

Defending the Preference and Fraudulent Transfer Safe Harbor

Part One of a Two-Part Article

By Michael L. Cook

The Bankruptcy Code (“Code”) has at least nine so-called “safe harbor” (i.e., bankruptcy insulating) provisions for financial contracts. *See, e.g.*, §§ 555 (securities contracts); § 556 (commodities and forward contracts); § 559 (repurchase agreements); § 560 (swap agreements); § 561 (master netting agreements); § 546(e) (settlement payments); § 548(d)(2)(b) (fraudulent transfers); and §§ 362 and 553 (setoffs). Added incrementally by Congress between 1982 and 2005, with a technical amendment in 2006, these provisions essentially: 1) immunize nondebtor parties from the automatic stay as it applies to the termination of contracts; 2) permit nondebtor parties to enforce *ipso facto* termination provisions; 3) immunize nondebtor parties from avoidance actions (e.g., preferences, fraudulent transfers); and 4) immunize nondebtor parties from the automatic stay as it applies to the setoff of mutual debts. As shown below, some lower courts have inconsistently enforced those safe harbor provisions in the preference and fraudulent transfer context, generating costly litigation for the asserted cause of creditor recovery.

THE NEEDLESS LITIGATION PROBLEM

Bankruptcy trustees, Chapter 11 debtors-in-possession, and other statutorily authorized entities pursuing fraudulent transfer and preference claims, have, for at least the past 25 years, relentlessly resisted the specific safe harbor of Code § 546(e), which insulates from a preference and constructive fraudulent transfer attack, among other things, “a [pre-bankruptcy] settlement pay-

ment, as defined in section 101 or 741 ... made by or to a ... stockbroker, financial institution” Because the plaintiffs have been able to convince some lower courts to accept novel ways around § 546(e), they have extracted recoveries for the estates they represent. *See e.g., Wieboldt Stores, Inc. v. Schottenstein*, 131 B.R. 655, 663-65 (N.D. Ill. 1991) (Code § 546(e) did not prevent fraudulent transfer recovery from selling shareholders because Congress intended only to protect brokers and clearing agencies); *In re Norstan Apparel Shops, Inc.*, 367 B.R. 68, 76-77 (Bankr. E.D.N.Y. 2007) (definition of settlement payment does not encompass payments for privately held securities); *Jewel Recovery, L.P. v. Gordon*, 196 B.R. 348, 353 (N.D. Tex. 1996) (held, Code § 546(e) not applicable to private stock purchase; Code § 546(e) only “appl[ies] to settlement payments in the clearance and settlement process in the public market”).

THE EMERGING APPELLATE COURT CONSENSUS

Five circuits, including three in 2009, have read the Code’s plain language to enforce the § 546(e) safe harbor despite some contrary lower court rulings. *In re Plassein Int’l Corp.*, 590 F.3d 252. (3d Cir. 12/22/09); *In re QSI Holdings*, 571 F.3d 545 (6th Cir. 2009); *Contemporary Inds. Corp. v. Frost*, 564 F.3d 981, 986 (8th Cir. 2009); *Kaiser Steel Corp. v. Charles Schwab & Co.*, 913 F.2d 846 (10th Cir. 1990) (“*Kaiser I*”); *Kaiser Steel Corp. v. Pearl Brewing Co. (In re Kaiser Steel Corp.)*, 952 F.2d 1230 (10th Cir. 1991) (“*Kaiser II*”); *Jonas v. Resolution Trust Corp. (In re Comark)*, 971 F.2d 322 (9th Cir. 1992); *In re Resorts Int’l, Inc.*, 181 F.3d 505 (3d Cir. 1999) (“*Resorts*”); *In re Bevil, Bresler & Schulman Asset Mgmt. Corp.*, 878 F.2d 742 (3d Cir. 1989) (“*Bevil*”). *See also In re Nat’l Gas Distrib., LLC*, 556 F.3d 247 (4th Cir. 2009) (reversing bankruptcy court, held commodities forward agreement insulated as swap agreement from fraudulent transfer attack by Code §§ 546(g) and 548(d)

(2) safe harbor provisions). *But see In re Munford, Inc.*, 98 F.3d 604, 610 (11th Cir. 1996) (2-1) (... § 546(e) ... not applicable since ... transaction did not involve a transfer to one of the listed protected entities.”). In 2008, one commentator complained that by “using the rhetoric of ‘plain meaning’ and by looking only to the securities trade for a definition of [settlement payment] ... the courts seem to have insulated far more types of transactions than would be necessary to provide the protection that Congress intended.” Christopher W. Frost, “Settlement Payments and the Safe Harbor Section 546(e)” 28 *Bankr. Letter* 1, 9 (May 2008). In this writer’s view, however, some courts have forced recoveries that Congress (rightly or wrongly) never intended. And Congress has only added more safe harbor provisions to the Code since 1982, showing no intention to limit their application.

Two other commentators, in 2005, found nothing wrong with applying the Code’s plain language. “As long as a pre-petition payment fits within industry definitions of ‘settlement payment’ ... it is protected from avoidance ... [T]here is little to commend a rule that varies the Code’s protections based on a court’s assessment of its importance to market stability.” Edward R. Morrison & Joerg Riegel, “Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges,” 13 *Am. Bankr. Inst. L. Rev.* 641, 662-63 (2005) (“Morrison”). *See, e.g., In re Plassein* at *16 (“We will not ignore the plain language ... which governs the present dispute.”).

A RECENT HARD CASE

The so-called Enron Commercial Paper litigation, started over six years ago in November, 2003, two years after Enron Corporation sought Chapter 11 relief, graphically shows how expensive and time-consuming preference and fraudulent transfer disputes can be for courts and litigants. Enron sued about 200 former holders of Enron com-

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mercial paper (*i.e.*, notes), seeking to avoid and recover, as preferential or fraudulent transfers, more than \$1 billion of pre-maturity payments Enron made on Oct. 29, 2001. Significantly, Enron asserted no actual fraud in the payments to any of the defendants.

The bankruptcy court denied the defendants' motions to dismiss in 2005. *In re Enron Corp.*, 325 B.R. 671, 686 (Bankr. S.D.N.Y. 2005) ("*Enron I*"), signaling that the settlement payment defense might be limited to particular types of securities transactions not present in the case ("... the § 546(e) safe harbor only protects from avoidance ... settlement payments ... 'commonly used in the securities trade.'"). Two years later, in 2007, the district court denied motions for leave to file an interlocutory appeal made by the defendants. While all this was going on, many defendants settled with Enron, and others conducted extensive documentary and deposition discovery. The parties hired experts who were deposed extensively after writing reports on industry practices seemingly required by the bankruptcy court's 2005 decision. By 2008, those defendants who had not settled moved for summary judgment dismissing Enron's complaint now prosecuted by Enron's successor, a creditors' litigation trust. The bankruptcy court denied these motions on June 29, 2009, when only three defendants remained — two ING investment funds ("*ING*") and Alfa, S.A.B. de C.V. ("*Alfa*"). *In re Enron Creditors Recovery Corp.*, 407 B.R. 17 (Bankr. S.D.N.Y. 2009) ("*Enron II*").

ING and Alfa had sold their holdings of Enron commercial paper in October, 2001 to their stockbroker through the Depository Trust Corporation ("*DTC*") same-day settlement system — "delivery versus payment" — to complete the transfers. They never dealt with Enron. In denying summary judgment, the bankruptcy court stressed the unusual nature of Enron's pre-bankruptcy redemptions of its commercial paper, finding that the retirement of commercial paper was not a settlement payment because no securities transaction had occurred, holding that only a securities transaction involving a "transfer of ownership" could be followed by a settlement payment qualifying under § 546(e)'s safe harbor. *Enron II*, 407 B.R. at 39. When the bankruptcy court ordered a trial on the issue of whether J.P. Morgan had acted as Enron's agent during the redemptions, Alfa and ING moved in the district court for leave to appeal.

U.S. District Judge Colleen McMahon granted the defendants' motion for leave to appeal on Oct. 16, 2009. 2009 WL 3349471 (S.D.N.Y. 2009). In her 17-page opinion, Judge McMahon held that the bankruptcy

court's legal analysis was "contrary to 20 years of decisions from five Circuit Courts of Appeal" outside the Second Circuit. *Id.* at *7. Moreover, the Securities and Exchange Commission ("*SEC*") "believes the matter to have been wrongly decided." *Id.* Because the Second Circuit had yet to address the issue, *Id.* at *6, Judge McMahon ordered immediate briefing only on the safe harbor defense. *Id.* at *8. One month later, on Nov. 19, 2009, she held that ING and Alfa could not be held liable for receiving settlement payments from their stockbroker, and ordered the dismissal of the Enron litigation trust's fraudulent transfer and preference complaint. *Alfa, S.A.B. de C.V. v. Enron Creditors Recovery Corp.*, ___ F. Supp. 2d ___, 2009 WL 5174119, *1 (S.D.N.Y. 11/20/2009) ("*Enron III*"). In doing so, she held that the stockbroker's settlement payments to the defendants were insulated by the § 546(e) safe harbor, finding specifically that: 1) the Code's plain language applied to the Enron commercial paper sold here by the defendants to their stockbroker; and that 2) the payments to the defendants consummated securities transactions, thus making them settlement payments. In the words of Judge McMahon, "[t]hat is the end of the matter." *Id.* at *19. In the seventh year of the litigation, eight years after Enron's Chapter 11 filing, Enron appealed to the Second Circuit.

ANALYSIS OF THE PURELY LEGAL DEFENSE

The district court rejected each of Enron's imaginative arguments that had been accepted by the bankruptcy court. Because these issues still have to be resolved by the Second Circuit, practitioners who either prosecute or defend these claims should understand the principal issues.

THE STATUTORY TEXT

Code § 546(e) reads in relevant part as follows: *Notwithstanding sections 544, ... 547, 548(a)(1)(B) and 548(b) ... the trustee may not avoid a transfer that is a ... settlement payment, as defined in section 101 or 741 ... made by or to (or for the benefit of) a ... stockbroker, financial institution, financial participant, or securities clearing agency.*

11 U.S.C. § 546(e) (emphasis added).

It was undisputed in *Enron III* that the challenged payment passed through a "stockbroker" and that DTC is a "securities clearing agency."

Application of the safe harbor thus turned on whether Enron's cash transfers were "settlement payments." Code § 741(8) defines "settlement payment" as follows:

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) (emphasis added). Thus, a settlement payment is any mode of transferring property that may be one of any five listed clauses (including "final settlement payment"), none of which turns on commonness (the sixth option) "in the securities trade." According to Enron and the bankruptcy court, however, only a payment made as part of a "commonly used" securities transaction could qualify as a "settlement payment," forcing an inquiry as to whether the transaction was "irregular," "rare," or outside the "ordinary course." *Enron I*, at 686.

LEGISLATIVE HISTORY OF THE SAFE HARBOR

Judge McMahon succinctly summarized the relevant legislative history, noting that it had first been "enacted in 1978 in response to a" decision holding that a bankruptcy trustee was not barred "from recovering [on fraudulent transfer grounds] a margin payment made to a commodities clearinghouse." *Seligson v. New York Produce Exchange*, 394 F. Supp. 125, 128-36 (S.D.N.Y. 1975). *Enron III*, at *5. By 1982, explained the court, § 546(e) "broadened the safe harbor by extending its scope to include the securities markets ... 'beyond the ordinary course of business to include margin and settlement payments to and from brokers, clearing organizations, and financial institutions.'" *Enron III*, at *5-6, quoting *Kaiser I*, at 849, and citing H.R. Rep. 97-420, at *2 (1982). "This broad protection was designed to ensure settlement finality, and therefore market stability." *Enron III*, at *6.

Next month, we continue the discussion of the Enron transfers.

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