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Shelter from the Storm: Recent Decisions from the Third Circuit and Southern District of New York Confirm the Breadth of Bankruptcy Code Section 546(e)'s Safe Harbor for Transactions Involving the Purchase or Sale of Securities

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The authors discuss a string of recent cases from the Third Circuit and Southern District of New York where defendants have prevailed in relying upon Bankruptcy Code Section 546(e)'s safe harbor to defend fraudulent transfer actions brought by trustees or debtors in possession. These cases, as well as decisions by the Sixth and Eighth Circuits earlier in 2009, highlight a trend towards a broad interpretation of Section 546(e) of the Bankruptcy Code.

In a string of recent cases from the Third Circuit and Southern District of New York, defendants have prevailed in relying upon Bankruptcy Code Section 546(e)'s safe harbor to defend fraudulent transfer actions brought by trustees or debtors in possession. These cases — *Brandt v. B.A. Capital Co. LP* (*In re Plassein Int'l Corp.*),[1] *In re Enron Creditors Recovery Corp.*,[2] and *Miller v. CSFB*[3] — as well as decisions by the Sixth and Eighth Circuits earlier in 2009 — highlight a trend towards a broad interpretation of Section 546(e) of the Bankruptcy Code. This trend may significantly reduce the bankruptcy risk in securities transactions with insolvent counterparties who later enter bankruptcy.

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PURPOSE OF SECTION 546(E)

The so-called safe harbor of Section 546(e) of the Bankruptcy Code insulates certain types of commodities and securities transactions from avoidance by a bankruptcy trustee or debtor in possession.[4] Section 546(e) has been used with increasing frequency as a defense to avoidance actions arising out of securities purchase transactions, including transactions involving payments to former shareholders in leveraged buyouts.

Congress enacted Section 546(e) in 1982 to "minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries."[5] Through Section 546(e), Congress sought to maintain stability in the market by ensuring that settled securities transactions remain final.[6] The statute provides that:

> …the trustee may not avoid a transfer that is a…settlement payment, as defined in section 101 or 741 of [] title [11], 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)…that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.[7]

One type of securities transaction that qualifies for protection is a "settlement payment." The term "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

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payment on account, a final settlement payment, a net settlement payment, or any other similar payment commonly used in the securities trade."[8]

While courts have wrestled with the definition of "settlement payment" — a definition that judges often refer to as circular and tautological — the term is generally interpreted to mean the transfer of cash or securities made to complete the purchase or sale of a security or other securities transaction.[9]

TREND TOWARDS BREADTH

In 2009, two Courts of Appeals confirmed the trend towards a liberal reading of the safe harbor in Section 546(e). The Eighth Circuit Court of Appeals in *Contemporary Indus. Corp. v. Frost*[10] and the Sixth Circuit Court of Appeals in *QSI Holdings, Inc. v. Alford* (*In re QSI Holdings, Inc.*)[11] joined every other Court of Appeals to have considered the issue in holding that Section 546(e) is to be interpreted broadly.

The recent decisions in *Plassein, Enron*, and *Miller* rely heavily on *Contemporary Industries* and *QSI Holdings* in reaching conclusions on three legal issues that, taken together, underscore the breadth of Section 546(e): (1) that Section 546(e) applies to private transactions; (2) that Section 546(e) is not limited to transactions that take place in the ordinary course; and (3) that conduits may qualify as financial institutions under the statute.

SECTION 546(E) APPLIES TO PRIVATE TRANSACTIONS

Joining the Sixth and Eighth Circuits, the Third Circuit in *Plassein* and Judge Jed Rakoff in the *Miller* cases confirmed that Section 546(e)'s safe harbor is broad enough to insulate private securities transactions from avoidance.

The Third Circuit in *Plassein* reiterated and clarified its holding in *In re Resorts International*, one of the first cases to consider the scope of Section 546(e).[12] In *Resorts*, the Third Circuit had held that the payment of cash for shares during a leveraged buyout is a "settlement payment" for the purposes of Section 546(e).[13] The plaintiff in *Plassein* attempted

to distinguish the transfers in its case from the transfers at issue in *Resorts* on the grounds that the shares in *Resorts* represented stock in a publicly traded company, while the shares transferred in *Plassein* represented stock in a privately held company.[14] Rejecting the plaintiff's argument, the Third Circuit relied on the plain language of Section 546(e) and held that the phrase "settlement payment" in Section 546(e) encompasses the purchase and sale of shares of a privately held company.[15] The Third Circuit rejected the contention that a transfer must travel through the system for settlement of publicly traded securities to qualify as a "settlement payment."[16] Although the shares at issue in *Resorts* were publicly traded, they were acquired in a leveraged buyout by transferring money to the shareholders — not through the publicly traded securities settlement system.[17] In reaching its conclusion, the Third Circuit in *Plassein* emphasized that the value of privately held securities is often substantial and that unwinding a settlement transaction involving private securities would have just as much of an impact on financial markets as unwinding a transaction involving publicly traded securities.[18]

In the *Miller* cases — a group of fraudulent transfer actions — U.S. District Judge Jed Rakoff, of the Southern District of New York, recently affirmed the Report and Recommendation of a Special Master that he had appointed to consider motions to dismiss constructive fraudulent transfer claims brought by a Chapter 7 Trustee under Sections 544 and 548 of the Bankruptcy Code.[19] The transaction that the plaintiff sought to avoid involved the payment of cash for shares of a privately held company through a tender offer. In his Report and Recommendation, the Special Master concluded that Section 546(e) applies to private transactions.[20] The Special Master held that nothing in the text of the statute excludes private transactions — in his words: "the textual silence is deafening."[21]

In addition, the Special Master opined that nothing in the legislative history limits the safe harbor to public trades.[22] The Special Master acknowledged that a principal purpose of Section 546(e) is to protect clearance and settlement systems from the disruption that would occur when public securities transactions are unwound due to the bankruptcy of any one party in the chain. But the Special Master nevertheless concluded that unwinding the transactions at issue in the *Miller* cases would have just as

much of an impact on the securities markets.[23]

Judge Rakoff adopted the Special Master's Report and Recommendation in full, terming its analysis "thorough and well-reasoned."[24]

SECTION 546(E) IS NOT LIMITED TO SETTLEMENT PAYMENTS MADE IN THE ORDINARY COURSE

Further highlighting the breadth of Section 546(e), the judges in *Enron* and the *Miller* cases held that the final phrase of Section 741(8)'s definition of settlement payment — "commonly used in the securities trade" — does not impose a limitation on the types of transactions that qualify as settlement payments.

On November 20, 2009, Judge McMahon, of the Southern District of New York, issued a decision holding that the phrase "commonly used in the securities trade" in Section 741(8) does not modify the term "settlement payment" and does not limit the protections of Section 546(e) to payments made in the ordinary course.[25] In reaching her conclusion, Judge McMahon relied upon conventions of statutory interpretation, including the "rule of the last antecedent," and examined the legislative history behind the 2006 amendment to the statute.

The rule of the last antecedent provides that a limiting clause should be read as modifying only the noun or phrase that immediately precedes it.[26] Accordingly, the phrase "commonly used in the securities trade" modifies only "other similar payment."[27] The phrase "settlement payment," therefore, is not limited to "payments commonly used in the securities trade," but rather includes any payment in settlement of a securities transaction.[28] Judge McMahon stressed that every Circuit Court of Appeals that has considered the issue has defined "settlement payments" expansively, which counseled in favor of interpreting the safe harbor as reaching transactions beyond the ordinary course.[29]

In the *Miller* cases, the plaintiff similarly urged that Section 546(e) was limited to transactions in the ordinary course. The plaintiff argued that the transactions at issue were not "ordinary," in part because the defendants were allegedly paid more for the tendered shares than the shares were worth. Essentially, the plaintiff contended that a transaction is not

"commonly used" if the underlying facts indicate illegal or manipulative activity. The Special Master (in the Report and Recommendation adopted by Judge Rakoff) rejected this contention, holding that the phrase "commonly used" does not qualify the other types of settlement payments described in the statutory definition.[30]

The Special Master went on to note that even if Section 741(8) could be read to impose a "commonly used" limitation on settlement payments, that limitation must refer to the mechanics of the transaction — not to its underlying fairness.[31] Because Section 546(e) itself already expressly excludes intentional fraudulent transfers under Section 548 from its reach, reading the phrase "commonly used in the securities trade" in the separate definition of "settlement payment" to carve out an exception for transactions involving fraudulent conduct would not make sense as a matter of statutory construction.[32] Accordingly, the Special Master concluded that the phrase "commonly used in the securities trade" covers payments similar to those listed in Section 741(8) that are effectuated with commonly used procedures.[33]

CONDUITS MAY QUALIFY AS FINANCIAL INSTITUTIONS

The Special Master in the *Miller* cases also followed the lead of the Sixth and Eighth Circuits in adhering to the plain language of the statute on the issue of whether Section 546(e) affords protection to settlement payments that traveled through financial institutions that obtained no beneficial interest in the funds. In the *Miller* cases, The Bank of New York had served as an intermediary to which the tendering shareholders transferred their shares and the purchaser transferred its funds. The Bank of New York never acquired a beneficial interest in the funds that comprised the settlement payment. But the Special Master noted that nothing in the language of Section 546(e) requires that the "financial institution" acquire beneficial title to the shares — all it requires is that the settlement payment be made by or to the financial institution.[34] Accordingly, the safe harbor applies even when the financial institution acts only as a conduit for, and has no beneficial interest in, the settlement payment.[35]

THE BOTTOM LINE

These recent decisions make it increasingly clear that Section 546(e)'s safe harbor is to be interpreted expansively and that it offers protection from avoidance (except as an intentional fraudulent transfer under Section 548(a)(1)(A) of the Bankruptcy Code) to a wide range of securities transactions. The protection of Section 546(e) is important both to defendants in bankruptcy litigation and to parties entering into securities transactions outside of bankruptcy that are, or may later become, subject to counterparty insolvency risk.

NOTES

[1] 2009 WL 4912137 (3d Cir. Dec. 22, 2009).
[2] 2009 WL 5174119 (S.D.N.Y. Nov. 20, 2009).
[3] Report and Recommendation of the Special Master, *In re Refco Securities Litigation*, 07 MDL No. 1902 (JSR), Docket No. 475 (S.D.N.Y. Nov. 13, 2009) ("R&R"). The R&R resulted in the dismissal of identical complaints filed by the plaintiff in a number of fraudulent transfer actions referred to herein as the "*Miller* cases."
[4] This protection excludes transactions involving intentional or "actual" fraudulent transfers avoidable under Section 548(a)(1)(A) of the Bankruptcy Code, but includes transactions for less than fair value or "constructive" fraudulent transfers otherwise avoidable under Section 548(a)(1)(B).
[5] H.R. Rep. 97-420, at 2 (1982), as reprinted in 1982 U.S.C.C.A.N. 583, 583.
[6] *In re Enron*, 2009 WL 5174119, at *6.
[7] 11 U.S.C. § 546(e).
[8] 11 U.S.C. § 741(8).
[9] *Lowenschuss v. Resorts Int'l, Inc.* (*In re Resorts Int'l, Inc.*), 181 F.3d 505, 515 (3d Cir. 1999).
[10] 564 F.3d 981 (8th Cir. 2009).
[11] 571 F.3d 545 (6th Cir. 2009).
[12] *In re Resorts Int'l, Inc.*, 181 F.3d 505 (3d Cir. 1999).
[13] *Id.* at 514-15.
[14] *In re Plassein*, 2009 WL 4912137, at *4.
[15] *Id.*

[16] *Id.*
[17] *Id.*
[18] *Id.* (citing *In re QSI Holdings, Inc.*, 571 F.3d at 549-50).
[19] Order, Case No. 07 MDL 1902 (JSR), Docket No. 525 (S.D.N.Y. Jan. 11, 2010) ("Order").
[20] R&R at 7.
[21] *Id.* at 5.
[22] *Id.* at 5 ("While Congress may have been predominantly concerned about public transactions, there is nothing to indicate that Congress affirmatively intended to *exclude* private transactions from the safe harbor.") (emphasis in original).
[23] *Id.* at 5-6.
[24] Order at 2.
[25] *In re Enron*, 2009 WL 5174119, at *11.
[26] *Id.* at *10.
[27] *Id.*
[28] *Id.*
[29] *Id.* at *9.
[30] R&R at 7.
[31] *Id.* at 7.
[32] *Id.* at 7-8.
[33] *Id.* at 8.
[34] R&R at 10.
[35] *Id.* (citing *In re QSI Holdings*, 571 F.3d at 550 ("the plain language of § 546(e) simply does not require a 'financial institution' to have a 'beneficial interest' in the transferred funds"); *In re Contemporary Industries*, 564 F.3d at 987-88 ("Where statutory language is plain and does not lead to an absurd result, we must enforce it as written.")).