Second Circuit Settles the Meaning of Settlement Payments Under Section 546(e) of the Bankruptcy Code

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The powers and protections granted to a bankruptcy trustee or chapter 11 debtor in possession under the Bankruptcy Code are numerous and far-reaching. From the automatic stay of creditor collection actions afforded by section 362 of the Bankruptcy Code to the unilateral power to assume or reject contracts under section 365 to the avoidance powers of chapter 5, the filing of a petition for relief under the Bankruptcy Code shifts the balance of power in many respects to the debtor.

Concerned by the potential for systemic risk to financial markets, however, Congress enacted a number of curbs on these key bankruptcy powers to the extent they might otherwise affect transactions involving certain financial instruments and securities. One of these "safe harbors" relating to (among other things) certain settlement payments under securities contracts can be found in section 546(e) of the Bankruptcy Code. The scope of protection afforded by section 546(e) has been the subject of considerable discussion and debate in the courts. In particular, some courts have attempted to reconcile a conflict between the apparently plain meaning of section 546(e) and Congress's stated intent in enacting it, yielding divergent results. Implicitly overruling a recent New York bankruptcy court's decision in *In re MacMenamin's Grill Ltd.*, 450 B.R. 414 (Bankr. S.D.N.Y. 2011), the Second Circuit Court of Appeals in *In re Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329 (2d Cir. 2011), ruled that section 546(e) does, in fact, mean what it says.

The Safe Harbor of Section 546(e) of the Bankruptcy Code

Section 546 of the Bankruptcy Code imposes several limitations on a trustee's avoidance powers. Several subsections of section 546, including section 546(e), provide safe-harbor protections against avoidance of transfers related to securities transactions that are complementary to the safe-harbor provisions found elsewhere in the Bankruptcy Code. Section 546(e) provides in part that:

> the trustee may not avoid a transfer that is a . . . settlement payment as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a . . . financial institution . . . or 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 section 741(7), . . . that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

Thus, under section 546(e), the trustee may not avoid, among other things, transfers to or by financial institutions, if such transfers are settlement payments made in connection with a securities contract, unless the transfer was made with actual fraudulent intent to hinder, delay, or defraud creditors under section 548(a)(1)(A) of the Bankruptcy Code.

The term "settlement payment" is defined in both sections 101 and 741 of the Bankruptcy Code, with only minor variations between the definitions. A "settlement payment" is defined in section 741(8), somewhat circularly, as "a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade." The definition of the term in section 101(51A) varies slightly by adding the phrase "net settlement payment" and substituting "forward contract trade" for "securities trade." Section 741(7) of the Bankruptcy Code defines a "securities contract" as, among other things, "a contract for the purchase, sale, or loan of a security," and section 101(49) defines "security" to include "stock."

Although the plain language of section 546(e) and its defined terms do not clearly restrict application of the safe harbor to publicly traded securities, the legislative history of section 546(e) appears to tell a different story. Section 546(e) was enacted in 1982 (originally as subsection 546(d)) and altered by, among other amendments, the Financial Netting Improvements Act of 2006 ("FNIA"), to include within its protections transfers made in connection with securities contracts. The legislative history of section 546(e) indicates that it was enacted "to minimize the displacement caused in the commodities and securities markets in the event [of] a major bankruptcy affecting those industries" and "to prevent the 'ripple effect' created by the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected industry.' " Some tension therefore exists between the broad coverage of section 546(e), which appears to include within its safe harbor all forms of settlement payments in connection with securities contracts, and congressional intent underlying the enactment of the provision, which can be interpreted to limit the scope of the protections to transactions that could imperil the stability of financial markets.

In re MacMenamin's Grill

New Rochelle, New York, bar and grill MacMenamin's Grill (the "Debtor") was the target of what the bankruptcy court later described as "a classic LBO, although writ small." In 2007, the Debtor's three shareholders, each holding 31 percent of the Debtor's issued and outstanding common stock, entered into an agreement to sell their stock to the Debtor. To finance the purchase, the Debtor borrowed $1.15 million from a bank, granting the bank a security interest in substantially all of its assets. At the closing of the transaction, the lender bank wire-transferred each shareholder's share of the loan proceeds directly to the shareholder's bank account.

The Debtor filed a chapter 11 petition in New York in November 2008. Thereafter, a chapter 11 trustee appointed in the case commenced an adversary proceeding against the shareholders and the bank seeking to avoid, among other things, the stock purchase as a constructively fraudulent transfer under section 548 of the Bankruptcy Code and the New York Debtor and Creditor Law, as incorporated by section 544 of the Bankruptcy Code. The shareholders and the bank moved for summary judgment on the ground that the transaction was protected from avoidance by section 546(e) of the Bankruptcy Code.

The trustee made several concessions with respect to the availability of section 546(e)'s safe harbor. The trustee did not dispute that the banks involved were "financial institutions" within the meaning of that subsection and that, generally, an agreement to purchase stock is a "securities contract," whether or not the stock is publicly traded. The trustee also acknowledged that a payment on account of such a purchase is a "settlement payment" notwithstanding the Bankruptcy Code's "frustratingly self-referential" definition of the term. The issue thus presented to the court was whether the safe harbor of section 546(e) would protect an otherwise qualifying private sale of stock in the absence of evidence that avoidance of the transfer would affect securities markets in any way.

As a threshold matter, the court disagreed with a number of courts that have held that the addition of the phrase "or any other similar payment commonly used in the securities trade" to section 741(8)'s definition of "settlement payment" by the FNIA somehow restricts the definition of "settlement payment" to payments involving the securities trade. To the contrary, the court found that the amendment was added to broaden, and not restrict, the scope of the "settlement payment" definition.

The court concluded that the plain meaning of the terms of section 546(e)—as amended by the FNIA—provided no basis to limit the scope of the safe harbor to those transactions that have at least some prospect of impacting financial markets. The court thus proceeded to consider those arguments for applying one or more exceptions to the "plain meaning" rule of statutory interpretation.

The court acknowledged several Southern District of New York decisions identifying multiple factors that may be relevant to whether a transaction should be denied the protections of section 546(e) of the Bankruptcy Code, notwithstanding its plain meaning. At the same time, the court recognized that a number of courts, including several circuit courts of appeal (other than the Second Circuit), had concluded that they were constrained by the plain meaning of section 546(e) to enforce it according to its terms.

Ultimately, the bankruptcy court was unable to ignore what it considered to be Congress's clear intent against unrestricted access to the safe harbor for purely private transactions. Quoting the U.S. Supreme Court's decision in *United States v. Ron Pair Enterprises*, 489 U.S. 235 (1989), the court concluded that it was authorized to stray beyond the language of section 546(e) because literal application of its plain terms would " 'produce a result demonstrably at odds with the intention of its drafters.' "

The court determined that the textual context of key defined terms upon which section 546(e) relies opened the door to consultation of the relevant (and, in its view, dispositive) legislative history. The court noted that section 546(e) draws its definitions from sections 741 and 761 of the Bankruptcy Code, provisions that deal with the liquidation of stockbrokers and commodity brokers, respectively. Given the context of these definitions and, in some cases, their ambiguity in isolation, the court deemed it appropriate to refer to the legislative history of section 546(e) as a means of divining congressional intent.

Once the court decided to consult the legislative history behind section 546(e), its holding became somewhat predictable. The court denied the former shareholders the protections of section 546(e)'s safe harbor because of the "clear and consistent" legislative history to the effect that the purpose of section 546(e)'s safe harbor is to protect financial markets. The shareholders' private stock transaction posed no risk to the financial markets and therefore did not qualify for section 546(e)'s safe harbor.

Enron Creditors Recovery Corp.

Barely two months afterward, the Second Circuit Court of Appeals issued an opinion in *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V. (In re Enron Creditors Recovery Corp.),* 651 F.3d 329 (2d Cir. 2011), that has had the effect of overruling *MacMenamin's Grill*.

Prior to filing for chapter 11 on December 2, 2001, in New York, Enron paid more than $1.1 billion to retire certain of its unmatured, unsecured, and uncertified commercial paper at an accrued par value (original purchase price plus interest) significantly higher than its actual market value. Enron later sought to avoid the redemption payments in bankruptcy court as preferential transfers under section 547(b) of the Bankruptcy Code and constructive fraudulent transfers under section 548(a)(1)(B) of the Bankruptcy Code.

The transferees of the payments filed for summary judgment, arguing that the payments were protected by section 546(e)'s safe harbor. The bankruptcy court denied the motion, concluding that the definition of "settlement payments" in section 741(8) of the Bankruptcy Code includes only payments made to buy or sell securities and not payments to retire debt and that Enron's payments were therefore not protected by the safe harbor. The district court reversed, and Enron appealed to the Second Circuit Court of Appeals.

The Second Circuit's Ruling

Enron argued that the redemption payments were not "settlement payments" under section 546(e) of the Bankruptcy Code because: (i) the payments were not "commonly used in the securities trade," as required by the definition of "settlement payment" in section 741(8) of the Bankruptcy Code; (ii) the redemption payments were made to retire debt and not to acquire title to commercial paper, meaning no title to the securities changed hands, as required for a transaction to be considered a "settlement payment"; and (iii) the payments did not involve a financial intermediary that took title to the securities, and therefore they did not create the risks to the financial markets that prompted Congress to enact the safe-harbor provisions. Broadly interpreting the plain language of section 546(e), a three-judge panel of the Second Circuit rejected each of Enron's arguments and held that the redemption payments were "settlement payments" entitled to the protection of the safe-harbor provision.

Consistent with *MacMenamin's Grill*, the Second Circuit rejected Enron's argument that the phrase "commonly used in the securities trade" in subsection 741(8)'s definition of "settlement payment" applied to each preceding term, thus limiting the definition of "settlement payment" to transactions that are commonly performed in the securities trade. Applying the "last antecedent" rule of construction, the court held that the phrase "commonly used in the securities trade" modifies only the term immediately preceding it, *i.e.*, "any other similar payment." The phrase, therefore, was intended to be a catchall underscoring the breadth of section 546(e), and not a limitation. The court also expressed concern that adopting Enron's reasoning would require courts in future safe-harbor cases to make factual determinations regarding the commonness of any given transaction, causing uncertainty and unpredictability.

The Second Circuit found no other basis for restricting the scope of section 546(e)'s protections. In particular, the Second Circuit found no support for the requirement that title to securities must change hands for a payment to qualify as a "settlement payment," and the court refused to read such a requirement into the statute.

In addition, the Second Circuit rejected Enron's argument that the payments at issue were not "settlement payments" because the transaction lacked a financial intermediary that took a beneficial interest in the securities. Citing the legislative history of section 546(e), Enron argued that, absent such a financial intermediary, the transaction did not pose any systemic risk to financial markets and therefore should not benefit from the protections of the safe harbor.

The Second Circuit disagreed, citing to opinions in several other circuits where similar arguments in the context of leveraged buyout transactions were rejected because, regardless of whether a financial intermediary took a beneficial interest in the exchanged securities, undoing settled leveraged buyouts would have a substantial impact on the stability of financial markets. The Second Circuit found that avoiding Enron's debt-retirement payments would have a similarly negative effect on the financial markets. As a result, applying the safe harbor to these payments, the court concluded, would further congressional intent regarding section 546(e).

Dissent

District judge John G. Koeltl, sitting by designation, dissented. In his dissent, Judge Koeltl argued that the majority's expansive reading of the term "settlement payment" and its accompanying legislative intent would bring virtually every transaction involving a debt instrument within the safe harbor of 546(e). Indeed, his prognostication may have hit the mark. One month after *Enron* was decided, a New York bankruptcy court, in *In re Quebecor World (USA) Inc.*, 453 B.R. 201 (Bankr. S.D.N.Y. 2011), examined the application of section 546(e) in the context of a debtor's repurchase and subsequent cancellation of privately placed notes. Relying heavily on *Enron*, the bankruptcy court concluded that courts no longer need: (i) to consider conflicting evidence about usage of the term "settlement payment" within the private-placement sector of the securities industry; or (ii) to decide whether prepetition transfers of value to the defendants should be characterized as a redemption of private-placement notes rather than a repurchase. Instead, the court ruled, any transaction involving a transfer of cash to complete a securities transaction is a "settlement payment" and thus cannot be avoided.

Outlook

Enron and *MacMenamin's Grill* demonstrate the exacting scrutiny with which courts are increasingly called upon to construe the Bankruptcy Code's financial-contract provisions in an innovative and quickly evolving global financial-products industry. The quick pace of industry change can be expected to continue.

In *Enron*, the Second Circuit joined the Third, Sixth, and Eighth Circuits in ruling that section 546(e) and the Bankruptcy Code's definition of "settlement payment" should be broadly interpreted to cover a wide array of financial transactions. *See In re Plassein Int'l Corp.*, 590 F.3d 252 (3rd Cir. 2009); *In re QSI Holdings, Inc.*, 571 F.3d 545 (6th Cir. 2009); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009). Thus, the ruling does much to clarify the scope of section 546(e)'s protections by resolving the tension between the plain language of the provision and the related legislative history.

As predicted by the dissent in *Enron* and demonstrated in *Quebecor*, *Enron* may make it substantially more difficult for plaintiffs to maintain a viable cause of action for avoidance of many transactions involving the prepetition transfer of a security. Still, although *Enron* construes the safe harbor in section 546(e) to protect transactions involving a far-reaching list of debt and equity instruments, the ruling's impact is hardly unlimited. For example, the decision should have no effect on preference litigation involving trade creditors because, by definition, the term “security” excludes “debt or evidence of indebtedness for goods sold and delivered or services rendered.”