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Structured Finance Is Safe Despite Merit Ruling

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In *Merit Management Group LP v. FTI Consulting Inc.*,[1] the U.S. Supreme Court scrutinized the proper application of the safe harbor found in U.S. Bankruptcy Code[2] Section 546(e), which protects from avoidance certain transfers made in connection with securities, commodity and forward contracts. Resolving a circuit split,[3] the Supreme Court held that Section 546(e) only protects from avoidance qualifying transfers by and to entities enumerated in Section 546(e) and does not protect transfers that merely pass through such entities. While the Supreme Court's decision seemingly narrowed the reach of the safe harbor, it did little to change the landscape for the multibillion-dollar U.S. structured finance industry, including warehouse lending.

Structured Finance and Warehouse Lending

Structured finance transactions deploy a variety of complex and capital-efficient techniques to facilitate asset-based financing in lieu of more expensive or unavailable company-level borrowings. One typical structure involves a repurchase agreement, or "repo agreement," through which an owner of certain assets — a "repo seller" — sells the assets to a lender — a "repo buyer" — in exchange for cash and an agreement by the repo seller to repurchase the assets from the repo buyer at a later date, generally for an amount equal to par plus the negotiated, accrued interest. Unlike a secured loan, title to the underlying assets actually passes to the repo buyer in a repo transaction, giving the repo buyer the ability to sell the assets in the event of a repo buyer default, including a repo seller bankruptcy or a failure to repurchase at the end of the agreed term.[4] Since assets are sold at a discount to par and typically marked to market on a daily or regular basis to preserve a negotiated asset pool value, repo buyers/lenders generally are able to preserve the value of their investment or at least have greater control over their position compared to traditional collateralized lending.

This type of repurchase agreement structure commonly is referred to as "warehouse lending." The assets financed typically are mortgage loans or securities evidencing a beneficial interest in or that are collateralized by mortgage loans. Repo sellers/borrowers use a warehouse line to pool mortgage loans for ultimate sale to a government sponsored entity, such as Ginnie Mae, or securitization and sale of resulting bonds into the secondary market.

Repo sellers generally deploy one of two types of safe harbors for warehouse lending structures: the repurchase agreement safe harbor or the securities contract safe harbor. Both safe harbors impose different requirements for a warehouse structure to qualify for protection.

The first of the two safe harbor structures, the repurchase agreement, is relatively simple to qualify for,

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but far less flexible than the securities contract safe harbor. To qualify for the repurchase agreement safe harbor, a transaction must have a qualifying asset type, such as a mortgage loan, and the repurchase date must be fixed at no longer than one year following the purchase date. Courts have held that the asset limitation excludes servicing rights associated with mortgage loans[5] and "REO" (real estate owned) property or property acquired by a lender through foreclosure. The Bankruptcy Code imposes no limitations on the types of entities that can be sellers or buyers under the repurchase agreement safe harbor.

The second safe harbor structure, the securities contract, which expressly includes repurchase agreements, exacts a higher price to qualify as a repo seller/lender ("qualified entities") and requires that the asset sold be a qualifying "security" (including, by definition, a mortgage loan) ("qualified security"), but dictates neither a repurchase time limitation nor the types of assets that can "back" the qualified security. Thus, many leading practitioners believe that servicing rights and REO can be included among the assets backing a qualified security in addition to mortgage loans.

While there are a number of drivers for warehouse lending structures (less haircut, better coupon, tax), the Bankruptcy Code safe harbors enacted in 2005 were essential to the creation of this type of warehouse lending and remain critical to removing borrower credit risk from and isolating the intrinsic value in the underlying asset financed. A safe harbored transaction enjoys three key features that set it apart from other types of financing.

First, safe harbored transactions are not affected by the onset of the Bankruptcy Code's automatic stay triggered by a borrower bankruptcy filing thanks to exceptions enumerated in Section 362 for various types of safe harbored transactions. Among those exceptions is Section 362(b)(6), which is significant for warehouse lenders seeking to qualify a repurchase agreement under the securities contract safe harbor because it precludes staying a qualified repo buyer's exercise of repurchase agreement remedies, including setoff rights.[6] To enjoy the protections of this exception, the repo buyer must be a qualified entity (typically a "financial institution" or a "financial participant"[7]). A repo buyer that is not directly a qualified entity may nevertheless become one as a customer of a "financial institution" acting as its agent or custodian, a tool potentially impacted by the Merit Management decision.[8]

Second, transfers made in connection with safe harbored transactions, both the initial transfer and subsequent mark-to-market payments, are protected from avoidance as constructively fraudulent or preferential transfers under Bankruptcy Code Section 546. Section 546(e) specifically protects from avoidance settlement payments, margin payments and transfers related to a securities contract ("qualified transfers") made by or to (or for the benefit of) a qualified entity.

Finally, repo buyers can exercise essential termination rights — acceleration of obligations, liquidation of collateral, and termination of the repo agreement — and protect investment downside upon a repo seller/borrower bankruptcy filing notwithstanding the Bankruptcy Code's general prohibition against enforcement of contractual provisions triggered by a counterparty's bankruptcy filing.[9] Enforcement of such ipso facto clauses is prohibited absent a safe harbored contract, such as securities contracts and repurchase agreements.

Merit Management

At issue in Merit Management was whether the Section 546(e) safe harbor protects from avoidance

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qualified transfers by and to entities that are not qualified entities themselves if such transfers pass through qualified entities. The Supreme Court said no, concluding that Section 546(e) requires evaluation of the entities making the specific transfer a trustee seeks to avoid, not intermediaries facilitating the same.[10]

In Merit Management, the qualified transfer was an indirect payment by Valley View Downs LP to Merit Management Group LP that passed through two financial institutions. Subsequently, Valley View filed for bankruptcy, and the litigation trustee sued Merit to avoid the payment as a constructively fraudulent transfer under Section 548(a)(1)(B). Merit invoked the Section 546(e) safe harbor, arguing that the transfer was a settlement payment made by or to or for the benefit of a "financial institution" because it passed through two qualified entities before reaching Merit.

While the Seventh Circuit focused on the meaning of the words "by or to (or for the benefit of)" used in Section 546(e), the Supreme Court found this question premature because a court must first identify the relevant transfer for purposes of the safe harbor.[11] The litigation trustee sought to avoid the overarching transfer from Valley View to Merit. As such, the court concluded that the component parts of the transfer were irrelevant absent an argument by Merit that the litigation trustee improperly identified the transfer to be avoided.[12] Merit neither challenged the designation of the Valley View-to-Merit transfer as the avoidable transfer, nor argued that either Valley View or Merit were qualified entities. Thus, the court had no reason to consider the components of the transfer because Section 546(e) defines the limit on the trustee's avoiding power by reference to an otherwise avoidable transfer.[13] Because the litigation trustee sought to avoid the transfer from Valley View to Merit and neither Valley View nor Merit were qualified entities under Section 546(e), the Supreme Court held that the transfer fell outside the Section 546(e) safe harbor.[14]

Significantly, neither party raised the issue of whether Valley View or Merit qualified as a "financial institution" by virtue of its status as a "customer" of a "financial institution."[15] In fact, Justice Stephen Breyer specifically pondered why neither party raised the issue and stated that it seemed as though one of the financial institutions was acting as an agent or custodian for Valley View.[16] Because the issue was not before the court, the court did "not address what impact, if any, §101(22)(A) would have in the application of the §546(e) safe harbor," suggesting a different result had the parties addressed this issue.

Implications

Although Merit Management narrowed the scope of the Section 546(e) safe harbor with respect to transfers that merely pass through qualified entities, it does not disturb safe harbor protection for warehouse lending structures relying on the use of custodians or agents to qualify an otherwise nonqualified entity as a qualified entity. Parties engaging in structured finance transactions should take care to ensure the use of a qualified entity as a custodian or agent if the transferor or transferee is not itself a qualified entity. Litigators defending this tool expressly permitted in the Bankruptcy Code should articulate the same or be prepared for a Supreme Court scratching its head and a call from their malpractice carriers.

Notes

[1] *Merit Management Group LP v. FTI Consulting Inc.*, 138 S. Ct. 883 (U.S. Feb. 27, 2018) ("Merit Management").

[2] See Title 11 of the United States Code, 11 U.S.C. §§ 101–1532.

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[3] The Second, Third, Sixth, Eighth and Tenth Circuits have held that the scope of § 546(e) includes transfers that merely pass through a financial institution. See In re Quebecor World(USA) Inc., 719 F.3d 94 (2d Cir. 2013); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 987 (8th Cir. 2009); In re QSI Holdings Inc., 571 F.3d 545, 551 (6th Cir. 2009); In re Resorts Int'l Inc., 181 F.3d 505, 516 (3d Cir. 1999); In re Kaiser Steel Corp., 952 F.2d 1230, 1240 (10th Cir. 1991). The Seventh and the Eleventh Circuits have held that transfers through a financial institution where the institution was serving as merely a conduit fall outside the scope of § 546(e). See *FTI Consulting v. Merit Management Group*, 830 F.3d 690 (7th Cir. 2016); Matter of Munford, Inc., 98 F.3d 604, 610 (11th Cir. 1996).

[4] Interestingly, repo sales are treated as financings for accounting purposes.

[5] See *Calyon N.Y. Branch v. Am. Home Mortg. Corp. (In re Am. Home Mortg. Inc.)*, 379 B.R. 503, 519, n. 43 (Bankr. D. Del. 2008) (holding that that the portion of the agreement that provided for the servicing of the mortgage loans was not entitled to the protections afforded “repurchase agreements” and “securities contracts” under the Bankruptcy Code).

[6] 11 U.S.C. § 362(b)(6).

[7] “Financial institutions” generally are banks and “financial participants” are repo buyers with significant outstanding repo or mark-to-market positions. 11 U.S.C. §§ 101(22) and (22)(A).

[8] 11 U.S.C. § 101(22)(A).

[9] See 11 U.S.C. § 365(e).

[10] Merit Management at 18-19.

[11] Id. at 10.

[12] Id. at 14.

[13] Id.

[14] Id. at 19.

[15] Id. at 6, n. 2.

[16] Id. At oral argument, Justice Breyer asked why this argument was not raised in the lower courts or in the parties’ briefing, but counsel to Merit did not have an explanation:

> Justice Breyer: Now, it seems to me that Citizens Bank is acting for agent or custodian of a customer, namely VVD, and it seems to me that Credit Suisse is acting as a — as an agent or custodian for VVD. So why doesn’t that cover it?
>
> Mr. Walsh: I think that is a fair way to look at it, Your Honor.
>
> Justice Breyer: Well, why doesn’t that cover it? Why are we dealing with a case ... where this is absolutely dealt with in a statute, under — under another provision, and nobody refers us to that provision, and I can’t understand why they didn’t — what’s going on?

Transcript of Oral Argument at 16, 9:25.

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