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The Expansion of Bankruptcy Code Section 546(e)'s Application to Leveraged Buyouts Involving Privately Held Securities

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This article provides a brief history of the "Safe Harbor" under Section 546(e) of the Bankruptcy Code, its historically limited application to leveraged buyout payments made in connection with publicly held securities, and the recent expansion of the "Safe Harbor" beyond publicly traded securities.

In a typical leveraged buyout or "LBO," the assets of the target company are used as collateral for the loans issued to finance the acquisition. Occasionally, the debt financing used to finance the LBO becomes too much of a burden for the target company, ultimately causing the target company to file for bankruptcy. Once in bankruptcy, creditors often scrutinize the LBO transaction to determine whether the assets transferred, or the obligations assumed, by the company in connection with the transaction can be recovered or avoided for the benefit of the company and its creditors as a constructively fraudulent transfer pursuant to Section 548(a)(1)(B) of Title 11 of the United States Code (the "Bankruptcy Code") or similar state statutes.

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A barrier to such recovery, however, may be Section 546(e) of the Bankruptcy Code (the "Safe Harbor"), which provides that certain payments made in connection with commodities and securities transactions are protected from avoidance.[1] Historically, in the LBO context, this protection extended only to payments made in connection with LBOs involving publicly traded securities, but recently, the Third, Sixth and Eighth Circuit Courts of Appeals have expanded the application of the Safe Harbor to include payments made in LBOs involving privately held securities. This article provides a brief history of the Safe Harbor, its historically limited application to LBO payments made in connection with publicly held securities and the recent expansion of the Safe Harbor beyond publicly traded securities.

THE SAFE HARBOR AND ITS OPERATION

In response to an action to avoid LBO payments as constructively fraudulent transfers, defendants often argue that such payments were "settlement payments" made by, to or for the benefit of one of the Safe Harbor's enumerated parties and are, therefore, protected from avoidance by the Safe Harbor. The Safe Harbor provides:

> Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.[2]

Thus, the Safe Harbor protects from avoidance any "margin payment" or "settlement payment" made by, to or for the benefit of a "commodity broker," "forward contract merchant," "stockbroker," "financial institution," "financial participant" or "securities clearing agency," as those terms are defined in the Bankruptcy Code. The margin payment or settlement payment may be made *by* one of the parties enumerated in the Safe Harbor to a third party, or by a third party *to* one of the enumerated parties.

Additionally, the Safe Harbor protects from avoidance any transfers (not just margin payments and settlement payments) made by, to or for the benefit of one of the enumerated parties in connection with a "securities contract," "commodity contract" or "forward contract," as those terms are defined in the Bankruptcy Code. This final phrase of the Safe Harbor, which was added as part of the 2005 amendments to the Bankruptcy Code, provides on its face an even broader exception than the "settlement payment" exception discussed above. Indeed, certain defendants have argued that challenged LBO payments were protected from avoidance because they were transfers made in connection with a securities contract.[3] However, perhaps because the "transfer in connection with a securities contract" language was added to the Safe Harbor relatively recently, the issue to date in nearly all cases involving leveraged buyouts and the Safe Harbor is whether the LBO payments were "settlement payments" made "by or to (or for the benefit of)" one of the parties listed in the Safe Harbor.

"Settlement payment" is defined in Section 741(8) of the Bankruptcy Code 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."[4] Thus, in the context of a challenged LBO payment, a court typically must decide whether the term "settlement payment" encompasses a payment made in exchange for securities in an LBO transaction. As noted above, a challenged LBO payment might also be a "margin payment," as defined in the Bankruptcy Code, or a transfer in connection with a securities contract; however, the cases discussed herein address, almost exclusively, the question of whether a challenged LBO payment was a "settlement payment," as that term is defined in the Bankruptcy Code. If a court determines that a challenged payment was a "settlement payment," the court must also find that such payment was made "by or to (or for the benefit of)" one of the enumerated parties in order for the Safe Harbor to apply. Although there is slight disagreement among the courts, most agree that the "by or to (or for the benefit of)" requirement of the Safe Harbor is satisfied even if the enumerated party (*i.e.*, a financial institution) making or receiving the payment acts merely as an intermediary or a conduit, without obtaining a beneficial interest in the funds or securities being exchanged.[5]

A BRIEF OVERVIEW OF THE SAFE HARBOR'S LEGISLATIVE HISTORY

What is now Section 546(e) of the Bankruptcy Code was first enacted in 1978 as Section 746(c) of the Bankruptcy Code. Through former Section 746(c) of the Bankruptcy Code, Congress sought to "promote customer confidence in the commodity markets" by protecting "commodity market stability[,]" especially in the event of a commodity broker insolvency.[6] In 1982, concerned about the volatile nature of the commodities and securities markets, Congress repealed Section 746(c) of the Bankruptcy Code and replaced it with Sections 546(e) and 741(5) and (8) of the Bankruptcy Code.[7] The purpose of the replacement was to "clarify and, in some instances, broaden the commodities market protections and expressly extend similar protections to the securities market."[8] Congress felt it was important to prevent the insolvency of one commodity or security firm from spreading to other firms (and possibly threatening the collapse of the entire commodities or securities market) by preventing a trustee in bankruptcy from avoiding, as preferential transfers, margin and settlement payments made by or to certain parties in the clearance and settlement chain.[9]

The clearance and settlement system works in this way:

> [T]ypically, when a customer wishes to buy a security, he or she places an order with his or her broker, who purchases the security from another broker, who is acting on behalf of a party who has placed an order to sell. Once the trade has been agreed upon, the process by which the security is delivered in exchange for the purchase price is known as "clearance and settlement." The clearing agency compares

> the trades its member brokers have made to arrive at an accounting of the day's transactions, which it then uses to establish each broker's money and securities settlement obligations. Finally, the trades are "settled" — funds and securities are delivered in satisfaction of the obligations.[10]

Each party in the clearance and settlement chain independently guarantees that he or she will make good on his or her obligation to the other parties in the chain.[11] As noted above, the legislative history reveals that Congress enacted the Safe Harbor because it was concerned that, as a result of these guarantees, the bankruptcy of one party in the clearance and settlement chain would spread to other parties in that chain.[12] However, in accordance with the "plain meaning rule" of statutory construction, only if a court finds the definition of "settlement payment" and the language of the Safe Harbor ambiguous or otherwise reasonably susceptible to differing interpretations should the court consider the legislative history of these provisions.

EARLY APPLICATION OF THE SAFE HARBOR TO LEVERAGED BUYOUTS

For years and with few exceptions, courts applied the Safe Harbor to protect payments made in leveraged buyouts involving only publicly traded securities.[13] However, when initially confronted with the question of whether the Safe Harbor applies to leveraged buyouts involving the sale of *privately* held securities, bankruptcy and district courts uniformly answered this question in the negative.[14] Each of these courts found that either the definition of "settlement payment" is ambiguous or the statute on its face requires reference to extrinsic information and interpretation in the context of the securities trade. As a result, these courts examined the legislative history of the Safe Harbor and determined that Congress did not intend for the Safe Harbor to protect settlement payments involving only privately held securities.

RECENT APPELLATE DECISIONS EXTENDING THE APPLICATION OF THE SAFE HARBOR TO PRIVATE LBOS

Recently, however, the Third, Sixth and Eighth Circuit Courts of Appeals, relying on the plain meanings of the applicable statutory provisions, have held that the Safe Harbor extends to LBOs that do not involve the public securities markets. The Eighth Circuit was the first to address the issue in *Contemporary Industries Corp. v. Frost*.[15] In *Contemporary Industries*, the shareholders of a privately held Nebraska corporation agreed to sell their shares to an outside investment group in an LBO transaction.[16] To facilitate the acquisition, the shareholders deposited their shares with a bank and the investment group set up a new corporation, which deposited the purchase price into the same bank, and the bank ultimately distributed the purchase price funds to the shareholders.[17] Subsequently, the corporation filed for relief under Chapter 11 of the Bankruptcy Code, and the unsecured creditors' committee sought to avoid the LBO payments made to the shareholders by the bank in exchange for their stock during the LBO.[18] The Eighth Circuit held that the payments were protected by the Safe Harbor, stating:

> Nothing in the relevant statutory language suggests Congress intended to exclude these payments from the statutory definition of "settlement payment" simply because the stock at issue was privately held. Section 741(8) is certainly not expressly limited to public securities transactions, and neither is § 546(e). Similarly, we do not believe § 741(8)'s concluding phrase "or any other similar payment commonly used in the securities trade" evinces an intent to exclude payments for privately held stock. To the contrary, the phrase follows a long list of various kinds of settlement payments and so we think it is most naturally read as a catchall phrase intended to underscore the *breadth* of the § 546(e) exemption. For these reasons, we conclude the payments at issue are settlement payments within the plain meaning of § 546(e) and § 741(8).[19]

The *Contemporary Industries* court rejected the argument of the debtor and the unsecured creditors' committee that the Safe Harbor did not apply because the bank never obtained a beneficial interest in the payments made to the shareholders.[20] The court held that the "settlement payments" were protected from avoidance because the bank was a financial institution within the meaning of the Safe Harbor, and the Safe Harbor, by it terms, does not expressly require that the financial institution obtain a beneficial interest in the funds.[21]

The Sixth Circuit in *QSI Holdings, Inc. v. Alford (In re QSI Holdings, Inc.)*[22] reached a similar conclusion on the question of whether payments made from a disbursing agent to shareholders in an LBO transaction involving privately held securities fell within the Safe Harbor. In this case, in order to effectuate an LBO of a privately held corporation, the purchasing companies deposited cash into a bank and the shareholders deposited their shares of the target company into the same bank.[23] The bank then transferred the securities to the purchasers and distributed the cash to the target company's shareholders.[24] Subsequently, an involuntary bankruptcy petition was filed against the target company, but before an order for relief was entered, the target company filed a voluntary petition for relief under Chapter 11 and sought to avoid the LBO payments to the shareholders as constructively fraudulent conveyances.[25]

The *QSI* court, unlike the *Contemporary Industries* court, found the definition of "settlement payment" to be somewhat circular and, thus, briefly gave consideration to the Safe Harbor's legislative history.[26] Like the *Contemporary Industries* court, however, the *QSI* court found the reference to the "securities trade" in the definition of "settlement payment" to be a catchall intended to underscore the breadth of the Safe Harbor and held that nothing in the text of Section 546(e) of the Bankruptcy Code precludes its application to settlement payments involving privately held securities.[27] The *QSI* court also rejected the plaintiffs' contention that the transaction did not involve a settlement payment *by* a financial institution because the bank, which disbursed the cash from the LBO to the shareholders, never had "dominion or control" over the funds.[28] Like the *Contemporary Industries* court, the *QSI* court held that the role played by the bank was sufficient to satisfy the Safe Harbor's requirement that the settlement payment be made by or to a financial institution.[29]

There are indications, however, that the Sixth Circuit would not be inclined to extend Safe Harbor protection to *all* LBOs involving privately held companies. The *QSI* court distinguished *Norstan*[30] by noting that the transaction at issue in *Norstan* involved the "two sole shareholders of a closely held Subchapter S corporation, did not implicate the public securities markets, and lacked many of the indicia of transactions 'commonly used in the securities trade.'"[31] Distinguishing *Norstan* in this way suggests that if a case involving a transaction similar to the one in *Norstan* were to come before the Sixth Circuit, the Sixth Circuit might conclude that payments made in connection with such a transaction do not fall within the Safe Harbor. Thus, the *QSI* holding is arguably narrower than the *Contemporary Industries* holding.

Most recently, the same issue was addressed by the Third Circuit in *Brandt v. B.A. Capital Co. (In re Plassein International Corp.)*.[32] In this case, a company called Plassein International Corporation was formed to acquire several privately held manufacturing corporations. After agreeing to the buyouts, the selling shareholders of the privately held companies delivered their shares directly to Plassein, which directed its bank to wire funds to the shareholders' private accounts at their various banks in exchange for the shares delivered.[33] After Plassein and the acquired companies filed for bankruptcy (they filed Chapter 11 petitions but the cases were converted to Chapter 7), the Chapter 7 trustee sought to avoid, as constructively fraudulent transfers, the payments made to the shareholders by the bank.[34] The shareholders moved to dismiss, arguing that the payments were "settlement payments" protected from avoidance by the Safe Harbor.[35] The bankruptcy court agreed with the shareholders, and the district court affirmed.[36]

On appeal to the Third Circuit, the trustee argued that the Third Circuit's prior holding in *Lowenschuss v. Resorts International, Inc. (In re Resorts International, Inc.)*[37] limited the term "settlement payment" to those payments made for securities in the public securities market.[38] The *Plassein* court disagreed, explaining that *Resorts* had held that the meaning of "settlement payment" is best understood by examining how the term is used by those who work in the public securities market, not that the term is limited to transactions involving publicly traded securities.[39] The *Plassein* court thus held that the payments made to the shareholders of the privately held companies as part of the LBO transaction were "settlement payments" protected by the Safe Harbor.[40]

A RECENT DECISION REFUSING TO EXTEND THE APPLICATION OF THE SAFE HARBOR TO PRIVATE LBOS

By contrast, a bankruptcy court in the Southern District of New York recently declined to follow *Contemporary Industries*, *Plassein* and *QSI*. In *Geltzer v. Mooney (In re MacMenamin's Grill Ltd.)*,[41] the Chapter 11 trustee sought to avoid LBO payments made via wire transfer, at the instruction of the debtor (which operated a bar and grill), to the three lone shareholders of the debtor. After considering the universe of cases regarding the Safe Harbor's application to LBOs involving privately held securities, including *Contemporary Industries*, *Plassein* and *QSI*, the *MacMenamin's Grill* court concluded that reference to the Safe Harbor's legislative history was warranted in light of the set of ambiguous definitions referenced therein.[42]

After examining the legislative history, the court held that the risks to the securities and commodities markets that Congress sought to address with the Safe Harbor were not implicated by the avoidance of the wire transfers to the debtor's three shareholders and that the shareholders failed to provide "any evidence that the avoidance of the transactions at issue involved any entity in its capacity as a participant in any securities market, or that the avoidance of the transaction at issue poses any danger to the functioning of any securities market."[43] Accordingly, the *MacMenamin's Grill* court held that the Safe Harbor did not protect the LBO payments at issue.[44]

After *MacMenamin's Grill*, the Second Circuit in *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*[45] had occasion to consider whether prepetition payments made by a debtor to retire unsecured commercial paper prior to its maturity were avoidable as preferential transfers or were protected by the Safe Harbor. The *Enron* court, citing favorably to *Contemporary Industries*, *Plassein* and *QSI*, determined that an analysis of the Safe Harbor should be limited to its plain language and that the definition of "settlement payment" is extremely broad—enough so to encompass the redemption payments, which the court held were protected by the Safe Harbor.[46] Although *Enron* did not deal with a leveraged buyout, the case may suggest that the Second Circuit might follow *Contemporary Industries*, *Plassein* and *QSI* on the issue of the Safe Harbor's applicability to private LBOs.

WHERE DO WE GO FROM HERE?

By refusing to examine and give effect to the legislative history of the Safe Harbor, the *Contemporary Industries*, *QSI* and *Plassein* courts have expanded the Safe Harbor beyond its historical application and may also have opened the door for further expansion. For example, in a leveraged buyout of a company with one private shareholder, would the payment made to that shareholder be protected from avoidance by the Safe Harbor if such payment passed through the hands of one of the Safe Harbor's enumerated parties? *Contemporary Industries* and *Plassein* (and, to a lesser degree, *QSI*) seem to suggest that the answer might be yes. Nevertheless, as evidenced by the recent *MacMenamin's Grill* decision, not all courts have embraced this expanded view of the Safe Harbor, and outside of the Third, Sixth and Eighth Circuits, the scope of the Safe Harbor remains in flux.

NOTES

1 Only constructively fraudulent transfers are relevant here because the Safe Harbor, by its terms, does not protect fraudulent transfers, which are avoidable pursuant to Section 548(a)(1)(A) of the Bankruptcy Code.

2 11 U.S.C. § 546(e).

3 *See, e.g., Geltzer v. Mooney (In re MacMenamin's Grill Ltd.)*, 450 B.R. 414, 422 (Bankr. S.D.N.Y. 2011).

4 11 U.S.C. § 741(8).

5 *See, e.g., Brandt v. B.A. Capital Co. (In re Plassein Int'l Corp.)*, 590 F.3d 252, 257 (3d Cir. 2009), *cert. denied*, 130 S. Ct. 2389 (2010) (discussing a prior decision in which the Third Circuit held that the application of the Safe Harbor is not precluded where the "financial institutions involved acted only as conduits"); *QSI Holdings, Inc. v. Alford (In re QSI Holdings, Inc.)*, 571

F.3d 545, 551 (6th Cir. 2009) (holding that the Safe Harbor does not require a financial institution to have a beneficial interest in the transferred funds and that, by transferring securities and disbursing funds, a bank had satisfied the Safe Harbor's requirement that the settlement payment be made by or to a financial institution); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 987 (8th Cir. 2009) (same); *Miller v. CSFB, Lab Morgan Corp. (In re Refco, Inc. Sec. Litig.)*, 2009 WL 7242548, at *8 (S.D.N.Y. Nov. 13, 2009), *report and recommendation of the special master adopted by* 2010 WL 5129072 (S.D.N.Y. Jan. 12, 2010) (stating, in the context of discussing the Safe Harbor, that "[t]he predominant view in the Circuits—that 'financial institution' means what it says and covers financial institutions even when they act only as a conduit for a settlement payment—is cogent and persuasive"); *Loranger Mfg. Corp. v. PNC Bank, Nat'l Ass'n (In re Loranger Mfg. Corp.)*, 324 B.R. 575, 584-85 (Bankr. W.D. Pa. 2005) (where the debtor instructed a bank to pay a shareholder via wire transfer to effectuate an LBO transaction, the Safe Harbor's requirement that the payment be made by or to a financial institution was satisfied). *Contra Munford v. Valuation Research Corp. (In re Munford, Inc.)*, 98 F.3d 604, 610 (11th Cir. 1996) (holding that (i) the Safe Harbor's requirement that a settlement payment be made by or to a financial institution is not satisfied where a bank acts as "nothing more than an intermediary or conduit" and (ii) LBO "settlement payments" made to shareholders from a bank, at the direction of the purchaser, were not protected by the Safe Harbor because the bank never acquired a beneficial interest in either the funds distributed to shareholders or the shares transferred to the purchaser); *Rushton v. Bevan (In re D.E.I. Sys., Inc.)*, 2011 WL 1261603, at *4 (Bankr. D. Utah Mar. 31, 2011) (holding, among other things, that LBO payments made to shareholders by the purchaser, accomplished by wire transfers and drafts from banks, did not satisfy the Safe Harbor's requirement that payments be made by or to a financial institution because the banks did not acquire any beneficial interest in the property as a result of the LBO transaction).

6 S. Rep. 95-989 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5794.

7 H.R. Rep. 97-420 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583, 583.

8 *Id.*

9 *Id.*

10 *Wieboldt Stores, Inc. v. Schottenstein*, 131 B.R. 655, 664 n.9 (N.D. Ill. 1991) (citation omitted).

11 *Id.* at 664 n.10.

[12] *Id.* at 664.
[13] *See, e.g., Lowenschuss v. Resorts Int'l, Inc. (In re Resorts Int'l, Inc.)*, 181 F.3d 505, 516 (3d Cir. 1999) (holding that LBO payments made to shareholders of a publicly held corporation by a financial institution were "settlement payments" protected by the Safe Harbor); *Kaiser Steel Corp. v. Pearl Brewing Co. (In re Kaiser Steel Corp.)*, 952 F.2d 1230, 1239 (10th Cir. 1991) (holding that payments made to holders of publicly traded securities by stockbrokers and clearing agencies in settlement of an LBO transaction were "settlement payments" protected by the Safe Harbor); *Kaiser Steel Corp. v. Charles Schwab & Co.*, 913 F.2d 846, 847 (10th Cir. 1990) (holding that payments made to a securities broker in connection with an LBO of a publicly held corporation were "settlement payments" protected by the Safe Harbor); *Official Comm. of Unsecured Creditors v. Fleet Retail Fin. Group (In re Hechinger Inv. Co. of Delaware)*, 274 B.R. 71, 87 (D. Del. 2002) (holding that LBO payments made to both insider and non-insider shareholders of a publicly held company by a financial institution are protected by the Safe Harbor).
[14] *See, e.g., Jewelry Recovery L.P. v. Gordon*, 196 B.R. 348, 353 (N.D. Tex. 1996) (holding that the Safe Harbor applies "to settlement payments in the clearance and settlement process in the public market" and finding that a tender offer transaction involving a family controlled corporation was a private transaction that did not implicate the clearance and settlement system and, thus, was not protected by the Safe Harbor); *Kapila v. Espirito Santo Bank (In re Bankest Capital Corp.)*, 374 B.R. 333, 346 (Bankr. S.D. Fla. 2007) (holding that a $10 million payment from a debtor to a bank for the purpose of buying out the bank's interest in another entity was not protected by the Safe Harbor because it did not involve the utilization of public markets or publicly traded securities); *Official Comm. of Unsecured Creditors v. Lattman (In re Norstan Apparel Shops, Inc.)*, 367 B.R. 68, 77 (Bankr. E.D.N.Y. 2007) (holding that the Safe Harbor protects the public securities markets and finding that because a payment made in settlement of an LBO transaction did not involve publicly traded securities, or otherwise implicate the public securities markets, such payment was not protected by the Safe Harbor); *Official Comm. of Unsecured Creditors v. Asea Brown Boveri, Inc. (In re Grand Eagle Cos.)*, 288 B.R. 484, 494 (Bankr. N.D. Ohio 2003) (holding that payments made to effectuate an LBO involving two private parties, though funds were channeled through a financial institution, were not protected by the Safe Harbor).

[15] 564 F.3d 981 (8th Cir. 2009).
[16] *Id.* at 983.
[17] *Id.*
[18] *Id.*
[19] *Id.* at 986 (citation omitted) (emphasis in original).
[20] *Id.* at 987.
[21] *Id.*
[22] 571 F.3d 545 (6th Cir. 2009).
[23] *Id.* at 548.
[24] *Id.*
[25] *Id.*
[26] *Id.* at 550.
[27] *Id.*
[28] *Id.* at 550-51.
[29] *Id.* at 551.
[30] *See supra* note 14.
[31] *QSI*, 571 F.3d at 550 (citing *Norstan*, 367 B.R. at 73).
[32] 590 F.3d 252 (3d Cir. 2009), *cert. denied*, 130 S. Ct. 2389 (2010).
[33] *Id.* at 255.
[34] *Id.*
[35] *Id.*
[36] *Id.*
[37] 181 F.3d 505, 516 (3d Cir. 1999). *See supra* note 13.
[38] *Plassein*, 590 F.3d at 258.
[39] *Id.*
[40] *Id.*
[41] 450 B.R. 414 (Bankr. S.D.N.Y. 2011).
[42] *Id.* at 425.
[43] *Id.*
[44] *Id.*
[45] 651 F.3d 329 (2d Cir. 2011).
[46] *Id.* at 339.