Clients&FriendsMemo

KYC – "Know Your Customer," or Agent, or Financial Institution, to Qualify for the Bankruptcy Code Safe Harbors

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Parties structuring certain financial transactions to comply with the Bankruptcy Code safe harbor provisions, including protections from the avoidance powers in Section 548 of the Bankruptcy Code,[1] must be cognizant of recent case law prescribing the identity of counterparties within the ambit of the provisions. For example, the safe harbor protections extend to financial institutions, but the Supreme Court's 2018 decision in *Merit Management* excluded financial institutions that were "mere conduits" in a transaction.[2] Subsequently in *Tribune II*, the Court of Appeals for the Second Circuit held that a party who was a "customer" of a financial institution acting as the party's "agent" may be a qualifying entity.[3]

In an opinion issued in connection with the Nine West 2014 leveraged buyout ("LBO"), a three-judge panel of the Second Circuit reiterated and refined *Tribune II*'s analysis of when a party who is a customer of a financial institution may qualify for Bankruptcy Code safe harbor protection.

However, the majority, Circuit Judges Denny Chin (writing) and Joseph F. Bianco, also held that a transferee within the larger LBO transaction must be safe harbor-qualified to gain safe harbor protection – safe harbor qualification of one party to the LBO transaction will not, in and of itself, extend safe harbor protection to other parties and their transfers within the LBO. In a thoughtful dissent, Circuit Judge Richard J. Sullivan would have extended safe harbor protections to all transfers made in connection with a safe harbor-protected transaction and not applied the qualified party requirement on a transfer-by-transfer basis.

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1 Unless otherwise indicated, "Section" references are to the U.S. Bankruptcy Code, 11 U.S.C. §§ 101 *et seq.*

2 *See Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, 583 U.S. 366, 377–78 (2018).

3 *See In re Trib. Co. Fraudulent Conv. Litig.* ("*Tribune II*"), 946 F.3d 66, 77–79 (2d Cir. 2019). Cadwalader's memorandum discussing that decision is available at https://www.cadwalader.com/resources/clients-friends-memos/no-youre-a-customer--recent-second-circuit-decision-circumscribes-merit-and-preempts-state-law-impairment-of-safe-harbor-protections-in-the-wake-of-a-failed-lbo.

By this ruling, the Second Circuit affirmed the breadth of safe harbor protections, but also reminded transaction parties that they must structure their transactions with precision and close adherence to statutory and case law requirements to gain protection of the safe harbors afforded under the Bankruptcy Code.

In an important secondary ruling, the court also reaffirmed *Tribune II*'s holding that state law constructive fraud claims are preempted by the safe harbor's non-avoidance protections and extended preemption to dismiss related unjust enrichment claims.

I. Background on the Dispute

In 2014, private equity firm Sycamore Partners ("Sycamore") acquired Jones Group, Inc. ("Jones Group"), which housed brands such as Nine West, Anne Klein, Stuart Weitzman, and Kurt Geiger, through an LBO. To effectuate the LBO, a newly created Sycamore subsidiary merged with Jones Group, and the surviving corporation was renamed Nine West Holdings, Inc. ("Nine West").[4]

As part of the LBO, former public shareholders of Jones Group (the "Public Shareholders") were entitled to receive $15 per share in exchange for the cancellation of their shares. The majority of Jones Group shares were held as of record by the Depository Trust Company ("DTC"), while others were held as physical certificates. As required by the Merger Agreement, Jasper Parent and Jones Group hired Wells Fargo Bank to act as Paying Agent for purposes of distributing payments to the Public Shareholders. In addition, certain former directors, officers and employees of the Jones Group (the "Individual Shareholders") were entitled to receive payment for their restricted shares, share-equivalent units and accumulated dividends on restricted stock.

To effectuate the LBO, Nine West deposited $1.105 billion (composed of $1.101 billion for the shares held at DTC and $4 million for the certificated securities) in accounts at Wells Fargo, and Wells Fargo distributed those amounts to the Public Shareholders (such transfers, the "Paying Agent Transfers"). Notably, Jones Group paid $78 million directly to the Individual Shareholders through payroll and other means (the "Payroll Transfers" and collectively with the Paying Agent Transfers, the "Transfers").[5]

Sycamore subsequently sold three Nine West brands – Stuart Weitzman, Kurt Geiger, and Jones Apparel – to recently formed Sycamore affiliates. Roughly four years later, Nine West filed for bankruptcy leading to the avoidance litigation.[6]

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[4] *In re Nine W. LBO Sec. Litig.* ("*Nine West*"), 87 F.4th 130, 139–40 (2d Cir. 2023).

[5] *Id.* at 141.

[6] Voluntary Petition, *In re Nine W. Holdings, Inc.*, No. 18-10947 (Bankr. S.D.N.Y. Apr. 6, 2018) [ECF No. 1].

II. The Bankruptcy Code Safe Harbor for Avoidance Actions

Pursuant to Section 548(a), a trustee may avoid as a constructive fraudulent transfer any payment made by the debtor (i) that was made or incurred within a specified time period, (ii) that was made or incurred while the debtor was insolvent or that rendered the debtor insolvent, and (iii) for which the debtor received less than reasonably equivalent value in exchange.[7]

The safe harbor in Section 546(e) provides an exception to the trustee's avoidance powers for a constructively fraudulent transfer, if the transfer was made by or to (or for the benefit of) a "financial institution" in connection with a "securities contract." The Section 546(e) safe harbor is designed to provide stability in the financial markets in the event of a bankruptcy of a market participant by forestalling the chain reaction that may occur if other market participants were required to repay amounts received in settled securities transactions.[8]

At issue in the Nine West LBO was the scope of the term "financial institution," including the parameters of "acting as an agent" of a customer.

The Bankruptcy Code defines "financial institution" to include, among other things, a bank, savings and loan association, trust company, federally insured credit union and, <u>when any such entity is acting as agent or custodian for a customer in connection with a securities contract</u>, such customer.[9] The Bankruptcy Code defines "securities contract" to include a contract for the purchase, sale or loan of a security.[10] The Second Circuit readily concluded that the Merger Agreement qualified as a "securities contract."[11]

III. District Court Opinion

The Litigation Trustee for the Nine West Litigation Trust and Wilmington Savings Fund Society FSB, as successor indenture trustee (collectively, the "Trustees") for various notes issued by Nine West, brought actions against 175 of the Public Shareholders and Individual Shareholders, seeking to avoid the Transfers to such Shareholders.[12]

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7 11 U.S.C. § 548(a)(1)(B).

8 *See* H.R. REP. NO. 97-420, at 2, *reprinted in* 1982 U.S.C.C.A.N. at 584; *see also Enron Creditors Recovery Corp. v. ALFA, S.A.B. de C.V. (In re Enron Creditors Recovery Corp.)*, 651 F.3d 329, 334 (2d Cir. 2011). The *Nine West* District Court readily concluded that the Merger Agreement qualified as a "securities contract." *See In re Nine W. LBO Sec. Litig.*, 482 F. Supp. 3d 187, 198 (S.D.N.Y. 2020). The Second Circuit agreed. *Nine West*, 87 F.4th at 149.

9 11 U.S.C. § 101(22)(A) (emphasis added).

10 11 U.S.C. § 741(7).

11 *Nine West*, 87 F.4th at 149–50.

12 *Nine West*, 87 F.4th at 142.

In the consolidated litigation, the Public Shareholders and Individual Shareholders argued that Nine West qualified as a "financial institution" and thus the safe harbor set forth in Section 546(e) protected the Transfers from avoidance as transfers by a financial institution in connection with the Merger Agreement. Relying on the Second Circuit's decision in *Tribune II*, which was also an LBO transaction, District Judge Rakoff found that Section 546(e) barred the Trustees' fraudulent transfer claims.

Tribune II recognized that the Tribune Company qualified as a "financial institution" because it had retained a trust company to facilitate the LBO payments to Tribune's public shareholders, and therefore Tribune Company was a "customer" of a trust company, and the trust company was its "agent."[13] Similarly, in *Nine West*, the District Court analyzed certain of the Paying Agent Transfers and held that Nine West qualified as a "financial institution" because it was a "customer" of Wells Fargo, which was acting as its "agent" in connection with the Paying Agent Transfers. In its decision, the District Court employed a "contract-by-contract" interpretation of the definition of "financial institution," finding that because Wells Fargo was Nine West's agent with respect to certain of the Paying Agent Transfers, it should be considered Nine West's agent with respect to all Transfers under the Merger Agreement, even the Payroll Transfers in which Wells Fargo had no involvement.[14] The Trustees appealed the District Court's decision.

IV. The Second Circuit's Interpretation of the Definition of "Financial Institution"

On appeal, the Second Circuit rejected the District Court's "contract-by-contract" approach and instead employed a "transfer-by-transfer" analysis. In analyzing the two approaches, the Second Circuit first found that the plain language of the definition of "financial institution" includes a customer only "<u>when</u>" the bank is "acting as its agent," which indicates that the bank must be acting with respect to a specific transaction.[15] Next, the Second Circuit looked to the structure of the Bankruptcy Code, finding that the trustee's avoidance powers, which "help implement the core principles of bankruptcy," would be greatly compromised under the more expansive contract-by-contract approach.[16] Finally, the Second Circuit recognized that the Section 546(e) safe harbor intended to mitigate systematic risk in the financial markets, but concluded that the contract-by-contract approach would limit the avoidance powers even when the financial markets are not implicated.[17]

In applying the transfer-by-transfer approach to the Transfers, the Second Circuit dismissed the claims against the Public Shareholders because the Paying Agent Transfers were made by Wells

[13] *Tribune II*, 946 F.3d at 77-81; *see also* 11 U.S.C. § 101(22)(A).

[14] *Nine W. LBO Sec. Litig.*, 482 F. Supp. 3d at 199.

[15] *See* 11 U.S.C. § 101(22)(A) (emphasis added).

[16] *Nine West*, 87 F.4th at 146 (internal quotations removed) (quoting *Merit Mgmt.*, 583 U.S. at 370).

[17] *Id.* at 146.

Fargo to the Public Shareholders in its capacity as Nine West's agent.[18] In contrast, the Second Circuit declined to extend the Bankruptcy Code safe harbor to the Individual Shareholders because Wells Fargo played no agency role in the Payroll Transfers.

In addition, the Second Circuit panel unanimously concluded that the safe harbor provisions preempted state law constructive fraud claims and similar relief sought under unjust enrichment claims with respect to the Paying Agent Transfers.[19]

V. The Dissent

While Circuit Judge Richard Sullivan agreed with the majority opinion's approach finding that the Paying Agent Transfers were safe-harbored, Judge Sullivan disagreed with the majority's conclusion that Nine West did not qualify as a "financial institution" with respect to the Payroll Transfers. Judge Sullivan concluded that the plain meaning of the definition of "financial institution" supported the conclusion that Wells Fargo was acting as Nine West's agent in connection with the Merger Agreement (itself, a securities contract under the safe harbor), including all transfers made in connection with the Merger Agreement. In Judge Sullivan's view, use of the contract-by-contract approach is consistent with the expansive reach of safe harbor protections.[20]

VI. The Continued Evolution of the Bankruptcy Code Safe Harbors

The Second Circuit's *Nine West* decision and its "transfer-by-transfer" analysis with respect to the definition of "financial institution" builds on the Supreme Court's prior ruling in *Merit* that the ultimate beneficiary of a transfer must itself be a qualifying entity even if a financial institution is involved in the transaction.[21]

The *Nine West* decision reiterates that the precise mechanics of transactions matter when considering the safe harbors, and that nothing can be taken for granted in terms of qualifying for safe harbor protection from avoidance actions. Parties should be mindful of this in structuring transactions that may involve a financial institution acting as agent, and should ensure that the agent role applies to each transfer and meets the requirements for "agency" under applicable non-bankruptcy law.

The Second Circuit's decision also reemphasizes a critical principle underlying the Bankruptcy Code safe harbors – these protections were included in the statute to minimize the chances that systemic risks would be triggered by avoidance of fraudulent transfers. Parties considering the

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[18] *See id.* at 149.

[19] *Id.* at 150. The Second Circuit noted that the claims arising from the Payroll Transfers do not conflict with Section 546(e) because such payments do not fall under the safe harbor.

[20] *Id.* at 152–56.

[21] *See Merit Mgmt.*, 583 U.S. at 377–78.

potential applicability of the safe harbors should always analyze how and whether the purpose behind the Bankruptcy Code safe harbors is implicated by protection from avoidance in the context of their particular transaction.

While some parties have read the *Nine West* decision to "narrow" the safe harbors, it can be viewed as consistent with precedent such as *Merit* and *Tribune II*, and continues to encourage parties to carefully consider the who, how and when of safe harbor applicability.

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