argument that the BosGen Transfer was not made in connection with a securities contract because BosGen was not a party to the Tender Offer. While not conceding that Section 546(e) required BosGen to be a party to the Tender Offer, the Second Circuit found

[5] 583 U.S. 366 (2018).

that the plain text of the agreement made clear that BosGen was a party to the contract as an EBG subsidiary. The Second Circuit further noted that the trustee did not dispute that BosGen provided the funds for the specific purpose of making payments in exchange for EBG members tendering their units under the contract.

Further, the Second Circuit found that the following factors made BosGen and EBG financial institutions under the safe harbor provision:

- A financial institution includes a customer of a bank when the bank "is acting as agent" for the customer "in connection with a securities contract."[6]
- A debtor is a customer of a bank when the bank receives and holds a deposit to purchase shares, receives tendered shares, retains those shares for the debtor, and pays tendering shareholders with the funds.
- An agency relationship exists where a plaintiff shows that a bank "made payments to, and received information from, a debtor's shareholders during the relevant transactions."[7]
- The BosGen Transfer was a securities contract since the credit facilities expressly contemplated that the loan proceeds would be used to fund the Distribution and Tender Offer.

In the present case, BosGen and EBG retained BNY as their agent because BNY acted as a depository in connection with the Tender Offer. It noted that BNY received documentation from members who tendered their units and then made payments to those members on behalf of BosGen and EBG. BosGen and EBG maintained control over the transactions that BNY carried out in connection with the Tender Offer and thus BNY indisputably acted as an agent. The court therefore found that the bankruptcy court correctly determined that BosGen and EBG were financial institutions with respect to the BosGen Transfer and concluded that the defendants were entitled to the safe harbor as a matter of law.

Accordingly, the Second Circuit concluded that the safe harbor provision preempted the trustee's state law fraudulent conveyance claims and affirmed the district court's judgment.

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[6] See 11 U.S.C. 101(22)(A).

[7] In re Nine West LBO Securities Litigation, 87 F.4th 130, 146 (2d Cir. 2023).

KEY TAKEAWAYS

Although the *Holliday* ruling is a summary order and thus lacks precedential effect, it reflects the Second Circuit's broad interpretation of the safe harbor provision with respect to securities transactions.

The ruling may therefore provide comfort to recipients of funds arising out of such transactions that the funds will not be subject to clawback under state law where the company making the transfers files for bankruptcy.

It additionally sheds further light on the Second Circuit's interpretation of *Merit*, and that the relevant transfer for avoidance purposes is the overarching, end-to-end transfer, rather than any component transfers.