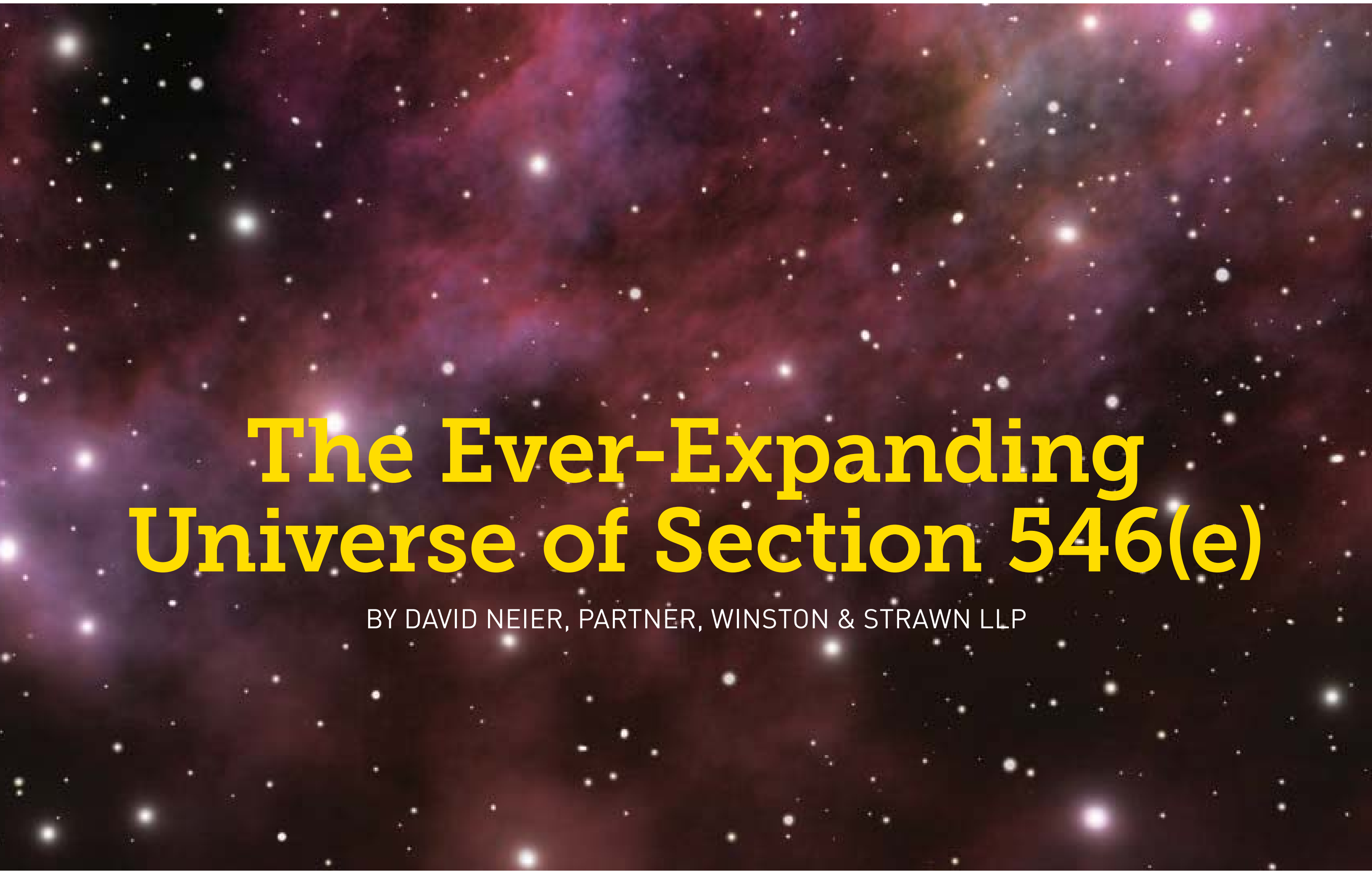

The Ever-Expanding Universe of Section 546(e)

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Section 546(e) of the U.S. Bankruptcy Code has expanded to the point that every bankruptcy, corporate finance, and M&A practitioner now needs to be intimately familiar with it. Indeed, virtually any transaction now has the potential of being substantially immunized from any fraudulent conveyance and preference exposure.

Despite all the current complexity of the litigation, the purpose behind Bankruptcy Code Section 546(e) is relatively simple. Congress wanted to ensure that transactions in the financial markets and through financial institutions were protected from avoidance actions. Failure to protect such transactions could cause investors to lose confidence in the safety and finality of such transactions.

Thus, Section 546(e) was enacted so as "to protect the nation's financial markets from the instability caused by the reversal of settled securities transactions." *Kaiser Steel Corp. v. Charles Schwab & Co.*, 913 F.2d 846, 848 (10th Cir. 1990)). Given the volatile and highly interconnected nature of the financial markets, Congress was concerned that a major bankruptcy filing could lead to attempts to unwind the debtor's prior securities transactions and present the "danger of a 'ripple effect' [] on the entire market." *Id.* at 849 (quoting H.R. Rep. 97-420, at 1 (1982), as reprinted in 1982 U.S.C.C.A.N. 583, 583)).

Section 546(e) of the Bankruptcy Code provides as follows:

> Notwithstanding sections 544 [which allows a bankruptcy trustee to pursue actions under state fraudulent transfer laws]... 548(a)(1)(B)[] and 548(b) of this title, [both of which empower the bankruptcy trustee or debtor to avoid certain constructive fraudulent transfers,] the trustee may not avoid a transfer that is a ... settlement payment, as defined in section ... 741 of this title [which refers to settlement payments commonly used in the securities trade], made by or to (or for the benefit of) a ... financial institution ... that is made before the commencement of the case.... 11 U.S.C. § 546(e).

Although drafted obtusely, Section 546(e) establishes a "safe harbor" protecting settled securities transactions from being subject to a constructive fraudulent transfer action that is filed after one party to that transaction files for bankruptcy. The Second Circuit has held that Section 546(e) of the Bankruptcy Code provides a complete defense to such actions. *In re Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V. (In re Enron Creditors Recovery Corp.),* 651 F.3d 329 (2d Cir. 2011) (early repayment of commercial paper by debtor was a settlement payment and therefore exempt from fraudulent transfer laws).

The Second Circuit in *Enron* determined that the language of what constitutes a settlement payment should be interpreted "broadly." As a result, the Second Circuit held that prepetition payments made within the 90-day preference period by Enron to retire unsecured commercial paper prior to its maturity were not avoidable as preferential transfers.

The payments, which were made one day prior to maturity, redeeming the commercial paper, were funneled to individual holders through certain broker-dealers. The trustee in *Enron* argued that 546(e) was intended to cover only securities transactions in the public markets, not transactions involving debt instruments such as commercial paper. The Second Circuit disagreed, finding that repayment of commercial paper, which typically consists of low-interest, short-term loans by high-net-worth companies, was precisely the kind of market transaction that Bankruptcy Code Section 546(e) was intended to protect and dismissed the preference actions against the holders of Enron commercial paper.

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The broad interpretation of Section 546(e) and the definition of what constitutes a "settlement payment" have also been endorsed by the Third, Sixth, Eighth, Ninth, and Tenth Circuits.

A number of courts have attempted to provide guidance as to the types of transactions that fall within Section 546(e)'s protection. In the bankruptcy case of *In re Adler Coleman Clearing Corp.*, 263 B.R. 406, 478-485 (S.D.N.Y. 2001), the court identified five considerations for determining whether a transaction qualifies as a "settlement payment" under Bankruptcy Code Section 546(e), including whether:

1. The transaction has long been settled by means of actual transfer of consideration, so that subsequent reversal of the trade may result in disruption of the securities industry, creating a potential chain reaction that could threaten collapse of the affected market
2. Consideration was paid out in exchange for the securities or property interest as part of settlement of the transaction
3. The transfer of cash or securities affected contemplates consummation of a securities transaction
4. The transfers were made to financial intermediaries involved in the national clearance and settlement system
5. The transaction implicated participants in the system of intermediaries and guarantees that characterize the clearing and settlement process of public markets and therefore would create the potential for adverse impacts on the functioning of the securities market if any of those guarantees in the chain were invoked

In re Adler Coleman Clearing Corp., 263 B.R. at 479-80 (citations omitted). Any transaction that has these characteristics is effectively immunized from preference and constructive fraudulent conveyance actions.

Pushing the Envelope

Several recent decisions have pushed the 546(e) defense envelope even further than *Enron* did. In *Picard v. Katz (In re: Madoff)*, 462 B.R. 447 (S.D.N.Y. 2011), the District Court determined that payments made by a broker on account of "investments" in securities that were in fact completely fictional constituted settlement payments subject to Bankruptcy Code Section 546(e) and therefore were not payments subject to avoidance.

In the more recent case of *In re Quebecor World (USA) Inc.,* 719 F.3d 94 (2d Cir. 2013), the prepetition debtor attempted to avoid a covenant default on junior notes that would have caused a cross-default of senior notes by redeeming the junior notes and paying a make-whole premium. The company then ended up filing for bankruptcy within 90 days of having made the payment.

On its face, this is exactly the type of transaction preference laws were intended to address. A junior creditor was preferred at a time when the company was insolvent. Nevertheless, the Second Circuit easily determined that the payment fell within the safe harbor of protected transactions under Section 546(e), in that the payments to the junior noteholders were paid to a financial institution, which then disbursed payments to the junior noteholders.

Bankruptcy Code Section 546(e) has also been held to preempt state fraudulent transfer laws. If the purpose of Section 546(e) is to protect certain transactions and thereby inspire confidence in the financial markets, it would do little good to permit state law actions to serve as an end run to frustrate this purpose. See *U.S. Bank N.A. v. Verizon Commc'ns Inc.,* No. 3:10-CV-1842-G, 2012 WL 4050088, at*18-19 (N.D. Tex. Sept. 14, 2012) (holding that § 546(e) preempted state law unlawful dividend claim to recover a $2.4 billion payment in a spin-off transaction that was protected by Section 546(e) because "allowing the plaintiff in this case to recover for the cash payments under state unlawful dividend statute would render section 546(e) meaningless"); *Hechinger Inv. Co.*, 274 B.R. 71, 96-98 (D. Del. 2002) (holding that § 546(e) preempted state law unjust enrichment claim to recover payments to shareholders in a leveraged buyout (LBO) because "the exemption set forth in section 546(e) would be rendered useless" if the payments could be recovered under state law and would "implicate the same concerns regarding the unraveling of settled securities transactions," "which is precisely the result that section 546(e) precludes").

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Even state intentional fraudulent transfer claims may be preempted by Section 546(e). Although it makes sense to preempt state constructive fraudulent transfer law claims so as to preclude an end run around Bankruptcy Code Section 546(e), why should state law claims for intentional fraudulent transfer also be precluded? What public policy is served by allowing a safe harbor to protect an intentional fraud? Although it may be on the outer fringes of both logic and how far Section 546(e) can be stretched, there is already some precedent that state law claims for intentional fraudulent transfer are also prohibited.

In *Katz*, the District Court granted, in part, the defendants' motion to dismiss a trustee's amended complaint. The court ruled that the safe harbor provision in Section 546(e) is applicable to all state law claims, including claims based on intentional fraud. There is no discussion in *Katz* as to why state law claims for intentional fraud should be dismissed.

Indeed, such a result seemed to be contrary to the intent of Bankruptcy Code Section 546(e) to not protect intentionally fraudulent transactions. The most one can glean from the decision is that since Section 546(e) prohibits any action under Bankruptcy Code Section 544 (which allows a trustee to sue under state fraudulent transfer laws), the plain words of the statute preempt state law claims based on intentional fraud.

Following *Katz*, in *AP Services v. Silva*, 483 B.R. 63 (S.D.N.Y. 2012), District Judge Lewis A. Kaplan relied on Bankruptcy Code Section 546(e) to dismiss all claims except for breach of fiduciary duty arising out of an LBO with respect to ChemRx Corporation. The only connection to the securities markets or a financial intermediary in the case was the wiring of funds from the LBO to the defendants' bank accounts.

Nevertheless the court had no issue with finding that Bankruptcy Code Section 546(e) applied. In addition, similar to *Katz*, without discussion, the court dismissed all state law fraudulent transfer claims alleging intentional fraud based on the "plain language" of Section 546(e). *Id* at 70.

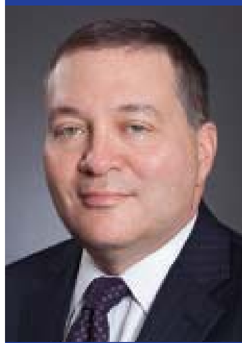
Attempted End Runs

Litigation trusts in *Tribune*, *Lyondell*, and other cases have attempted end runs around Bankruptcy Code Section 546(e) by proposing plans of reorganization that assign the direct state law fraudulent transfer claims of creditors to a trustee. However, thus far the courts have not permitted such assignments to frustrate the purpose behind Section 546(e).

In *Hechinger*, for example, plaintiffs argued that their state-law claims for unjust enrichment and unlawful dividend were not expressly foreclosed under Section 546(e) because they were not brought pursuant to "section 544" and did not seek to "avoid" the settlement payments at issue. The court nonetheless held the state claims barred under Section 546(e), holding that permitting the actions to go forward would allow the plaintiffs effectively to obtain the same relief Congress had prohibited and render the Section 546(e) exemption meaningless. *Hechinger*, 274 B.R. at 94, 96.

Most recently, in *Whyte v. Barclays Bank PLC,* 494 B.R. 196 (S.D.N.Y. 2013), the District Court held that a similar safe harbor for swap transactions, Bankruptcy Code Section 546(g), prevents creditors' claims that were assigned along with Chapter 5 federal avoidance claims to a litigation trust organized pursuant to a Chapter 11 plan from being asserted.

If the current trend with respect to Bankruptcy Code Section 546(e) litigation continues, it will be possible to extend the safe harbor to encompass almost any transaction. There are numerous critics of this current trend, and numerous cases that will further determine just how large the safe harbor afforded by Bankruptcy Code Section 546(e) should be are pending. One thing for certain is that professionals working on LBOs and other highly levered transactions have found a new friend in Bankruptcy Code Section 546(e).



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[1]See *Contemporary Indus. Corp v. Frost*, 564 F.3d 981, 986 (8th Cir. 2009) (quoting *In re Resorts Int'l., Inc.*, 181 F.3d 505, 515-16 (3d Cir. 1999)); *In re QSI Holdings*, 571 F.3d 545, 548-50 (6th Cir. 2009); *In re Plassein Int'l. Corp.*, 590 F.3d 252, 257-58 (3d Cir. 2009); *In re Bevill, Bresler & Schulman Asset Mgmt. Corp.*, 878 F.2d 742, 751-52 (3d Cir. 1989) ("Section 741(8) . . . gives an extremely broad definition of 'settlement payment' . . . [I]t is clear that 'settlement payment' does not only mean payment of cash to the dealer by the purchaser, but also encompasses transfer of the purchased securities to the purchaser from the dealer"); *Jonas v. Resolution Trust Corp. (In re Comark)*, 971 F.2d 322, 326 (9th Cir. 1992) (where reverse repo participant delivered additional securities to debtor as additional margin for purchase price, debtor returned additional securities to reverse repo participant upon withdrawing from transaction and return of additional securities fell within broad definition of "settlement payment" and was not avoidable as preference under Bankruptcy Code Section 546(e)); *Wyle v. Howard, Weil, Labouisse, Friedrichs Inc. (In re Hamilton Taft & Co.),* 114 F.3d 991, 993 (9th Cir. 1997) ("[W]e have broadly construed the term 'settlement payment' to 'include[] a transfer of securities that completes a securities transaction" (quoting *In re Comark*, 971 F.2d at 326); *In re Kaiser Steel Corp.*, 952 F.2d at 1237-1240 (definition of "settlement payment" is "extremely broad;" exchange of stock for consideration in LBO was "settlement payment" under Bankruptcy Code Section 546(e)); *PHP Liquidating, LLC v. Robbins*, 291 B.R. 592, 596 (D. Del. 2003) (stock redemption payments made by debtor and cleared through stockbrokers were settlement payments under Bankruptcy Code Section 546(e)); see also *In re Slatkin,* 525 F.3d 805 (9th Cir. 2008); *QSI Holdings, Inc. v. Alford,* 382 B.R. 731 (W.D. Mich. 2007), affirmed, 571 F.3d 545, 51 (6th Cir. 2009) (noting definition of settlement payment is "extremely broad" and exempting LBO merging two companies from constructive fraudulent transfer action), cert. denied, 130 S. Ct. 1141 (2010); *Contemporary Indus. Corp. v. Frost (In re Contemporary Indus. Corp.)*, 564 F.3d 981, 986 (8th Cir. 2009) (settlement payment exemption applies broadly and includes private transactions); *In re Olympic Natural Gas Co.,* 294 F.3d 737 555 (5th Cir. 2002) (payments under natural gas sales and purchase contract were insulated under Bankruptcy Code Section 546(e)).