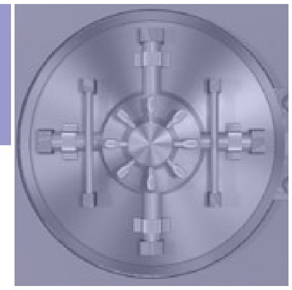

SETTLEMENT PAYMENTS IN FINANCIAL INDUSTRY TRANSACTIONS: HOW SAFE IS THE HARBOR?

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The limitations of avoidance powers set forth in §546 of the Bankruptcy Code include provisions aimed at providing a safe harbor against avoidance of "settlement payments" made in connection with various financial industry transactions. Broadly stated, these provisions preclude application of preference, strong arm or constructively fraudulent transfer theories to avoid "settlement payments" made in connection with securities transactions involving certain enumerated market participants. While many of the reported decisions regarding these transactions emanate from the fraudulent transfer challenges to leveraged buyouts in the 90's, the increasing prevalence of complex financial transactions to fund the operations of even middle market companies has brought new and increased relevance to the Bankruptcy Code's protection of settlement payments.

The Court of Appeals for the Third Circuit has described the settlement payment safe harbor provisions as "at the intersection of two important legislative policies on a collision course—the policies of bankruptcy and securities law." In re Resorts International, 181 F.3d, 505, 515(3d Cir. 1999). Recent cases suggest that there may be a bankruptcy specific collision brewing—one between courts of different circuits as to just how deep, and how safe, the safe harbor is.

I. The Language of the Statute

In the securities industry, a settlement payment is any transfer made to complete any securities transaction. The simplest form of settlement payment is the check delivered by an individual buying shares of publicly traded stock from their broker. The routine securities transaction actually involves two settlements. There is a "street side" settlement between the brokers who buy and sell the stock and the clearing agency, and a "customer-side" settlement between the broker and the customer.

Section 546 sets forth three separate safe harbor provisions that exempt settlement payments from avoidance under the strong arm, preference or constructive fraudulent transfer provisions of Chapter 5. Section 546(e) is the broadest, protecting from avoidance prepetition margin or settlement payments to or by commodity brokers, forward contact merchants, stockbrokers, financial institutions, financial participants or securities clearing agencies. Section 546(f) protects payments made by or to a repo participant or financial participant in connection with a repurchase agreement. Section 546(g) precludes avoidance of prepetition payments made by or to a swap participant or financial participant under or in connection with any swap agreement.

The wider breadth of §546(e)'s provisions has subjected that section to somewhat more extensive judicial scrutiny to date than the other safe harbor provisions have received.. The language of the section is 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, a settlement payment, as defined in section 101 or 741 of this title made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

11 U.S.C. §546(e). On its face, therefore, the statute provides that if a "settlement payment," or a "margin payment," was made by or to one of the identified links in a financial transaction chain, that payment is exempt from avoidance, unless it constitutes a fraudulent transfer made with actual intent to hinder delay or defraud within two years before the petition date and is therefore avoidable under section 548(a)(1).

Tracing the definitions set forth in §101 for the parties listed in §546(e) that payment must be made by or to in order for the transaction to be protected from avoidance reveals that a broad scope of financial industry participants are within the umbrella. By way of example, a "financial institution," includes:

> (A) a Federal reserve bank, or an entity (domestic or foreign) that is a commercial or savings bank, industrial savings bank, savings and loan association, trust company, federally-insured credit union, or receiver, liquidating agent or conservator for such entity and, when any such Federal reserve bank, receiver, liquidating agent, conservator or entity is acting as agent or custodian for a customer in connection with a securities contract (as defined in section 741) such customer; or
>
> (B) in connection with a securities contract (as defined in section 741) an investment company registered under the Investment Company Act of 1940.

11 U.S.C. §101 (22).

While the definitions of those whose participation in a settlement payment in order to obtain protection from avoidance are broad, the Bankruptcy Code-provided language as to what constitutes a settlement payment has been described by at least one court as being "as opaque as it is circular." Brandt v. Hicks, Muse & Co., (In re Healthco International, Inc.), 195 B.R. 971, 983 (Bankr. D. Mass. 1996). Indeed, the attempted definition of settlement payments does little more than repeat the words settlement payment several times with a different modifier preceding the term that the Code section purports to define. Section 741(8) defines a settlement payment 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." 11 U.S.C. §741(8).

II. Case Law—Three Approaches

The case law relating to the safe harbor from avoidance of settlement payments evidences three distinct approaches taken by courts. The first, most recently adopted by the Bankruptcy Court for the Western District of Michigan in the Quality Stores case,[1] originally articulated in two decisions of the Court of Appeals for the Eleventh Circuit in the Kaiser Steel cases[2] and adopted by the Court of Appeals for the Third Circuit in the Resorts International case,[3] views the statutory text as mandating an extremely broad definition of protected settlement payments, essentially holding that any transaction that involves some sort of security that passes through one of the identified market participants, including a payment through a financial institution, is immune from avoidance. The second, set forth in such decisions as Healthco from the Bankruptcy Court for the District of Massachusetts, and adopted by the Eleventh Circuit Court of Appeals in the Munford case,[4] focus on the degree of participation of the defined market participants that there must have been a settlement payment made "by or to" for the transaction to be protected from avoidance, and hold that if the defined market participant was a mere conduit, no payment was made by or to that entity and the transaction is not protected from avoidance. The third approach, evidenced in three reported decisions in the Enron case,[5] examines whether the alleged settlement payment was in fact the type of transaction that is "common within the securities trade," which those decisions view as a precondition to entitlement to protection as a "settlement payment.

In addition to framing the debate regarding the scope of section 546's safe harbor for settlement payments, some of these decisions provide a primer on the types of transactions the financial markets are engaging in, the roles of the various participants in the market and the travel of the various transaction types. Some, in particular the Enron case where over twenty of the defendants in a preference action were fiduciary trusts, family foundations or individuals, debunk any thought that the need to understand the financial market related provisions of the Bankruptcy Code is limited to large firms engaged in a Wall Street practice.

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[1] In re Quality Stores, Inc., 355 B.R. 629 (Bankr. W.D. Mich 2006).

[2] Kaiser Steel Corporation v. Charles Schwab & Co., 913 F.2d 846 (10^{th} Cir. 1990) and Kaiser Steel v. Pearl Brewing Company (In re Kaiser Steel), 952 F.2d 1230 (10^{th} Cir. 1991).

[3] The Court of Appeals for the Third Circuit had initially stated its view that the text of the statute required a broad view of the definition of a protected settlement payment in connection with repurchase agreement provisions of §546(f) in a case that predates the Kaiser Steel decisions in Bevill, Bresler & Schulman Asset Management Corp. v. Spencer Savings & Loan Association, 878 F. 2d 742 (3d Cir. 1989).

[4] Munford v. Valuation Research Corp., (Matter of Munford), 98 F. 3d 604 (11^{th} Cir. 1996).

[5] Enron Corp. v. Bears Stearns International Ltd. (In re Enron Corp.) 323 B.R. 857 (Bankr. S.D.N.Y. 2005); Enron Corp. v. J.P. Morgan Securities (In re Enron Corp.), 325 B.R. 671 (Bankr. S.D.N.Y. 2005); and Enron Corp. v. International Finance Corp. (In re Enron Corp.), 341 B.R. 451 (Bankr. S.D.N.Y. 2006)

A. The Textually Based "Broad" Approach.

The cases adopting the approach that the text of §546(e) and the incorporated by reference definition of settlement payment set forth in §741(8) mandates a conclusion that the safe harbor for settlement payments is broad, encompassing virtually any transaction involving a security transfer where any of the defined market participants were at all involved, all arise in cases involving challenged leverage buyouts. The most recent such opinion, the Quality Stores decision, is illustrative of both the transaction at issue and the analysis of the other courts adopting this approach.

In Quality Stores, an acquirer gained control of the debtor entity through a leveraged buyout. The acquirer purchased the stock of the pre-transaction equity holders for $208 million, of which $111.5 million was paid in cash and $91.8 million was paid in stock of the acquirer. The cash component of the consideration to be paid to the pre-transaction shareholders was obtained by the acquirer through a loan that was secured in part through a lien on all assets of the post-transaction debtor's assets. Both the consideration to be paid by the acquirer, and the shares tendered by the target-debtor's pre-transaction equity holders, were deposited with HSBC bank, which acted as an exchange agent. Upon closing, HSBC distributed the acquisition consideration to the pre-transaction shareholders, and transferred the tendered shares to the acquirer.

Post-petition, the debtor, through its chief litigation officer, brought a fraudulent transfer action against the former equity holders and the acquirer. The defendants in the fraudulent transfer action defended on the grounds that, because the transaction involved a transfer of securities, and because the exchange of the consideration and the stock were effected by HSBC, an entity that fell within the Bankruptcy Code definition of a "financial institution," the transaction was insulated from avoidance by §546(e)'s safe harbor provisions.

The Bankruptcy Court, reluctantly, agreed. After a lengthy discussion of the Tenth Circuit's decisions in the Kaiser Steel cases, the Court in Quality Stores adopted the view expressed in Kaiser Steel that the Bankruptcy Code's definition of "settlement payment" is "extremely broad," In re Quality Stores, 355 B.R. at 633, "meant to encompass any transfer which would be considered a settlement payment in the securities industry." Id. It favorably quoted the Tenth Circuit's statement that the securities industry's view of a settlement was "the completion of a securities transaction," and included "the transfer in consideration in an LBO." Id. While the Court in Quality Stores found some merit in views expressed by other courts that the Congressional policy underlying §546(e) of "minimiz[ing] the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries," id at 634, was not furthered by application of the safe harbor to avoidance actions relating to private transactions like the LBO at issue, and in the position of the courts in the Healthco and Munford cases that use of a financial institution as a mere conduit without involvement in the transaction as an actual transferee was insufficient to implicate any one of the listed transactional participants required to insulate that transfer from avoidance, it expressly rejected both positions as result-based policy decisions that were not consistent with the language of the statute. Id. at 634.

B. The Threshold Level Of Participation Approach

Apparently not sanguine with the practical implication of the textual interpretation made by courts like the Tenth Circuit in Kaiser Steel and the bankruptcy court in Quality Stores, that "transferees of an otherwise possibly avoidable fraudulent conveyance [could] insulate themselves from liability by using a financial institution to effectuate the settlement payment in exchange of their stock in an LBO transaction," In re Quality Stores, 355 B.R. at 634, n.5, other courts, like the bankruptcy court in Healthco and the Eleventh Circuit in Munford have established a minimum threshold of participation by one of the enumerated market participants needed to qualify for the safe harbor. In these courts' view, the statutory language that a settlement payment must be made "by or to" a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency requires more than simply using a bank as a transfer agent. Rather, in the view of these courts, the participating financial institution has to be an "actual transferee" in the sense of having at one time held a beneficial interest in the property that was the subject matter of the avoidance action, and not having simply acted as a mere conduit through which the property passed on its way to the ultimate transferee.

In explaining the rationale for its holding that a leveraged buyout in which a "financial institution within the securities and clearance system" served as a disbursing agent for the purpose of collecting and distributing the consideration paid by the acquirer and the stock tendered by the target's shareholders, Matter of Munford, 98 F.3d at 607, was not protected from avoidance by 546(e)'s safe harbor provision, the Court of Appeals for the Eleventh Circuit explained that, while the transaction at issue did involve a "settlement payment," that:

> [n]one of the entities listed in 546(e)—i.e., a commodity broker, forward contract merchant, stockbroker, financial institution, or a securities clearing agency—made or received the payment." Id. at 610. The involvement of the financial institution was not sufficient to invoke the safe harbor because, the bank was nothing more than an intermediary or conduit. Funds were deposited with the bank and when the bank received the shares from the selling shareholders, it sent funds to them in exchange. The bank never acquired a beneficial interest in either the funds or the shares.

Id. at 610.

The Court in Munford pointed to §550 as the source of statutory authority for its position. That section only authorizes recovery of an avoidable transfer from a "transferee," id. at 610 and not from a mere conduit. See also, In re Healthco, 195 B.R. at 982 ("The courts have reasoned that a party who exercises no control over the transferred property and claims no beneficial interest in it should not be held responsible for having received a fraudulent transfer."). The transfer at issue, therefore, was viewed by the Munford Court as being a direct transfer between the acquirer and the target's shareholders, therefore not involving one of the market participants that §546(e) requires payment "by or to" as condition for protection from avoidance by the statutory safe harbor.

C. The Common Market Transaction Approach

In three published opinions in the Enron case, the Bankruptcy Court for the Southern District of New York held that §546(e)'s safe harbor only protected from avoidance "those settlement payments that are 'commonly used in the securities trade.'" Enron Corp. v. Bear Stearns International, Ltd., 323 B.R. at 870. The Court based these holdings on its view that the phrase "or any other similar payment commonly used within the [securities] industry," appearing in §741(8)'s definition of "settlement payment," modified the entirety of the preceding laundry list of types of settlement payments that fit the statutory bill, and was not simply a dragnet provision seeking to catch any types of settlement payments not specifically mentioned. Id. at 870. It cited with approval language in the Ninth Circuit BAP case of In re Grafton Partners, L.P., 321 B.R. 527, 538 (9^{th} Cir. BAP 2005), to the effect that a determination of whether a transaction falls within the safe harbor from avoidance provided by §546(e) required an examination of "the operation of trades in the securities industry," Enron Corp. v. Bear Stearns International, Ltd., 323 B.R. at 866, and that the protected payments were "restricted to the securities trade and must be commonly used." Id.

Having established the ground rules, the Court in all three cases then set about the task of describing the transactions before it, the travel of the transactions through the financial industry and its view of the comparison of that path with the industry norm. As a result, each decision provides a primer on complex financial transactions worth reading.

1. Enron v. Bear Stearns International Ltd (Enron I)

Enron I involved an equity forward swap documented on a standard International Swaps and Derivatives Associations ("ISDA") form. Under the agreement, Enron agreed to purchase from Bear Stearns, and Bear Stearns agreed to sell to Enron, 323,000 shares of Enron's own publicly traded stock at an agreement-established per share price that could be paid by Enron in cash or in Enron stock. The agreement, as amended, required that the transfer occur approximately two and one-half months after the agreement's execution, subject to Bear Sterns' right to demand immediate settlement if the market price of Enron stock dipped below an agreement-established floor. The transfer occurred in accordance with the agreement in August, 2001, when Enron paid the agreement-established purchase price in cash, and Bear Stearns delivered to Enron the Enron stock.

Enron commenced its Chapter 11 case on December 2, 2001 and, on November 23, 2003 brought an adversary proceeding against Bear Stearns seeking to avoid the transfer by recovering the $25,904,602.50 purchase price that Enron had paid for its own stock as a fraudulent transfer. Bear Stearns moved to dismiss the complaint on the basis that the challenged transaction was a settlement payment shielded from avoidance by §546(e).

The Court determined, based upon publicly filed documents, that Bear Sterns was a "stockbroker," and therefore fell within the statutorily enumerated market participants that had to participate in a transaction in order to invoke the safe harbor. Although it agreed in principle with statements in prior decisions that the term "settlement payment" was intended by Congress to be construed broadly, it stated that the definition was not intended to be "boundless." Enron Corp. v. Bear Sterns International Ltd., 323 B.R. at 865. Rather, the Court held that "in order to qualify as a settlement payment that is protected by the safe harbors, the settlement payment must be 'commonly used' within the [securities] industry." Id. at 870.

Based upon an analysis of substantive Oregon law, applicable because the Enron entity that was involved in the transaction was an Oregon corporation, the Court determined that, under that state's law, a corporation's acquisition of its own stock at a time when it was insolvent is a void act, "of no legal effect at all." Id. at 876. The Court went on to state that, "[i]f the Oregon law was violated, the payment cannot be a settlement payment because the transaction is void and there is no settlement obligation to discharge nor any securities transaction to complete." Id. "Therefore, the payment could not be considered a settlement payment that qualifies for protection from avoidance under section 546(e) of the Bankruptcy Code." Id. at 879.

2. Enron Corp. v. J.P. Morgan Securities, Inc. (Enron II)

Enron II involved Enron's actions as to approximately $1 billion of its commercial paper. The commercial paper, essentially uncertificated debt undertakings, was issued and sold by Enron in accordance with an offering memorandum dated September 14, 2001. That memorandum provided for maturities on the commercial paper of up to 270 days, and further provided that the commercial paper was not subject to prepayment or early redemption.

The commercial paper was purchased by J.P. Morgan, Goldman Sachs and Lehman for their own accounts, as market makers, on behalf of their customers and as dealers. These entities traded much of the paper out, effecting trades to brokers and financial institutions that in turn sold the paper to their customers. Payments for the purchases were cleared through the Depository Trust Company.

Between October 26 and November 6, 2001, Enron, allegedly in response to market pressure arising from its increasingly public financial difficulties, paid out over $1 billion in connection with the commercial paper, and filed its Chapter 11 case less than a month after the last payment, on December 2, 2001. In its case, it commenced an adversary proceeding seeking to avoid the transfers totaling more than $1 billion as preferential.

Enron alleged that the payment was in early satisfaction of its obligations under the commercial paper. The more than 120 defendants in the action alleged that the funds were paid by Enron to acquire its commercial paper. It was undisputed, however, that the payment amounts were approximately at par and exceeded the then-market value of the commercial paper.

The defendants all sought dismissal of the adversary proceeding, asserting that §546(e) provided a safe harbor from avoidance for the transaction. They pointed out that virtually every imaginable market participant was in the chain of transfers, and asserted that the transfers constituted settlement payments.

The Court restated its position set forth in Enron I, that in order to be a settlement payment the transfer had to be one "commonly used in the securities trade." Enron Corp. v. J.P. Morgan Securities, Inc., 325 B.R. at 686. It indicated that the determination of whether the transactions at issue were common to the securities trade was an evidentiary issue and, therefore, could not be decided on a motion to dismiss. The Court indicated that it viewed the issue at trial to be, "whether payments made with respect to short-term commercial paper prior to the maturity date, at significantly above market prices and contrary to the offering documents in the midst of coercion by the holders of the commercial paper resulting from public announcements that make clear that the company is in a severe financial crisis constitute settlement payments commonly used in the securities trade." Id.

3. Enron Corp. v. International Finance Corp. (Enron III)

In Enron III, Enron sought to avoid transfers made in connection with a collateralized loan obligation, or CLO. In the CLO, Enron monetized a portfolio of loan facilities it had by transferring those facilities to a special purpose entity it established, referred to as "Holding." A trust was formed ("Trust") that became the sole equity holder of Holding. Trust sold notes under which it was the obligor in the market. Trust's obligations under those publicly sold notes were secured by Trust's equity interest in Holding. Trust would satisfy the notes it had sold in the market with funds received from Holding's collections in connection with its loan portfolio. Trust also passed the proceeds it received from sale of the notes to Holding, which passed the funds through to Enron to satisfy the purchase price for Holding's purchase of the loan portfolio from Enron.

When the loan portfolio owned by Holdings declined in value, Holdings exercised a put right it had against Enron, compelling Enron to acquire part of Holdings' loan portfolio at par. Holdings used the money it received from Enron to pay Trust, which in turn paid the funds to the holders of the notes Trust had sold to the market. When Holdings' loan portfolio continued to decline in value, Enron went to the market and purchased the notes issued by Trust directly from the holders of those notes. Enron bought the notes at par, which was above the then-market value of those notes. Enron paid the consideration for the notes of the holders through a wire transfer to Chase Manhattan, and the note holders effected the transfer of their notes to Enron through accounts at Bear Sterns.

In its Chapter 11 case, Enron sought to avoid the payments it made to the holders of the notes that Trust had issued. It asserted that its payment of par for notes that had a market value considerably below par at a time Enron was insolvent constituted fraudulent transfers.

The defendants moved to dismiss, asserting that the transactions constituted settlement payments immune from avoidance under §546(e). The Court agreed, and dismissed the complaint.

The Court ruled that the transaction at issue had sufficient involvement by an enumerated market participant to satisfy that prong of the safe harbor, noting that "[a]ll of the transactions involved transfers either to or from Chase [a financial institution] and BSSC and/or Bear Sterns [stockbrokers]." It restated its previous rulings in Enron I and Enron II that, to be considered a protected settlement payment, "the payment must be common in the securities trade." Enron Corp. v. International Finance Corp., 341 B.R. at 459. It found that, unlike the transactions in Enron I and Enron II, Enron's payment to purchase notes issued by Trust for more than market value were in fact payments common in the securities trade, holding that "[a] divergence in the price paid from the market value, by itself, is ordinarily not sufficient to take a particular transaction out of the realm of one 'normally regarded' as part of the settlement process ...." Id. It distinguished Enron III from Enron I and Enron II by characterizing those prior cases as involving "outright illegality or transparent manipulation," id., in that Enron I related to a transaction prohibited by applicable state law and Enron II involved early payment in contravention of the terms of the offering documents of an above-market price in response to market coercion. Id. at 458.

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