ALERTS

Safe Harbor Update: Still a Good Defense to Fraudulent Transfer and Preference Claims

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Appellate courts continue to agree on the vitality and breadth of the safe harbor defense contained in Bankruptcy Code ("Code") § 546(e) (insulating from the trustee's fraudulent transfer or preference attack "settlement payment" or "margin payment" on a "securities contract," "commodity contract" or "forward contract" *except* when the debtor's payment is made with "actual intent to hinder, delay, or defraud" creditors). *In re Quebecor World (USA) Inc.*, 2013 WL2460726, *1 (2d Cir. June 10, 2013) (*held*, payments by the debtor to the noteholder trustee for the noteholders "in exchange for private placement notes. . .clearly fell within the safe harbor for 'transfers made. . .in connection with a securities contract.'"); *In re Derivium Capital LLC*, 2013 WL2284876, *8 (4th Cir. May 24, 2013) (*held*, commission payments to stockbroker shielded from recovery by "settlement payment" defense; no exception for stockbroker defense in context of Ponzi scheme); *In re MBS Management Services, Inc.*, 690 F.3d 352, 355 (5th Cir. 2012) (*held*, pre-bankruptcy payments to power company for supplying electricity to the debtor's apartment complexes were settlement payments on "forward contract" for purchase of a "commodity").

Academics have unsuccessfully complained about the courts' expansive reading of Code § 546(e). *See* Lubben, *Repeal the Safe Harbors*, 18 Am. Bankr. Inst. L. Rev. 319, 329-32 (2010) (describing weaknesses of safe harbor system and arguing against recent expansive definition given safe harbors by courts); Edwards & Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?* 22 Yale J. On Reg. 91, 98 (2005) (safe

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harbors given to derivatives "encompass. . .far too many transactions."); Note, 2012 Am. Bankr. Inst. L. Rev. 423, 424 (2012) (". . .safe harbors have been expanded to include securities, commodities contracts and entities for which Congress did not envision the safe harbors affording protection."), citing *Enron Creditors Recovery Corp. v. Alfa, S.A.B.de C.V. (In re Enron Creditors Recovery Corp.)*[1] 651 F.3d 329, 339 (2d Cir. 2011) (*held*, settlement payments include the Chapter 11 debtor's pre-bankruptcy payments for early redemption of publicly traded commercial paper).

Protection for Privately Placed Note Repayments to the Noteholder Trustee with No Beneficial Interest in the Funds

The creditors' committee in *Quebecor* sued to avoid payments made by the debtor to certain noteholders "in exchange for private placement notes that had been issued by one of [the debtor's] affiliates." 2013 WL2460726, at *1. As the Second Circuit noted, the debtor "transferred funds to [the noteholder] trustee. . .in the amount and manner prescribed. . .for purchasing Notes. The parties agreed that [the noteholder trustee] is a financial institution. The [note purchase agreements] were clearly 'securities contracts' because they provided for both the original purchase and the 'repurchase' of the Notes." *Id.* at *3. In the words of the court, because "this was a transfer made to a financial institution in connection with a securities contract," it was "exempt from avoidance." *Id.*

More significant was the plaintiff committee's argument that the noteholder trustee was "only serving as a conduit or intermediary." *Id.* at *3. Noting a "split of authority regarding what role a financial institution must play in the transaction for it to qualify for the section 546(e) safe harbor," the Second Circuit followed its earlier *Enron* holding 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." *Enron*, 651 F.3d at 338, citing three other circuit courts' reliance on the Code's "plain language." *Id.*, at *3, *QSI Holdings, Inc. v. Alford (In re QSI Holdings, Inc.)*, 571 F.3d 545, 550-51 (6th Cir. 2009); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 987 (8th Cir, 2009); and *In re Resorts Int'l, Inc.*, 181 F.3d 505, 516 (3d Cir. 1999). *Contra, In re Munford, Inc.*, 98 F.3d 604, 610 (11th Cir. 1996) (per curiam) (2-1) (*held*,

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financial institution must acquire beneficial interest in transferred funds or securities for safe harbor to apply).

The Second Circuit rejected the plaintiff committee's "conduit" argument in *Quebecor*, reasoning as follows:

> "*Enron* rejected a similar argument, holding that the financial intermediary need not have a beneficial interest in the transfer. . . . To the extent *Enron* left any ambiguity in this regard, 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. . . .
>
> "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. . . . Accordingly, it was sufficient that [the debtor's] transfer was made to [the noteholder] trustee, even though [that entity] did not take title to the transferred funds."

Id. at *4-*5.

The *Quebecor* decision also contained an important footnote confirming the statutory limitation on the use of the safe harbor. "Of 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." *Id.* at *5 n.4, citing Code § 546(e), § 548(a)(1)(A), (transfer made "with actual intent to hinder, delay or defraud" the creditors expressly excluded from § 546(e) safe harbor protection). This explicit statutory limitation was also stressed by the Fourth Circuit in its recent *Derivium* decision, discussed below.

Commission Payments; No Ponzi Scheme Exception to Safe Harbor

The Fourth Circuit affirmed, among other things, in the *Derivium* case, the dismissal of the trustee's claims to recover commissions paid by a

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fraudulent stockbroker on the ground that the § 546(e) safe harbor protected those payments. Customers of Derivium transferred securities in exchange for three-year recourse loans worth 90 percent of the market value of the securities. When the loans matured, customers could either repay the principal plus interest and recover their securities, surrender the stock or refinance the loan for an additional term. Customers transferred their securities into brokerage accounts at a stockbroker that maintained accounts in the debtor's name. The debtor told its customers that they would hedge their collateral using a confidential, proprietary formula, but actually had directed the stockbroker to transfer the securities into other accounts and liquidate them, using the proceeds from the stock sales to fund, among other things, loans to other customers.

The debtor's scheme fell apart when it could no longer return the customers' securities and when the stockbroker closed its accounts. The trustee sued the stockbroker asserting several claims, including fraudulent transfer claims to recover $161 million in securities that customers had transferred into the brokerage accounts, plus commissions that the debtor had paid to the broker. After holding the customers' transfer of their securities to the broker not to have involved the debtor's property, the court then held that the debtor's commission payments were also insulated from recovery by reason of the "settlement payment" safe harbor in § 546(e), reasoning as follows:

> "Because Congress included in the definition of 'settlement payment' 'any other similar payment commonly used in the securities trade,' we also look to standard practice of the securities industry to inform the definition of 'settlement payment.' Several industry texts suggest that 'settlement payment' means the transfer of funds paid in connection with the completing of a securities transaction."

2013 WL 2284876, at *6.

Equally important was the Fourth Circuit's holding that it was not required "to establish an extra-statutory fraud exception to the stockbroker defense" contained in § 546(e). *Id.* at *8. According to the unsuccessful trustee, allowing "a broker to retain ill-gotten profits" in a Ponzi scheme would "undermine the 'equitable goals of the. . .Code.'" *Id.* Affirming the bankruptcy and district courts, however, the Court of Appeals rejected the trustee's argument for "an exception to the stockbroker defense. . .in the context of an alleged Ponzi scheme. . . ." *Id.*

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Critical to the court's holding was its finding "several express [statutory] exceptions to the [stockbroker] defense, including claims. . .under [Code] § 548(a)(1) — 'fraudulent transfers' made 'with actual intent to hinder, delay, or defraud. . . .'" *Id.* Indeed, courts have regularly held that the "existence of a Ponzi scheme [gives] rise to a presumption of actual fraud on the part of the broker, triggering the fraud exception to the stockbroker defense." *Id.*, citing *In re Manhattan Investment Fund Limited*, 397 B.R.1, 14 n.18 (S.D.N.Y. 2007), *aff'd* 328 F. App'x 709 (2d Cir. 2009). In *Derivium*, the actual fraud issue was left "unanswered" because "the parties [later] settled certain claims, and it appears the later hearing was not held." *Id.* at *8.

Preferences, Settlement Payments, Forward Contract for Commodity Purchase

The Fifth Circuit held that a debtor's pre-bankruptcy payments to a power company for supplying electricity to the debtor's apartment complexes were settlement payments exempted from the trustee's preference claim. *In re MBS Management Services, Inc.*, 690 F.3d 352 (5th Cir. 2012). According to the court, the debtor's electricity-requirements contract with the power company constituted a "forward contract" covered by Code § 101(25)(A) ("a contract (other than a commodity contract. . .) for the purchase, sale, or transfer of a commodity. . .with a maturity date more than two days after the contract is entered into. . ."). *Id.* at 355. Code § 546(e) also exempts from avoidance "a transfer that is a. . .settlement payment by or to [a]. . .forward contract merchant. . . ." *Id.* Relying on the statutory language alone, the court rejected the trustee's proffered requirements of specific quantity and delivery date, explaining that no "such limitations" existed in the Code. *Id.* at 356. Moreover, explained the court, participants in forward contracts "sell or purchase the commodity in advance to hedge against. . .price fluctuations. . . . [F]orward contacts for electricity do not typically limit the quantity sold or purchased. Instead they are generally for the entire needs or demands of the purchaser," *Id.* at 357, citing *In re Nat'l Gas Distributors, LLC*, 556 F.3d 247, 258 (4th Cir. 2009) (deflected attempts to restrict definition of "forward agreements"; supply contracts between industry participants are not *per se* excluded as forward contracts).

Case to Watch

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Pending in the Second Circuit is an appeal from the district court's ruling in *AP Services LLP v. Silva*, 483 B.R. 63, 68-69, 71 (S.D.N.Y. 12) (*held*, § 546(e) even bars state common law claims such as unjust enrichment, aiding and abetting or conversion when the underlying facts show that the plaintiff seeks to undo a transaction otherwise insulated by § 546(e).). In *AP Services*, the court dismissed a litigation trustee's fraudulent transfer complaint under New York Law (Code § 544(b) and NY Debt & Cred. Law § 278) when a failed leveraged buyout preceded bankruptcy by three years. The debtor transferred funds "directly to [the selling shareholder defendants'] bank accounts and did not pass. . .through a clearing house or [similar] intermediary." *Id.* at 68. According to the district court, the "transaction fits within [the Code's] safe harbor." *Id.* at 69. Neither the Code nor "case law indicates that an intermediary is 'necessary' to trigger the safe harbor." *Id.* Moreover, "every circuit but one" has held that "§ 546(e) is not limited to publicly traded securities but also extends to transactions, such as the [one] here, involving privately held securities." *Id.*

Comment

Only Congress can amend the Code's safe harbor provision, much to the chagrin of certain academic commentators. Because Congress has only expanded the safe harbor between 1982 and 2006, however, parties seeking certainty need only look to the Circuit Courts of Appeals, whose interpretations of the § 546(e) safe harbor are "extremely broad." *Enron*, 651 F.3d at 334; *QSI Holdings*, 571 F.3d at 549.

Authored by Michael L. Cook.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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[1] SRZ represented the successful appellee, Alfa, in the *Enron* litigation.

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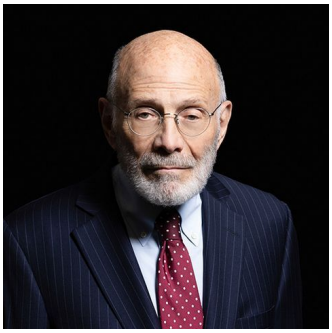

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