Pratt's Journal of Bankruptcy Law

LEXISNEXIS® A.S. PRATT® JULY-AUGUST 2024

LexisNexis

Pratt's Journal of Bankruptcy Law

VOLUME 20 NUMBER 5 July-August 2024

LexisNexis®

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Library of Congress Card Number: 80-68780

ISBN: 978-0-7698-7846-1 (print)

ISBN: 978-0-7698-7988-8 (eBook)

ISSN: 1931-6992

Cite this publication as:

[author name], [*article title*], [vol. no.] PRATT'S JOURNAL OF BANKRUPTCY LAW [page number] ([year])

Example: Patrick E. Mears, *The Winds of Change Intensify over Europe: Recent European Union Actions Firmly Embrace the "Rescue and Recovery" Culture for Business Recovery*, 10 PRATT'S JOURNAL OF BANKRUPTCY LAW 349 (2014)

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MATTHEW BENDER

(2024–Pub.4789)

Editor-in-Chief, Editor & Board of Editors

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POSTMASTER: Send address changes to *Pratt's Journal of Bankruptcy Law*, LexisNexis Matthew Bender, 230 Park Ave. 7th Floor, New York NY 10169.

Seventh Circuit Court of Appeals Upholds District Court's Decision That Safe Harbor Provision of Section 546(e) Applies to Privately Held Securities

By Valerie Eliasen and Jeffrey R. Dutson*

In this article, the authors examine a recent decision by the U.S. Court of Appeals for the Seventh Circuit holding that the safe harbor in Bankruptcy Code Section 546(e) is not limited solely to transactions involving public securities.

The recent ruling from the U.S. Court of Appeals for the Seventh Circuit in *PETR v. BMO Harris Bank*[1] provides additional comfort for lenders receiving full repayment in connection with leveraged acquisitions.

The U.S. Bankruptcy Code gives bankruptcy trustees the ability to recapture the value of certain transactions deemed to be "constructive fraudulent transfers." However, Section 546(e) of the Bankruptcy Code provides a safe harbor and exempts certain of these transactions. Among other things, Section 546(e) provides that a trustee cannot avoid a transfer "made by or to (or for the benefit of) a . . . financial institution . . . in connection with a securities contract. . . ." The scope and applicability of this safe harbor is often the source of controversy.

The Seventh Circuit (reversing an earlier bankruptcy court decision) held that:

(1) The safe harbor extends to "transactions involving private transactions that do not implicate the national securities clearance market" (i.e., the safe harbor is not limited solely to transactions involving public securities), and

(2) The safe harbor in Section 546(e) preempts state law fraudulent transfer claims (in addition to claims asserted under the avoidance provisions of the Bankruptcy Code).

BACKGROUND AND LOWER COURT DECISIONS

The case began as an adversary proceeding filed by the Chapter 7 trustee in the bankruptcy of BWGS, LLC (the Debtor), in the U.S. Bankruptcy Court for

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[1] PETR v. BMO Harris Bank, No. 23-1931 (7th Cir. March 15, 2024).

the Southern District of Indiana. In 2016, prior to the bankruptcy, an acquisition vehicle formed by Sun Capital Partners, VI, L.P., acquired all of the capital stock of the Debtor for $56.3 million pursuant to a stock purchase agreement. To help fund the acquisition, the acquisition vehicle obtained a bridge loan from BMO Harris Bank N.A. for $25.8 million and Sun Capital provided a guaranty for the bridge loan. The Debtor was not party to the acquisition transaction or the bridge loan.

About 4 weeks after the acquisition closed, the Debtor – a new wholly owned subsidiary of Sun Capital – entered into two credit facilities, which provided for a $20 million term loan and a revolving line of credit of up to $20 million. Upon closing the credit facilities, the Debtor used the loan proceeds and $409,706 of cash on hand to pay off the BMO bridge loan in full. Within one year, the Debtor's financial position had weakened, and it had defaulted under the new credit facilities.

The distressed situation continued until March 13, 2019, when an involuntary bankruptcy petition was filed against the Debtor under Chapter 7 of the Bankruptcy Code. The Bankruptcy Court entered an order for relief on April 24, 2019.

Pursuant to the Bankruptcy Code, a trustee may sue a creditor on behalf of the bankruptcy estate to avoid and recover payments made by the Debtor to such creditor in certain circumstances, including when a payment constitutes a fraudulent transfer under the Bankruptcy Code. The trustee's avoidance powers are limited by Section 546 of the Bankruptcy Code. Section 546(e), in particular, states that "[n]otwithstanding [S]ection[ ] 544 . . . of this title, the trustee may not avoid a transfer that is . . . a transfer made by or to (or for the benefit of) a . . . financial institution . . . in connection with a securities contract, as defined in [S]ection 741(7) . . . that is made before the commencement of the case, except under [S]ection 548(a)(1)(A) of this title."

Section 741(7) of the Bankruptcy Code defines a securities contract as, among other things, "[(1)] a contract for the purchase, sale, or loan of a security[, (2)] . . . any extension of credit for the clearance or settlement of securities transactions[, (3)] . . . any . . . credit enhancement related to any agreement or transaction referred to in this subparagraph, including any guarantee or reimbursement obligation by or to a . . . financial institution . . . in connection with any agreement or transaction referred to in this subparagraph[, (4)] . . . any other agreement or transaction that is similar to an agreement or transaction referred to in this subparagraph [or (5)] . . . any combination of the agreements or transactions referred to in this subparagraph."

John J. Petr, as Chapter 7 trustee for BWGS, LLC, sued Sun Capital and BMO on April 23, 2021, claiming that BWGS's repayment benefitted Sun

Capital by relieving them of their "credit enhancement commitments," constituting avoidable fraudulent transfers under Section 17(a) of the Indiana Uniform Voidable Transactions Act (IUVTA). Section 544 of the Bankruptcy Code allows the trustee to step into the shoes of a creditor and seek remedies for a transfer that is avoidable under the IUVTA. Section 18(b)(1) of the IUVTA and Section 550(a) of the Bankruptcy Code further enable the trustee to recover the value of a transferred asset if such transfer is avoidable. Sun Capital and BMO moved to dismiss the claims on grounds that the transfer falls within the Section 546(e) safe harbor because it was made by or to a financial institution in connection with a securities contract.

The bankruptcy court denied the motions, concluding that the 546(e) safe harbor does not apply to transfers made in connection with securities contracts concerning privately held securities and the transfer was not made in connection with a securities contract. The bankruptcy court further opined that a claim brought pursuant to state law by way of Section 544 was not subject to the Section 546(e) safe harbor.

On appeal, the U.S. District Court for the Southern District of Indiana reversed, concluding that the language of Section 546(e) is unambiguous and contains no publicly held securities limitation. Therefore, the stock purchase agreement, bridge loan, and guaranty were securities contracts falling within Section 546(e)'s safe harbor and the transfer was made in connection with such contracts. The district court also found, as a matter of first impression, that Section 546(e) preempts state law claims.

SECTION 546(e)'S SAFE HARBOR APPLIES TO TRANSFERS MADE IN CONNECTION WITH SECURITIES CONTRACTS FOR PRIVATELY HELD SECURITIES

On appeal, the Seventh Circuit sided with the district court. The circuit court determined that certain language of Section 546(e) was ambiguous, namely the phrases "by or to" and "for the benefit of," but it need not spend time considering the interpretation of such language because the parties did not dispute that the transfer was made by or to a financial institution.

The Seventh Circuit next determined that the plain text and definition of "securities contract" is broad and unambiguous as used in Section 546(e), and the 546(e) safe harbor therefore applies to transfers made in connection with securities contracts for both publicly and privately held securities.

The U.S. Courts of Appeals for the Third, Fifth, Sixth and Eighth Circuits have reached similar conclusions.

The Seventh Circuit agreed that the stock purchase agreement, which involved privately held securities, clearly fit within the definition of a securities

contract. The bridge loan authorization agreement also fit within the definition as an extension of credit "for the clearance or settlement of securities transactions." The court also found that because the guaranty was a credit enhancement for the bridge loan authorization agreement, it fit within the definition of a securities contract as a "credit enhancement related to any agreement or transaction referred to in [the definition.]" The court also noted that the three agreements were additionally covered by the catch-all language of the definition, which includes "any other agreement or transaction that is similar to an agreement or transaction referred to in [the definition]."

The Seventh Circuit wasted no time determining that the transfer was made "in connection with" a securities contract, noting that they "find it unnecessary to define the outer limits of the 'in connection with' requirement here" given the broad construction of the phrase, as recognized by the Seventh Circuit and Supreme Court of the United States in precedent case law such as *Peterson v. Somers Dublin Ltd.*,[2] *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*,[3] and *United States v. O'Hagan*.[4]

Finally, the Seventh Circuit joined the Second and Eighth Circuits in its determination that the Section 546(e) safe harbor preempts state law claims that seek recovery of transfer value that the safe harbor acts to shield. The circuit court agreed that to find otherwise would frustrate the purpose of the section and render the safe harbor meaningless. The circuit court also looked to the doctrine of conflict preemption, which applies to "instances where the challenged state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[5] The Seventh Circuit concluded that a state law claim brought under Section 544(a) "poses an insurmountable obstacle to the safe harbor – an obstacle that the doctrine of conflict preemption does not permit."

ENHANCED PROTECTION FOR CREDITORS

Section 546(e) of the Bankruptcy Code was enacted, in part, to protect creditors who enter into transactions involving securities contracts. The Seventh Circuit's decision ensures that this protection will preempt state law claims and will extend to transfers involving securities contracts for both privately and publicly held securities.

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[2] Peterson v. Somers Dublin Ltd., 729 F.3d 741, 749 (7th Cir. 2013).

[3] Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71 (2006).

[4] United States v. O'Hagan, 521 U.S. 642 (1997).

[5] McHenry Cnty. v. Raoul, 44 F.4th 581, 591 (7th Cir. 2022).