Safe Harbor Redux: The Second Circuit Revisits the Bankruptcy Code's Protection Against Avoidance of Securities Contract Payments

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"Safe harbors" in the Bankruptcy Code designed to minimize "systemic risk"—disruption in the securities and commodities markets that could otherwise be caused by a counterparty's bankruptcy filing—have been the focus of a considerable amount of judicial scrutiny in recent years. The latest contribution to this growing body of sometimes controversial jurisprudence was recently handed down by the U.S. Court of Appeals for the Second Circuit. The ruling widens a rift among the federal circuit courts of appeal concerning the scope of the Bankruptcy Code's "settlement payment" defense to avoidance of a preferential or constructively fraudulent transfer. In *Official Committee of Unsecured Creditors v. American United Life Insurance Co. (In re Quebecor World (USA) Inc.)*, 2013 WL 2460726 (2d Cir. June 10, 2013), the Second Circuit held that securities transfers may qualify for this section 546(e) safe harbor even if the financial institution involved in the transfer is "merely a conduit." The court affirmed dismissal of the $376 million suit brought by an official creditors' committee on behalf of the bankruptcy estate against a group of insurer-investors.

Section 546: Limitations on Avoiding Powers

The Bankruptcy Code empowers a bankruptcy trustee or chapter 11 debtor in possession ("DIP") to invalidate certain transfers (or obligations incurred) by a debtor during prescribed periods immediately prior to (and even after) filing for bankruptcy protection. Among these are the ability to “avoid” transfers that are fraudulent by design or because an insolvent transferor did not receive fair consideration in exchange (sections 544 and 548), the power to avoid transfers that prefer one creditor over others (section 547), and the ability to avoid postbankruptcy transfers that are not authorized by the Bankruptcy Code or the court (section 549).

Section 546 of the Bankruptcy Code, however, imposes important limitations on the rights and powers granted to the trustee or DIP elsewhere in the Bankruptcy Code. These include, among others, statutes of limitations for avoidance actions (section 546(a)), limitations based upon the perfection rights afforded under applicable nonbankruptcy law to entities with interests in the debtor’s property (section 546(b)), and limitations based upon reclamation rights arising under applicable nonbankruptcy law (sections 546(c) and 546(d)).

The restrictions also include provisions prohibiting avoidance in most cases of: (i) transfers that are margin or settlement payments made in connection with securities, commodity, or forward contracts (section 546(e)); (ii) transfers made by, to, or for the benefit of a repo participant or financial participant in connection with a repurchase agreement (section 546(f)); (iii) transfers made by, to, or for the benefit of a swap participant or financial participant under or in connection with a prepetition swap agreement (section 546(g)); and (iv) subject to certain exceptions, transfers made by, to, or for the benefit of a “master netting agreement participant” under certain circumstances (section 546(j)).

Section 546(e), which creates a safe harbor for margin or settlement payments, provides as follows:

> 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.

Prior to the enactment of the Bankruptcy Code in 1978, U.S. bankruptcy law did not protect margin or settlement payments from avoidance, and such payments were held to be avoidable. Lawmakers changed this by enacting section 764(c) of the Bankruptcy Code as part of the Bankruptcy Reform Act of 1978. That provision, which applied only in commodity-broker liquidation cases under chapter 7, prohibited a trustee from avoiding a transfer that was: (i) a margin payment or a deposit with a commodity broker or forward-contract merchant; or (ii) a settlement payment by a clearing organization. Its purpose was to facilitate prebankruptcy transfers, promote customer confidence in commodities markets, and ensure the stability of those markets.

Section 764(c) was repealed in 1982 and replaced by a provision that was designated subsection (e) of section 546 in 1984. Section 546(e) clarified prior section 764(c) and made it applicable to both the securities and commodities markets, again in an effort to ensure the public's confidence in and the stability of those markets. In 1984, Congress enacted section 546(f) to expand the safe harbor to include protection for repo participants in connection with repurchase agreements. Most recently, sections 546(e) and (f) were amended in 2005 by the Bankruptcy Abuse Prevention and Consumer Protection Act to include protection for "financial participants" in connection with repurchase agreements and in 2006 by the Financial Netting Improvements Act to clarify and expand their scope (e.g., by adding the phrase "(or for the benefit of)" to section 546(e) and by including within the scope of the section 546(e) safe harbor transfers made in connection with a "securities contract").

The limitations in section 546(e) expressly do not apply to section 548(a)(1)(A) of the Bankruptcy Code, which authorizes avoidance of transfers made or obligations incurred with the actual intent to hinder, delay, or defraud creditors. Section 546(e), however, does apply to actions to avoid constructively fraudulent transfers under section 548(a)(1)(B) or 544. (The latter authorizes, among other things, the pursuit of constructively fraudulent transfers under applicable state law.) In addition, section 546(e) does not restrict the trustee's rights and powers with respect to postpetition transfers under section 549 of the Bankruptcy Code. Although not mentioned in section 546(e), avoidance of prepetition setoffs involving margin and settlement payments is prohibited under section 553(b)(1) of the Bankruptcy Code.

Section 546(e) applies when a "margin payment" or "settlement payment" is made by, to, or for the benefit of a commodity broker, forward-contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, all of which are defined elsewhere in the Bankruptcy Code, prior to the commencement of a bankruptcy case. The payment may be made by any of these entities to a third party or by a third party to one of the entities listed.

Section 101(51A) defines "settlement payment" as "a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, a net settlement payment, or any other similar payment commonly used in the forward contract trade." The term is similarly defined with respect to the "securities trade" in section 741(8), which applies to stockbroker liquidation cases.

Most courts interpret the term "settlement payment" broadly to include any transfer of securities in connection with the completion of a securities transaction. Qualifying transfers include both routine securities transactions and, according to several federal circuit courts of appeal, more complicated transactions, such as transfers made during the course of a leveraged-buyout transaction ("LBO"). *See*, *e.g.*, *Lowenschuss v. Resorts Int'l, Inc. (In re Resorts Int'l, Inc.)*, 181 F.3d 505 (3d Cir. 1999); *Kaiser Steel Corp. v. Pearl Brewing Co. (In re Kaiser Steel Corp.)*, 952 F.2d 1230 (10th Cir. 1991). Moreover, the Third, Sixth, and Eighth Circuits have recently held that the safe harbor extends even to LBOs that involve nonpublic securities and thus have no impact on the public-securities markets. *See Brandt v. B.A. Capital Co. (In re Plassein Int'l Corp.)*, 590 F.3d 252 (3d Cir. 2009); *QSI Holdings, Inc. v. Alford (In re QSI Holdings, Inc.)*, 571 F.3d 545 (6th Cir. 2009); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009).

In *In re Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329 (2d Cir. 2011), the Second Circuit considered, as a matter of first impression, whether section 546(e) extends to an issuer's payments to redeem commercial paper prior to maturity. The plaintiff in *Enron* sued to avoid $1.1 billion in prepetition redemption payments made by the debtor to retire unsecured commercial paper. It argued that the payments were not shielded from avoidance as "settlement payments" under section 546(e) because: (i) the payments were not "commonly used in the securities trade," as required by the definition of "settlement payment" in section 741(8); (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), the Second Circuit disagreed, holding that the redemption payments were "settlement payments" entitled to the protection of the safe-harbor provision. The court rejected the argument that the phrase "commonly used in the securities trade" in section 741(8)'s definition of "settlement payment" applied to each preceding term, thus limiting the definition of "settlement payment" to transactions which 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 Second Circuit also found no support for the contention that title to securities must change hands in order for a payment to qualify as a "settlement payment," and it refused to read such a requirement into the statute.

Finally, the court rejected the argument that the payments at issue were not "settlement payments" because the transaction lacked a financial intermediary which took a beneficial interest in the securities. For support, the Second Circuit cited *Plassein*, *QSI Holdings*, and *Contemporary Industries*, in which sister circuits rejected similar arguments in the context of LBOs because, regardless of whether a financial intermediary takes a beneficial interest in the exchanged securities, undoing settled LBOs would have a substantial impact on the stability of financial markets. The court reasoned that avoiding 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).

In a dissenting opinion, district judge John G. Koeltl, sitting by designation, 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 section 546(e). As illustrated by *Quebecor World*, his prognostication may have hit the mark.

Quebecor World

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), *aff'd*, 480 B.R. 468 (S.D.N.Y. 2012), *aff'd*, 2013 WL 2460726 (2d Cir. June 10, 2013), examined section 546(e) in the context of a debtor's repurchase and subsequent cancellation of privately placed notes.

Canada-based Quebecor World, Inc. ("QWI") and its affiliates once operated the second-largest commercial printing business in North America. In 2000, QWI subsidiary Quebec World Capital Corp. ("QWCC") raised $371 million for the Quebecor entities by issuing private-placement notes (the "Notes") to a variety of institutional investors (the "Noteholders") pursuant to note purchase agreements (the "NPAs"). QWI and subsidiary Quebecor (USA) Inc. ("QWUSA"), to which a portion of the Note proceeds was eventually transferred, guaranteed the Notes.

The NPAs gave QWCC the option to prepay the Notes so long as it paid the outstanding principal, the accrued interest, and a special "make-whole amount." The agreements also prohibited any Quebecor affiliate from purchasing the Notes unless the buyer complied with the prepayment provisions. Finally, the NPAs provided for the acceleration of the maturity of the Notes if QWI's debt-to-capitalization ratio fell below a certain threshold. Under a separate $1 billion revolving credit facility provided to QWI, any default under the NPAs would also trigger a default under the credit facility agreement.

After QWI confronted financial difficulties in 2007, it negotiated a cooperation agreement with the Noteholders under which the Noteholders agreed not to sell their Notes to any entity other than another existing Noteholder. QWI approved the prepayment of all of the Notes in September 2007. However, upon realizing that redemption would have severe tax implications under Canadian law, QWI restructured the prepayment so that QWUSA would purchase the Notes for cash and QWCC would then redeem them from QWUSA in exchange for forgiveness of debt which QWUSA owed to QWCC.

On October 29, 2007, QWUSA transferred $376 million to the Noteholders' trustee, CIBC Mellon Trust Co. ("CIBC"). CIBC then distributed the funds to the Noteholders and eventually surrendered the Notes directly to QWI in Canada.

On January 20, 2008, QWI and its Canadian affiliates filed for protection under the Canadian Companies' Creditors Arrangement Act in Montreal. QWUSA filed for chapter 11 protection in New York on January 21, 2008, less than 90 days after making the payment for the Notes.

QWUSA's official creditors' committee was later authorized to sue the Noteholders on behalf of the estate, seeking to avoid the $376 million transfer as a preference. The Noteholders moved for summary judgment, arguing that the transfer was exempt from avoidance under section 546(e). Relying heavily on *Enron* (which was decided shortly after the committee filed its complaint), the bankruptcy court held that the payment was covered by the safe harbor.

Specifically, the court concluded that, because of *Enron*, 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.

The district court affirmed on appeal, agreeing that QWUSA's payment was a "settlement payment" under *Enron*. However, the court did not agree that a transfer to "redeem" securities can qualify as a "transfer made . . . in connection with a securities contract" because section 741(7)(A)(i) of the Bankruptcy Code defines a "securities contract" as a contract "for the purchase, sale, or loan of a security." Even so, the district court affirmed the bankruptcy court's alternative ruling because the transaction was in fact a "purchase" instead of a "redemption."

The Second Circuit's Ruling

A three-judge panel of the Second Circuit affirmed the ruling below. Writing for the court, circuit judge Denny Chin acknowledged that there is a split of authority regarding the role which a financial institution must play in the transaction in order to qualify for the safe harbor. Three circuits—the Third Circuit in *Resorts International*, the Sixth Circuit in *QSI Holdings*, and the Eighth Circuit in *Contemporary Industries*—have concluded that the plain language of section 546(e) encompasses any transfer to a financial institution, even if it serves only as a conduit or intermediary. Only the Eleventh Circuit, Judge Chin explained, has held that the financial institution must acquire a beneficial interest in the transferred funds or securities in order to trigger the safe harbor. *See Munford v. Valuation Research Corp. (In re Munford, Inc.)*, 98 F.3d 604 (11th Cir. 1996); *accord Rushton v. Bevan (In re D.E.I. Systems, Inc.)*, 2011 WL 1261603 (Bankr. D. Utah Mar. 31, 2011).

"In *Enron*," the judge wrote, "we cited the Third, Sixth, and Eighth Circuits' decisions with approval and concluded that 'the absence of a financial intermediary that takes title to the transacted securities during the course of the transaction is [not] a proper basis on which to deny safe-harbor protection.' " "To the extent *Enron* left any ambiguity in this regard," Judge Chin ruled, "we expressly follow the Third, Sixth, and Eighth Circuits in holding that a transfer may qualify for the section 546(e) safe harbor even if the financial intermediary is merely a conduit."

Judge Chin explained that the plain language of section 546(e) indicates that a transfer may be either "for the benefit of" a financial institution or "to" a financial institution, but need not be both. This construction of the provision furthers the purpose behind the exemption: to minimize displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries:

> A transaction involving one of these financial intermediaries, even as a conduit, necessarily touches upon these at-risk markets. Moreover, the enumerated

> intermediaries are typically facilitators of, rather than participants with a beneficial interest in, the underlying transfers. A clear safe harbor for transactions made through these financial intermediaries promotes stability in their respective markets and ensures that otherwise avoidable transfers are made out in the open, reducing the risk that they were made to defraud creditors.

In a footnote, Judge Chin explained that the phrase "(or for the benefit of)" was added to section 546(e) in 2006 as part of the Financial Netting Improvements Act. Because the change was made after the circuit split arose regarding the "mere conduit" issue, the Second Circuit wrote that "it is arguable that Congress intended to resolve the split with the 2006 Amendments," yet omitted any mention of the controversy in the legislative history. Even so, given his finding that the text of section 546(e) is unambiguous, the judge concluded that resort to the legislative history was unnecessary.

Judge Chin declined to address whether the $376 million payment was a "settlement payment," concluding that the court need not reach the issue due to the undisputed facts that: (i) QWUSA's payment "fits squarely" within the plain meaning of the securities-contract exemption because it was a "transfer made by (or for the benefit of) a . . . financial institution . . . in connection with a securities contract"; (ii) CIBC is a financial institution; and (iii) the NPAs were clearly "securities contracts" because they provided for both the original purchase and the "repurchase" of the Notes.

Judge Chin also concluded that the court need not decide whether the transfer would still be exempt if QWUSA had "redeemed" its own securities. Noting that the common definition of "redeem" is "to regain possession by payment of a stipulated price," he agreed with the district court that QWUSA made the transfer to "purchase," rather than redeem, the Notes because "it was acquiring for the first time the securities of another corporation." In fact, Judge Chin noted, under the NPAs, only QWCC had the right to "pre-pay" or redeem the Notes—its affiliates could "purchase" the Notes only if they complied with the prepayment provisions.

Outlook

Quebecor World continues the recent trend toward expansive interpretation of the Bankruptcy Code's safe harbors for securities and commodities transactions, in which courts typically cite the underlying purpose of the provisions: to manage systemic risk posed by a counterparty's bankruptcy. With *Quebecor World* and *Enron*, the Second Circuit has adopted a broad approach to both the "settlement payment" and "securities contract" prongs of section 546(e).

Perhaps acknowledging the dissent's concern in *Enron* regarding overly broad application of section 546(e), the Second Circuit wrote in a footnote in *Quebecor World* that "[o]f course, the 'securities contract' safe harbor is not without limitation, and, for example, mere structuring of a transfer as a 'securities transaction' may not be sufficient to preclude avoidance." As an example, the court cited the possibility that a transfer could still be avoided if it were found to be actually fraudulent.

The importance of the Bankruptcy Code's safe harbors has been a recurring theme in bankruptcy and appellate rulings since the advent of the Great Recession. Yet another important development in that connection was the Fourth Circuit's ruling in *Grayson Consulting, Inc. v. Wachovia Securities, LLC (In re Derivium Capital LLC)*, 716 F.3d 355 (4th Cir. 2013). In addition to finding that the transfer of certain securities as part of a Ponzi scheme could not be avoided because it did not involve "property of the debtor," the court, as a matter of first impression at the appellate level, ruled that commission payments can be shielded from recovery by the "settlement payment" defense of section 546(e).

In addition, in *Whyte v. Barclays Bank PLC*, 2013 BL 152743 (S.D.N.Y. June 11, 2013), a New York district court rejected a fraudulent-transfer suit with respect to payments made to a swap participant. In *Whyte*, the trustee of a litigation trust created by the chapter 11 plan of SemGroup LP, to which trust certain creditors' state-law claims had been assigned, attempted to avoid payments made to a swap participant as constructive fraudulent transfers under state law and section 544(b) of the Bankruptcy Code, despite the safe harbor for such transfers in section 546(g).

The trustee argued that, because section 546(g) applies only to "an estate representative who is exercising federal avoidance powers under [section 544 of] the Bankruptcy Code," section 546(g) should not apply to "claims asserted by creditors" after the bankruptcy concludes without a release of such claims. Since creditors' state-law fraudulent-transfer claims had been assigned to the litigation trust, the trustee contended that she was not asserting such claims as the trustee of a bankruptcy estate and that section 546(g) was therefore irrelevant.

The court rejected this contention, writing that "[t]he trouble with this clever argument is that it would, in effect, render section 546(g) a nullity." It held that section 546(g) impliedly preempted the trustee's attempt to resuscitate fraudulent-avoidance claims as the assignee of certain creditors "where, as here, she would be expressly prohibited by section 546(g) from asserting those claims as assignee of the debtor-in-possession's rights (or, indeed, as the functional equivalent of a bankruptcy trustee)." According to the court:

> The patent purpose and intended effects of section 546(g) would be totally undercut if, at the same time that a trustee in bankruptcy was prohibited from avoiding swap transactions, a Chapter 11 'litigation trustee' could hold swap-related avoidance actions in abeyance for eventual litigation as the mere assignee of creditors' claims.