K&L GATES

How Safe Are the “Safe Harbors”?: How to Protect Your Investment Funds and Trades From Bankruptcy Clawback After the Supreme Court’s Recent *Merit Management* Ruling

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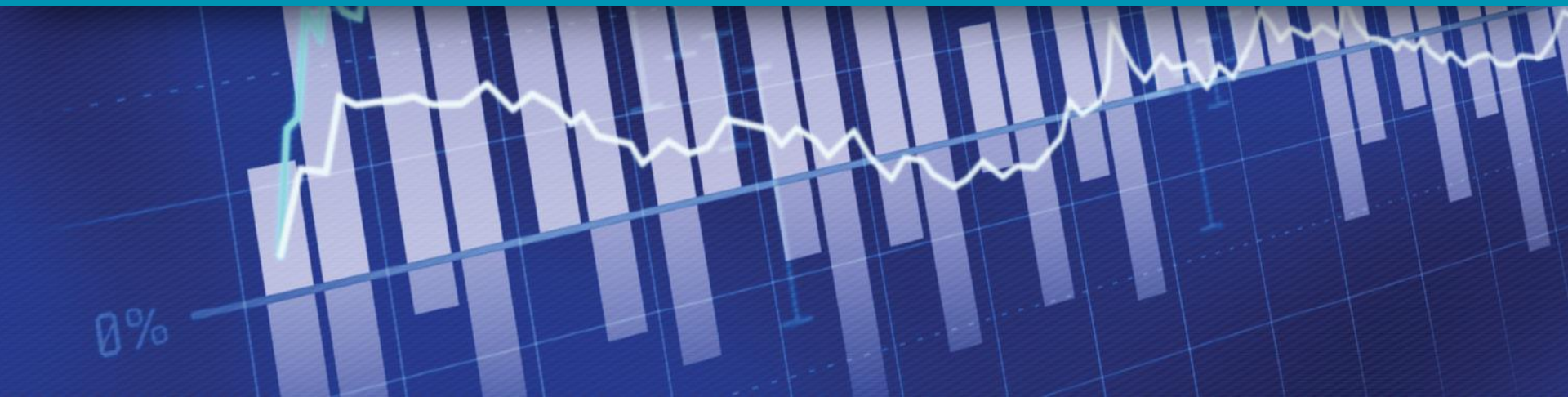
AGENDA

- Introduction: The Fallout (Real and Perceived) from *Merit Management*
- Overview of the Bankruptcy Code Safe Harbors
- Pre-Petition Payments and What *Merit* Did – and Did Not – Say
- Post-Petition Self-Help: Termination, Setoff, Netting
- How to Structure Trades and Deals Post-*Merit*
- Questions

Introduction



THE FALLOUT – REAL AND PERCEIVED – FROM THE SUPREME COURT'S *MERIT MANAGEMENT* DECISION

- LBOs, stock buybacks, bond redemptions, and dividends have of course been part of the IM and M&A landscape for decades.
- Recent trends show accelerated stock buybacks and dividend payments. Thanks in part to the tax cut, corporate buybacks hit a record in the first quarter of 2018 ($189.1 BN) — breaking the 2007 record — a 40% jump from Q4-2017 (Washington Post, 6/29/18).
- ***But what if the paying company then goes bankrupt? Is a feared "clawback" suit on the way?***

THE FALLOUT – REAL AND PERCEIVED – FROM THE SUPREME COURT'S *MERIT MANAGEMENT* DECISION

- For years, most IM and M&A practitioners could safely say: "**No.**" – thanks to a long-standing litigation defense known as the "*settlement payment*" defense.
- Most federal courts interpreted the defense (codified as § 546(e) of the U.S. Bankruptcy Code) as protecting any securities-related payments from later bankruptcy clawback as long as they passed through a specified "safe harbor" entity (*e.g.*, a bank or DTC).
- Section 546(e) is one of multiple "safe harbors" in the Bankruptcy Code that protect many financial and securities transactions from bankruptcy clawback.

THE FALLOUT – REAL AND PERCEIVED – FROM THE SUPREME COURT'S *MERIT MANAGEMENT* DECISION

- This status quo held for years, despite well-funded challenges to huge public company LBOs.
  - Consider *Tribune* and *Lyondell* – each multi-billion dollar LBOs later challenged as constructive fraudulent transfers – where courts found such claims to be barred by the safe harbors.
- But the Seventh Circuit upset the apple cart in July 2016, when it broke from nearly all other Circuit Courts that had considered the issue.

- In *FTI Consulting v. Merit Management*, the Seventh Circuit held that the "settlement payment" safe harbor did not apply to transactions that merely passed through a bank or DTC.

THE FALLOUT – REAL AND PERCEIVED – FROM THE SUPREME COURT'S *MERIT MANAGEMENT* DECISION

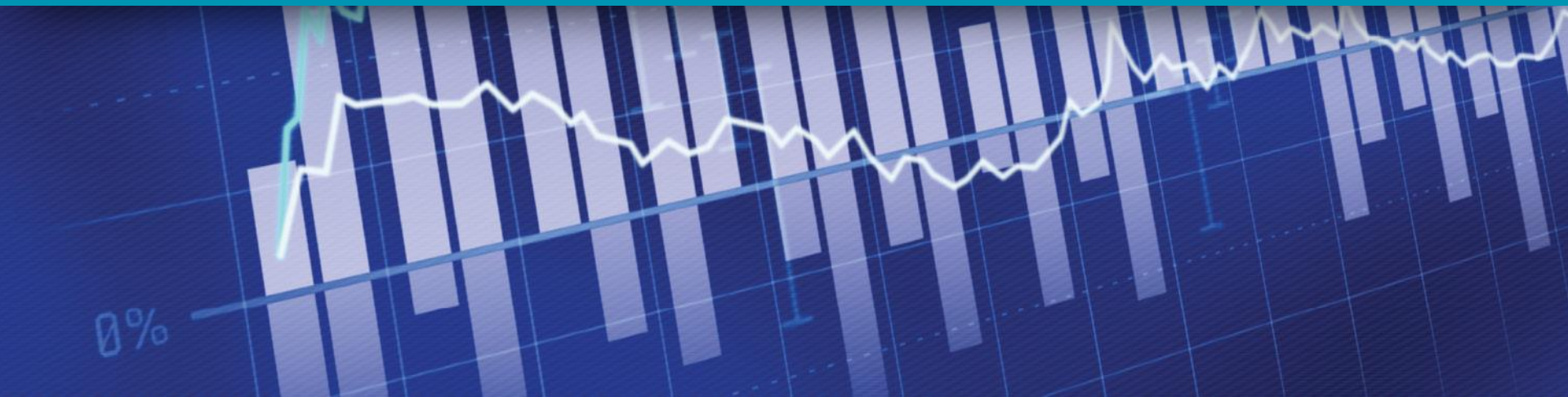
- This split amongst the Circuit Courts forced the Supreme Court to weigh in, ultimately resulting in its February 2018 decision in *Merit Management.*
- The Supreme Court unanimously affirmed the Seventh Circuit's judgment, though not necessarily its rationale.
- As we'll see, the *Merit* decision is a perfect example of **bad facts making bad law*** and has raised a number of questions for investment funds, traders, and M&A practitioners.

(* The speakers are revealing our biases as clawback defense counsel.)

THE FALLOUT – REAL AND PERCEIVED – FROM THE SUPREME COURT'S *MERIT MANAGEMENT* DECISION

- Our Goal Today → Explain:
  - The Bankruptcy Code's safe harbors and how we got to *Merit Management*;
  - What *Merit Management* means – and doesn't mean – for your investments and trades; and
  - Most importantly, how you can try to proactively adjust deal structures going forward to ensure that trades and M&A activity still qualify for the safe harbors in the event of a later bankruptcy filing.

The Bankruptcy Code's Safe Harbors



SAFE HARBOR PROTECTIONS: WHY?

- *To protect the financial and securities markets from the domino effect of a bankruptcy filing.*

  (Pictured: The floor of the New York Stock Exchange after the 1929 crash.)

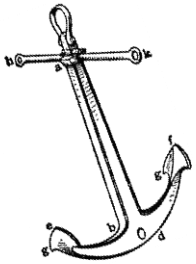
- A bankruptcy filing "freezes" all of a debtor's contracts, to give it a breathing spell to decide which to keep or shed ("assume"/"reject").
- Congress decided that certain types of contracts are too important to the financial and securities markets – so they should be carved out from the bankruptcy stay *and* protected from later bankruptcy "clawback" suits.

SAFE HARBOR PROTECTIONS

The Bankruptcy Code's safe harbors protect *two* types of financial and securities transactions:

1. **Pre-Bankruptcy Payments:** related to securities, commodity and forward contracts (§ 546(e)), repos (§ 546(f)), swaps (§ 546(g)), netting agreements (§ 546(j))
2. **Post-Petition Self-Help Remedies:** related to terminating securities contracts (§ 555), commodity and forward contracts (§ 556), repos (§ 559), and swaps (§ 560); and netting across such contracts or under a master netting agreement (§ 561). All are exempt from the bankruptcy stay: §§ 362(b)(6),(7),(17),(27); § 362(o)

SAFE HARBOR PROTECTIONS



- Other bankruptcy regimes: Include concepts similar to the automatic stay and similar safe harbors.
  - Banks - Federal Deposit Insurance Act: 12 U.S.C. §1821(e)(8); safe harbor rights are subject to an initial one-business day stay.
  - Broker-dealers - Securities Investor Protection Act: 15 U.S.C. § 78eee(b)(2)(C); safe harbors are usually subject to an initial 21-day stay.
  - ISDA Resolution Stay Protocols – Voluntary restraint (by contract) on safe harbor remedies when facing "too-big-to-fail" SIFIs (systemically important financial institutions) and their affiliates, to enable orderly cross-border insolvency proceedings.

SAFE HARBOR CONTRACTS

- The safe harbors apply to certain ***types of contracts***:
  - Securities contracts
  - Swap agreements
  - Repurchase agreements ("repos"): *only* short-term (one year or less) repos of mortgage loans, mortgage-backed securities, CDs, bankers' acceptances, and U.S. & OECD member securities
  - Commodity contracts
  - Forward contracts
  - Master netting agreements

SAFE HARBOR ENTITIES

- The safe harbors are available only to certain ***types of entities*** – depending on the safe harbor:
  - Financial institutions, stockbrokers, securities clearing agencies: settlement and margin payments (§ 546(e)); termination of securities contracts (§ 555); netting/setoff (§ 362(b)(6))
  - Commodity brokers, forward contract merchants: settlement and margin payments (§ 546(e)); termination of commodity and forward contracts (§ 556); netting/setoff (§ 362(b)(6))
  - "Repo participants," "Swap participants," "Master netting agreement participants": Payments, termination & netting/setoff related to repos (§§ 546(f), 559, 362(b)(7)); swaps (§§ 546(g), 560, 362(b)(17)); master netting agreements (§§ 546(j), 561, 362(b)(27))
  - "Financial participants": All of the above

SAFE HARBOR ENTITIES

1978

Commodity Broker
Forward Contract Merchant
Clearing Organization

SAFE HARBOR ENTITIES

1982

Commodity Broker

Forward Contract Merchant

Stockbroker

Securities Clearing Agency

SAFE HARBOR ENTITIES

1984

Commodity Broker

Forward Contract Merchant

Stockbroker

Securities Clearing Agency

Repo Participant

Financial Institution

SAFE HARBOR ENTITIES

1990

Commodity Broker
Forward Contract Merchant
Stockbroker
Securities Clearing Agency
Repo Participant
Financial Institution
Swap Participant

SAFE HARBOR ENTITIES

2005

Commodity Broker
Forward Contract Merchant
Stockbroker
Securities Clearing Agency
Repo Participant
Financial Institution
Swap Participant
Financial Participant

SAFE HARBOR ENTITIES

- What is a "financial institution?"

1984

Commercial or Savings Bank
Industrial Savings Bank
Savings and Loan Association
Trust Company

. . . and any customer of the above when it is acting
as agent or custodian in connection with a securities contract

SAFE HARBOR ENTITIES

- What is a "financial institution?"

2005

Commercial or Savings Bank
Industrial Savings Bank
Savings and Loan Association
Trust Company
Federal Reserve Bank
Federally-Insured Credit Union
Receiver or Conservator
Liquidating Agent
. . . and any customer of the above when it is acting
as agent or custodian in connection with a securities contract

. . . AND in connection with a securities contract, a '40 Act investment company

SAFE HARBOR ENTITIES

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SAFE HARBOR ENTITIES

- Who is a “customer” of a financial institution?

- At oral argument in *Merit*, Justice Breyer questioned why the defendant’s status as a customer of a financial institution — *i.e.*, a shareholder using a bank as an escrow agent — did not resolve the issue.

SAFE HARBOR ENTITIES

- What is a “financial participant”?

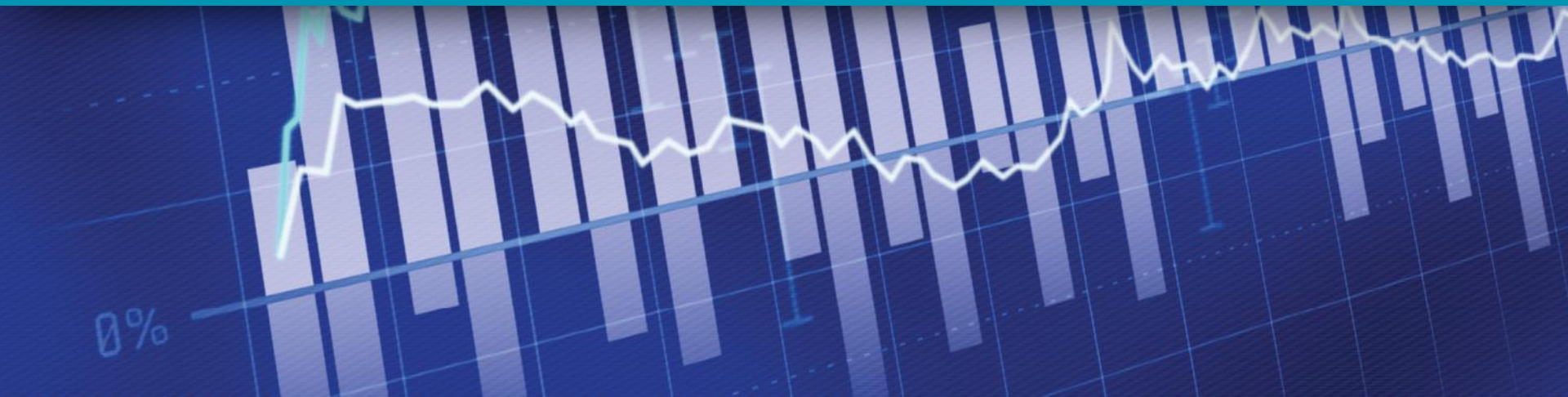
Short answer: A high-volume trader in the various types of safe harbor contracts.

Long answer:

11 USC § 101(22A)

- A) an entity that, at the time it enters into a securities contract, commodity contract, swap agreement, repurchase agreement, or forward contract, or at the time of the date of the filing of the petition, has one or more agreements or transactions described in paragraph (1), (2), (3), (4), (5), or (6) of section 561(a) with the debtor or any other entity (other than an affiliate) of a total gross dollar value of not less than $1,000,000,000 in notional or actual principal amount outstanding (aggregated across counterparties) at such time or on any day during the 15-month period preceding the date of the filing of the petition, or has gross mark-to-market positions of not less than $100,000,000 (aggregated across counterparties) in one or more such agreements or transactions with the debtor or any other entity (other than an affiliate) at such time or on any day during the 15-month period preceding the date of the filing of the petition; or
- (B) a clearing organization (as defined in section 402 of the Federal Deposit Insurance Corporation Improvement Act of 1991).

Pre-Bankruptcy (“Pre-Petition”) Payments



PRE-PETITION PAYMENTS AS CLAWBACK TARGETS

- Intentional Fraudulent Transfer
  - Transfer done with the actual intent to hinder, delay, or defraud a creditor. The relevant "intent" is of the debtor-payor, not the recipient-payee.
- Constructive Fraudulent Transfer
  - A transfer in which the debtor received less than "reasonably equivalent value" at a time when the transferor (debtor) was insolvent or rendered insolvent or undercapitalized as a result of the transfer.
- Preferences
  - Transfers by a debtor to unsecured creditors during the 90 days prior to a bankruptcy filing (1 year for insiders).

SAFE HARBOR APPLICABILITY TO PRE-PETITION PAYMENTS

- 11 U.S.C. § 546 Limits the Trustee's Avoidance Powers.
- Safe Harbor applies as a *defense* to:
  - Intentional Fraudulent Transfer claims under state law;
  - Constructive Fraudulent Transfer claims; and
  - Preference claims.
- Safe Harbor does not protect against federal intentional fraudulent transfer claims.

PROTECTED PRE-PETITION PAYMENTS

- Protected Pre-Petition Transactions Include:
  - Settlement payments, margin payments, *or*
  - Transfers in connection with:
    - Securities Contracts
    - Commodity Contracts
    - Forward Contracts
    - Repurchase Agreements
    - Swap Agreements
    - Master Netting Agreements
  - Made by or to (or for the benefit of)
  - A protected Safe Harbor entity

KEY CASE LAW ON THE SETTLEMENT PAYMENT SAFE HARBOR – PRE-*MERIT MANAGEMENT*

- Litigation concerning what type of payments qualified:
  - Tradable Debt Securities/Early Redemption Payments: *Enron**
  - Private Placement Notes: *Quebecor*
  - Ponzi Scheme Payments: *Madoff*
- Litigation concerning what contracts qualified:
  - Securities Contract: *Madoff*
  - Swap Agreement: *National Gas Distributors*
  - Repurchase Agreement: *American Home Mortgage*
- Clawback Litigation:
  - LBOs and corporate restructurings: *Tribune* and *Lyondell*

(* A list of case citations is provided at the end of this PowerPoint.)

KEY CASE LAW ON THE SETTLEMENT PAYMENT SAFE HARBOR – PRE-*MERIT MANAGEMENT* (*Cont'd*)

- Second, Third, Sixth, Eighth, and Tenth Circuits held that a Trustee could not avoid a transfer to the extent that the transfer was made "by or to" a safe harbored entity in the payment chain.

- Eleventh and Seventh Circuits adopted a more restrictive view, limiting the application of the "by or to" provision. Either the debtor-payor or the ultimate payee must be a safe harbored entity.

MERIT MANAGEMENT – WHAT IT SAID & DIDN'T SAY

- The Facts:
  - Valley View borrowed $55 million from Credit Suisse and others to buy 100% of Bedford Downs' stock.
  - Purchase price was routed through Citizens Bank as escrow agent for all payments to shareholders.
  - Merit Management owned 30% of Bedford Downs, received $16.5 million in the deal.
  - Valley View filed for bankruptcy; FTI, as bankruptcy trustee, sought to recoup the $16.5 million, claiming it was a constructive fraudulent transfer.

MERIT MANAGEMENT – WHAT IT SAID & DIDN'T SAY

- The Arguments:
  - Merit: The Bankruptcy Code's safe harbor for "settlement payments" barred FTI's constructive fraudulent transfer claim because the $16.5 million came from one financial institution (CS) and passed through another (Citizens) on the way to Merit.
  - FTI: Merely using a bank as an intermediary isn't enough to qualify for the safe harbor because the ultimate transaction being unwound – the $16.5 million from Valley View to Merit – was not a transfer "by or to" an entity covered by the safe harbor.

MERIT MANAGEMENT – WHAT IT SAID & DIDN'T SAY

- What *Merit Management* did not involve:
  - No public securities markets → The Valley View-Bedford deal was private M&A activity only, unlike the Tribune/Lyondell LBOs.
  - No discussion of the impact of banks serving as escrow agents in M&A transactions → Merit never argued that it was a "customer" of a "financial institution" within the meaning of the Bankruptcy Code's "settlement payment" defense, even though Merit and other shareholders used Citizens Bank as an escrow agent.

MERIT MANAGEMENT – WHAT IT SAID & DIDN'T SAY

- The Supreme Court's *Merit* Decision:
  - The Bankruptcy Code's avoidance provisions focus on the transfer that the trustee seeks to avoid, here the $16.5 million from Valley View to Merit.
  - To see if a Bankruptcy Code safe harbor applies, courts must similarly only look at the ultimate transaction that the clawback suit seeks to avoid.
  - *i.e.*, Courts can only look to the overarching, end-to-end transfer, not to its component parts.

MERIT MANAGEMENT – WHAT IT SAID & DIDN'T SAY

- The Supreme Court's *Merit* Decision (Cont'd):
  - In other words, using a bank as an intermediary or conduit for a settlement payment is not enough to qualify for the Bankruptcy Code's safe harbor.
  - Only if the transfer that the trustee seeks to avoid is a "settlement payment" *and* that payment was "made by or to (or for the benefit of)" a qualifying entity will it be protected by the safe harbor.
- Key takeaway: Routing money through a bank will not protect you.

Plaintiffs' bar: ☺ ☺ ☺ Defense bar: ☹ ☹ ☹ + *oh, #&$%!*

MERIT MANAGEMENT – WHAT IT SAID & DIDN'T SAY

- What does this mean for the safe harbors? a/k/a what *Merit* doesn't say:
  - Nothing about what constitutes a "settlement payment" → Prior case law on LBOs and commercial paper are not addressed.
  - Nothing about whether state law constructive fraud claims are preempted by the safe harbors → Prior case law on preemption (e.g., Second Circuit's decisions in *Tribune* and *Whyte*) are not addressed and, in fact, the Supreme Court denied cert in *Whyte*.

MERIT MANAGEMENT – WHAT IT SAID & DIDN'T SAY

- What does this mean for the safe harbors? a/k/a what *Merit* doesn't say (Cont'd):
  - Nothing about what constitutes a "financial institution" under the safe harbors → The Supreme Court expressly refused to address whether a payee who uses a bank as an "agent" or "custodian" for a pre-petition payment "in connection with a securities contract" qualifies for protection under the "settlement payment" safe harbor, *because* Merit never argued the point vis-à-vis Citizens, the escrow agent.

MERIT MANAGEMENT – WHAT IT SAID & DIDN'T SAY

- What does this mean for the safe harbors? a/k/a what *Merit* doesn't say (Cont'd):
  - Nothing about what constitutes a "securities contract" under the Bankruptcy Code's safe harbors → Prior case law on that point (e.g., the Second Circuit's decision in *Madoff*) – which itself impacts who may qualify as a "financial institution" under the agent/custodian components of the Bankruptcy Code's definition of that term – was not addressed.

Post-Petition Self-Help

TERMINATION OF FINANCIAL CONTRACTS

- GENERAL RULE: A non-debtor counterparty may not terminate a contract post-petition based on the bankruptcy filing, or enforce any bankruptcy-triggered contract provisions (so-called "*ipso facto*" clauses). The automatic bankruptcy stay prohibits any such action.
- EXCEPTION: A non-debtor counterparty may liquidate, terminate, or accelerate a securities contract, commodity or forward contract, repo agreement or swap agreement, and offset or net termination values across contracts. (Bankruptcy Code §§ 555, 556, 559-561)
- POLICY: Prevents a debtor from "riding the market" and cherry-picking certain contracts for assumption, while rejecting "out of the money" contracts; allows counterparty to quickly liquidate (and theoretically mitigate) its damages.

EXEMPTION FROM AUTOMATIC STAY

- Collateral foreclosure, netting, and setoff:
  - Stay carve-outs: §§ 362(b)(6), (7), (17) & (27); 362(o).
  - These supplement the safe harbors in §§ 555-561.
  - Protect the exercise by a safe harbor entity of "*any contractual rights*" (i) under a security agreement or credit enhancement related to a safe harbor contract, or (ii) to offset or net out termination values, payment amounts or other transfer obligations "under or in connection with" a safe harbor contract.
  - "Contractual rights" is defined expansively, to include any rights, "*whether or not in writing, arising under common law, under law merchant, or by reason of normal business practice*." (§§ 555, 556, 559-561).
  - So a wide range of self-help remedies should be available, beyond the express remedies stated in a contract.

EXEMPTION FROM AUTOMATIC STAY

- Case law disputes:
  - May only "mutual" debts be set off? – *i.e.*, both must be pre-petition debts? Do the normal mutuality requirements of § 553 apply? (*Lehman/Swedbank*)
  - Do all debts being set off have to "relate to" a qualifying safe harbor contract? Or may *any* outstanding debts be set off against a debt under a safe harbor contract? (*Lehman/Bank of America*)
  - Do safe harbor rights have to be exercised promptly? (*Lehman/Metavante*)
  - Do safe harbor rights apply abroad, *i.e.* to all foreign contracts? (*Madoff*, *Arcapita*)

LIMITATIONS ON SELF-HELP REMEDIES

- "Mutuality" Requirement for Setoff
  - Section 553 of the Bankruptcy Code recognizes the right to setoff only if the debts are "mutual," meaning "two debts due to and from the same persons in the same capacity."
  - This generally requires that only *pre*-petition debts owed by and to the debtor may be set off. § 553 does not permit setoff of post-petition debts or debts of affiliates (a/k/a "triangular" setoff).
  - In *Lehman/Swedbank*, a bank argued the safe harbors allowed it to set off a post-petition debt (a bank deposit) against a pre-petition swap debt. The court disagreed, finding the safe harbors subject to § 553 mutuality. The case settled on appeal.
  - Swedbank argued that in 2006, Congress removed a "mutual debt and claim" limitation from the § 362(b) safe harbors.

LIMITATIONS ON SELF-HELP REMEDIES

- Scope of Debts Subject to Setoff & Netting
  - Must the debts being set off be *related to* a safe harbor contract? Or may *any* outstanding debts be set off against a debt under a safe harbor contract?
  - In *Lehman/Bank of America*, the Bankruptcy Court held that a bank could not set off amounts in a deposit account (a debt it owed Lehman) against amounts Lehman owed under a swap agreement, because the bank's security rights against the account were not "contractual rights" related to the swap.
  - The bank argued that its setoff rights arose under New York common law, and were therefore within the "contractual rights" protected by the safe harbors. The case settled on appeal.

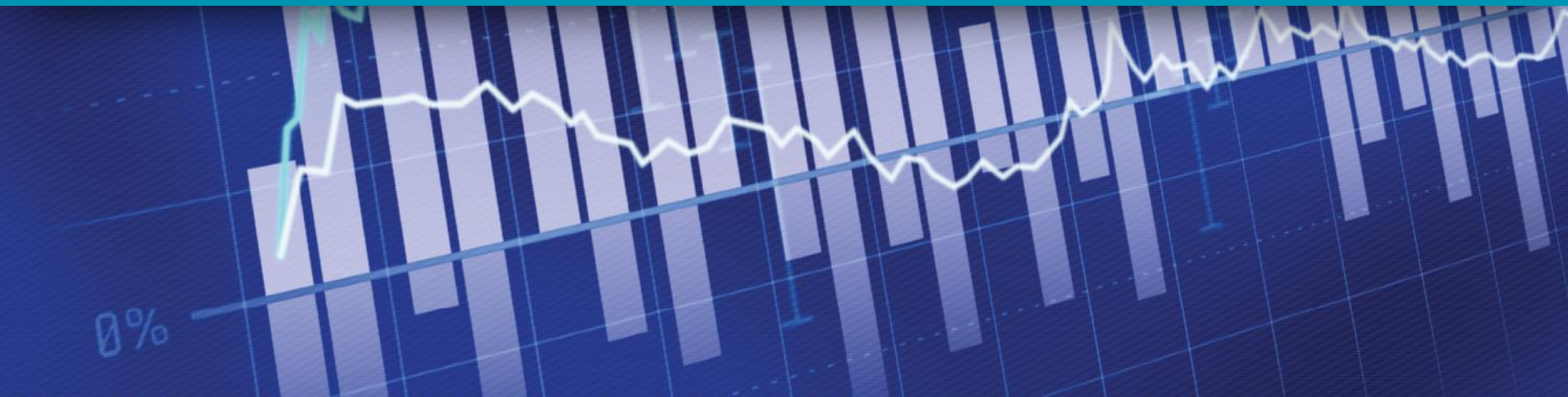
LIMITATIONS ON SELF-HELP REMEDIES

- Timing of Exercise of Safe Harbor Rights
  - In *Lehman/Metavante*, the Bankruptcy Court ruled that a swap counterparty must exercise termination rights promptly or risk losing them.
    - If an "out of the money" counterparty wants to ride the market prior to termination, it must make its periodic payments under the swap agreement.
    - *But see In re Southern California Edison Company*, 2018 WL 949223 (S.D. Tex. Feb. 15, 2018) (rejecting "promptness" requirement for party continuing to perform post-petition).
    - *Compare Amcor Funding Corp.*, 117 B.R. 549 (D. Ariz. 1990) (liquidating broker could not use the securities contract safe harbor to liquidate debtor's margin account 1 year after Chapter 11 filing).

LIMITATIONS ON SELF-HELP REMEDIES

- Extraterritoriality / Foreign Payees
  - Do bankruptcy clawback remedies apply abroad, *i.e.,* to all foreign payees anywhere?
    - *Madoff*: Clawback suits may reach foreign payees if the payments occurred "domestically," *i.e.,* the payee obtained control of the funds in a U.S. account.
  - Do foreign payees have the same safe harbor defenses as U.S. payees?
    - *Arcapita*: Clawback suit by Chapter 11 estate of Bahraini bank to recover investments and avoid setoffs under Islamic finance contracts by two other Bahraini banks (represented by K&L Gates). All safe harbor defenses are being asserted.

Post-*Merit* Adjustments to Deal Structures



HOW CAN YOU TRY TO PROTECT YOURSELF POST-*MERIT*

Deal Terminology

- Financial & supply contracts now routinely add language to expressly invoke the Bankruptcy Code safe harbors.
- Examples:
  - Form financial contracts of SIFMA (Securities Industry and Financial Markets Association) at: https://www.sifma.org/resources/general/mra-gmra-msla-and-msftas/
  - Electricity supply agreement in an oil-and-gas producer bankruptcy (Linn Energy/Berry Petroleum) - *In re Southern California Edison Co.*, 2018 WL 949223 (S.D.Tex. Feb. 15, 2018)

HOW CAN YOU TRY TO PROTECT YOURSELF POST-*MERIT*

- Electricity supply agreement in *In re Southern California Edison Co.*, 2018 WL 949223 (No. 6:16-cv-00057, S.D.Tex. Feb. 15, 2018) – Dkt. #2-2 (record on appeal), at p. 5817:

Power Purchase and Sale Agreement between
Southern California Edison Company and Berry Petroleum Company

9.08(m) The Parties acknowledge and agree that this Agreement and the transactions contemplated by this Agreement constitute a "forward contract" within the meaning of the United States Bankruptcy Code and that Buyer and Seller are each "forward contract merchants" within the meaning of the United States Bankruptcy Code.

HOW CAN YOU TRY TO PROTECT YOURSELF POST-*MERIT*

SIFMA Master Repurchase Agreement (1996 version / New York law)

19. Intent

(a) The parties recognize that each Transaction is a "repurchase agreement" as that term is defined in Section 101 of Title 11 of the United States Code, as amended (except insofar as the type of Securities subject to such Transaction or the term of such Transaction would render such definition inapplicable), and a "securities contract" as that term is defined in Section 741 of Title 11 of the United States Code, as amended (except insofar as the type of assets subject to such Transaction would render such definition inapplicable).

(b) It is understood that either party's right to liquidate Securities delivered to it in connection with Transactions hereunder or to exercise any other remedies pursuant to Paragraph 11 hereof is a contractual right to liquidate such Transaction as described in Sections 555 and 559 of Title 11 of the United States Code, as amended.

[plus FDIC-related provisions]

HOW CAN YOU TRY TO PROTECT YOURSELF POST-*MERIT*

SIFMA Master Securities Loan Agreement (2017 version / New York law)

26. Intent

26.1 The parties recognize that each Loan hereunder is a "securities contract," as such term is defined in Section 741 of Title 11 of the United States Code (the "Bankruptcy Code"), as amended (except insofar as the type of assets subject to the Loan would render such definition inapplicable).

26.2 It is understood that each and every transfer of funds, securities and other property under this Agreement and each Loan hereunder is a "settlement payment" or a "margin payment," as such terms are used in Sections 362(b)(6) and 546(e) of the Bankruptcy Code.

26.3 It is understood that the rights given to Borrower and Lender hereunder upon a Default by the other constitute the right to cause the liquidation of a securities contract and the right to set off mutual debts and claims in connection with a securities contract, as such terms are used in Sections 555 and 362(b)(6) of the Bankruptcy Code.

[plus FDIC-related provisions]

HOW CAN YOU TRY TO PROTECT YOURSELF POST-*MERIT*

SIFMA Master Securities Forward Transaction Agreement (2012 version / New York law)

18. Intent

(a) The parties recognize that (i) each Transaction and this Agreement is a "forward contract" as that term is defined in Section 101(25) of Title 11 of the United States Code, as amended (the "Bankruptcy Code") and a "securities contract" as that term is defined in Section 741 of the Bankruptcy Code, (ii) this Agreement is a "master netting agreement" as that term is defined in Section 101(38A) of the Bankruptcy Code, and (iii) this Agreement and each Transaction is of a type set forth in Section 5390(c)(8)(D) of Title 12 of the United States Code, as amended.

(b) It is understood that either party's right to cancel Transactions hereunder or to exercise any other remedies pursuant to Paragraph 7 hereof is a contractual right to liquidate, terminate or accelerate such Transaction as described in Sections 555 and 556 of the Bankruptcy Code, and a right to terminate, liquidate or accelerate as described in Sections 5390(c)(8)(A) and (C) of Title 12 of the United States Code, as amended.

[plus additional FDIC-related provisions]

HOW CAN YOU TRY TO PROTECT YOURSELF POST-*MERIT*

Deal Structure

- Consult the Bankruptcy Code definitions of the various types of safe harbor contracts closely, and ensure that the deal is structured to qualify.
  - For example, "*securities contract*" is defined as a "purchase, sale, or loan" or similar transaction (11 USC § 741(7)) relating to a "*security*" (11 USC § 101(49)). A deal designed for any of the safe harbors involving a "securities contract" must fit within these two definitions.
    - Some courts suggested a company's "redemption" of its securities is not a securities contract, but a "repurchase" of stock is (*Quebecor*). But the Second Circuit has since broadly interpreted the scope of "securities contract" in the context of the safe harbors (*Madoff*).
    - For safety, structure any securities transactions as a "purchase, sale or loan" transaction. Avoid any ambiguity.
    - Ensure the type of security is in the § 101(49) list — which is inclusive only — or qualifies under the extensive case law on what a "security" is.

HOW CAN YOU TRY TO PROTECT YOURSELF POST-*MERIT*

Deal Structure (*Cont'd*)

- Be as exhaustive as possible in listing termination, foreclosure, netting and setoff remedies in the contract itself.
  - As noted above, the various safe harbors (in 11 USC §§ 555-561 and 362(b) (6), (7), (17) & (27)) protect any "contractual rights" to terminate, liquidate or accelerate a contract, or to exercise foreclosure, netting or setoff rights "*whether or not in writing, arising under common law, under law merchant, or by reason of normal business practice*."
    - This suggests a very broad range of remedies, whether or not they're in the text of a qualifying safe harbor contract itself. But …
    - Put it in writing anyway, in all contracts that might qualify for safe harbors.
    - For safety, list (as "including without limitation") all possible common law, commercial law and other remedies that you can think of, to prevent a court from later questioning if they are "contractual rights" protected by the safe harbors (as in *Lehman/Bank of America*).

HOW CAN YOU TRY TO PROTECT YOURSELF POST-*MERIT*

Deal Cash Flow

- The Supreme Court in *Merit* seemed to invite the argument that using a commercial bank as an agent or custodian for a "settlement payment" that is ultimately going to the bank's customer would immunize a transfer from avoidance.
- Tip for routing deal cash flow: Going forward in any securities transactions, route the payee's payments for the deal to a commercial bank that is expressly acting, per the transaction docs, as the agent or custodian for its customer, the payee. This might qualify the payee as a "customer" of a "financial institution," making the payee itself a "financial institution" within the meaning of the safe harbors.

HOW CAN YOU TRY TO PROTECT YOURSELF POST-*MERIT*

Deal or Trade Ownership

- The main lesson of *Merit Management:* The identity and business of the payee is critical to whether the bankruptcy safe harbors are available.
- Consider the use of a subsidiary, affiliate or ’40 Act fund that clearly qualifies as a safe harbor entity, particularly when structuring deals with distressed or potentially distressed issuers.
- If possible, transfer the ownership of trades to such qualifying entities *before* engaging in buyout transactions with issuers.

Nothing is 100%-foolproof against future bankruptcy litigation. The best approach is to maximize potential defenses.

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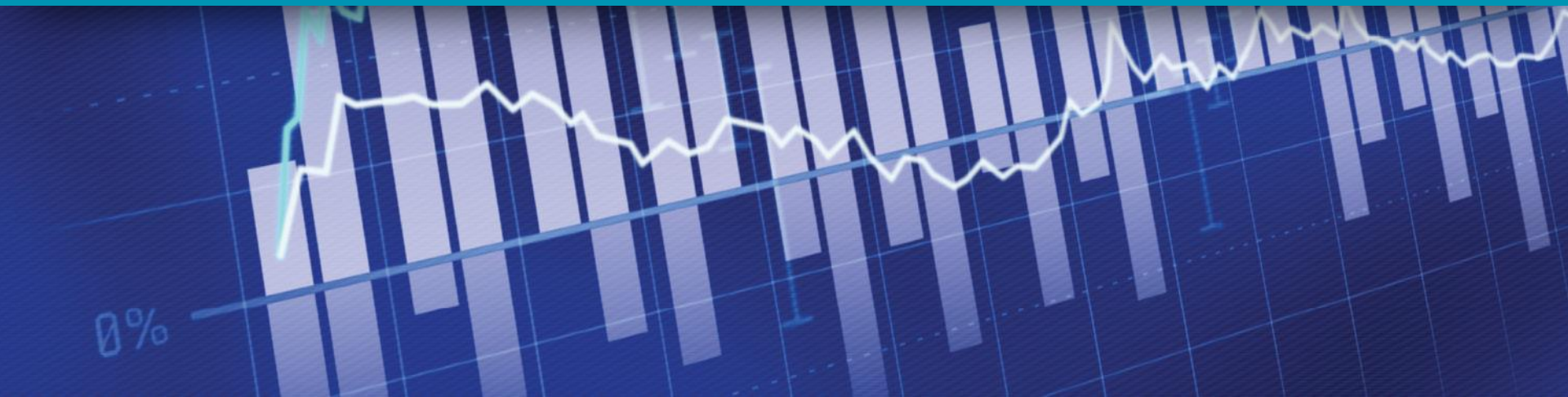
In re Southern California Edison Co., 2018 WL 949223 (S.D. Tex. 2018)

In re Tribune Co. Fraudulent Conveyance Litigation, 818 F.3d 98 (2d Cir. 2016) (preemption ruling on state law constructive fraudulent transfer claims), cert. pending, 2d Cir. reviewing based on S.Ct. “statement” on its *Merit* ruling; 2017 WL 82391 (S.D.N.Y. Jan. 6, 2017) (ruling on intentional fraudulent transfer claims), motion for direct appeal to 2d Cir. pending

Whyte v. Barclays Bank PLC, 644 Fed.Appx. 60 (2d Cir. 2016), *cert. denied*, 137 S.Ct. 2114 (2017)

Questions?



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