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The Evolving Scope of "Settlement Payments" under § 546(e)

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The bankruptcies of large institutions such as Enron Corp. and Lehman Brothers Holdings Inc. have had lasting effects on financial markets and are now significantly affecting interpretation of laws at the intersection of bankruptcy and securities practice. Specifically, the limitations on avoiding fraudulent transfers and preferences under § 546(e) of the Bankruptcy Code are being molded in the context of these large cases. What does this mean for financial institutions' and trustees' future reliance on avoidance powers and, ultimately, the recovery of the bankruptcy estate?

Limitations on Avoiding Powers

The Code permits trustees as well as debtors in possession (DIPs) to avoid certain transactions, thereby recovering value for debtors' bankruptcy estates.[1] However, § 546, entitled "Limitations on Avoiding Powers," limits trustees' avoidance powers.[2] Specifically, § 546(e) expressly limits recovery of "settlement payments," stating that

> the trustee may not avoid a transfer that is…[a] settlement payment, as defined in section 101 or 741 of this title, 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…commodity contract…or forward contract…except under section 548(a)(1)(A) of this title.[3]

This provision provides a "safe harbor" by prohibiting avoidance of transfers by or to financial institutions that are made in connection with a class of defined securities contracts. "The purpose of section 546 is to protect the nation's financial markets from the instability caused by the reversal of settled securities transactions,"[4] and was intended by Congress to "minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries."[5]

In re Enron Corp.: Catalyst for Addressing the Scope of "Settlement Payments"

After filing voluntary petitions for chapter 11 relief on Dec. 2, 2001, Enron, by way of adversary proceedings, sought to recover transfers made to JP Morgan Chase (JPMC) and Mass Mutual between Oct. 26, 2001, and Nov. 6, 2001, totaling approximately $892,000,000.00 and $233,000,000.00, respectively.[6] The transfers involved payments made in relation to short-term commercial paper prior to the maturity date, at significantly above-market prices and contrary to the offering documents.[7] In its complaint, Enron sought avoidance of the transfers as preferential payments under § 547(b), or in the alternative as fraudulent conveyances under §§ 544(b) and 548(a).[8]

The defendants filed motions to dismiss the complaints, arguing that the transfers were proper settlement payments made to complete securities transactions and thus protected by the safe harbor of § 546(e).[9] Enron opposed the dismissal motions, arguing that the payments were not for the purchase of securities but instead payments for the early redemption of notes.[10] The *Enron* court ultimately concluded that the purported settlement payments are of the type of payments that are common in the securities trade.[11] Furthermore, the court denied the motions to dismiss deeming these types of determinations factual issues for trial.[12]

Since Hon. Arthur Gonzalez's 2005 decision in *In re Enron Corp.*,[13] there have been numerous cases that have discussed whether a preference or fraudulent transfer was a settlement payment protected by § 546(e). Each decision redefines the scope of what is protected, leaving trustees and DIPs without consistency or predictability as to which transfers can be avoided for the benefit of the estate and ultimately, the creditors.

Developments Following _In re Enron Corp._

In the first of recent noteworthy cases, *In re Appleseed's Intermediate Holdings LLC*, the court considered whether dividends paid to investors in conjunction with a multifaceted leveraged buyout (LBO) fell within the scope of § 546(e) protection as settlement payments.[14] The defendants filed a motion to dismiss the trustee's complaint that sought avoidance of transfers as preferences or, alternatively, as fraudulent.[15] The facts leading to the dispute are those of a complex LBO, financing agreements between multiple parties and the subsequent disbursement of those funds.[16]

To provide context for discussion of the court's analysis and holding, a brief review of the transaction is warranted. A merger was effectuated by Orchard Brands Topco LLC, parent to the debtor Appleseed's Intermediate (Appleseed), between other subsidiaries of Orchard, BLR, an entity formed by private-equity investors, and Blair Corp.[17] As a result of the merger, Blair shareholders would be paid cash for their shares.[18] Financing in the amount of $650 million for the merger was secured by Appleseed's assets, causing Appleseed's insolvency.[19] Furthermore, the amount of the loan obtained through allegedly "unreasonably optimistic financial projections" was substantially greater than the amount needed to execute the merger and satisfy Blair's shareholders.[20] Less than one quarter of the loan, $138 million, was needed to satisfy Blair's shareholders and finalize the merger.[21] From the surplus, $138 million was used to satisfy existing debt, and $310 million, through various levels of Orchard and Appleseed subsidiaries, was paid as dividends to investors such that they could realize an immediate return on their investment.[22]

The private-equity investors, as the defendants, argued that even if the payments were avoidable by the trustee pursuant to § 544, the payment of dividends constituted settlement payments by or to a financial institution and, as such, are protected.[23] The court began its analysis by noting that a settlement payment, as defined by § 741(8), is any payment commonly used in the securities trade and that for payments for shares during an LBO to constitute settlement payments, there is a "necessary implication…that both parties exchanged some value."[14]

Ultimately finding that the dividends did not constitute settlement payments, the court determined that the dividend payments made to investors should not be conflated with the merger as a whole and that as individual transactions, separate and apart from the LBO, the transfers did not constitute settlement payments because there was no exchange of value, only one-way payments.[25] Notably, the court limited the applicability of § 546(e) by making it clear that while a transaction as a whole, such as the LBO and merger at issue, can fall within the safe-harbor protection, each individual transfer, as part of the transaction, should be considered independently for purposes of protection under § 546(e).

A similar issue faced the court in *In re Lehman Brothers Holdings Inc.*,[26] which was faced with whether transfers of funds and obligations serving as collateral for risk associated with credit and clearing agreements were settlement payments in connection with a securities contract. In *Lehman*, Lehman Brothers Holding Inc. (LBHI) with its official committee of unsecured creditors, initiated an adversary proceeding against JPMC.[27] JPMC provided pre-petition credit and clearance services to LBHI necessary for LBHI trading operations.[28] The court noted that the underlying theory of the claim rested on a "[f]orm of actionable economic coercion" against JPMC.[29] Leading up to the LBHI bankruptcy, amended clearance agreements were entered into between JPMC and LBHI requiring that certain LBHI subsidiaries be named as customers of JPMC and additionally, that LBHI guarantee all payments and liabilities owed to JPMC by the LBHI subsidiaries that were now parties to the clearance agreements.[30] Only one month before the LBHI filing, amid reports of financial distress, JPMC demanded that LBHI further guarantee all obligations and liabilities of LBHI, its subsidiaries and affiliates.[31] Additionally, in the days before the LBHI bankruptcy, JPMC requested additional collateral totaling $8.6 billion to cover intraday clearance risk even though allegedly knowing that it already held sufficient collateral.[32] After close of trading, JPMC refused LBHI access to the collateral, even upon the proper notice required by the amended agreements.[33]

The court engaged in an extensive analysis of each agreement and transfer of an interest or obligation under those agreements. First, the court noted that each extension of credit under the clearance agreements was an independent securities contract for purposes of § 546(e),[34] and that liens granted under those agreements and in connection with the agreements are transfers pursuant to § 101 (54).[35] With regard to collateral transfers made to JPMC, the court determined that the "in connection with" requirement has no temporal requirement with relation to actual exposure.[36] The court found the plaintiffs' argument "that there should be demonstrable exposure as a condition to satisfying the 'in connection with' language of section 546(e)" unpersuasive as it "would make it difficult to assure safe -harbor protections without making an impractical and burdensome inquiry as to the status of countless derivatives positions at arbitrary points in time in the multiple dealings between counterparties."[37]

Even funds sweeps, transfers of funds from the JPMC account holding funds as collateral to another account after the exposure being protected by the collateral subsided, were protected by § 546(e) because the original deposits were made in connection with safe harbor securities contracts.[38]

As to the obligations of LBHI in connection with its guarantee of all LBHI, LBHI subsidiaries and LBHI affiliates liabilities to JPMC, the court noted that language regarding the incurrence of obligations in connection with securities contracts is absent from § 546(e). The court determined that because the definition of "transfer" under the Code includes "each mode" of "disposing or parting with," it then also includes the incurrence of an obligation.[39] The court found that while obligations may be avoidable, as was argued by the plaintiffs, claims for avoidance may not be pursued where such pursuit leads only to transfers immune from avoidance, such as those at issue.[40]

The court granted the dismissal motion as to the claims for avoidance based on preference and constructively fraudulent transfers deeming the transfers protected by the safe harbor of § 546(e). Hon. James Peck stated that these were "[s] ystematically significant transactions between sophisticated financial players at a time of financial distress in the markets—in other words, the precise setting for which the safe harbors were intended," and that even the collateral transfers were "tied to and support transfers that are connected to securities contracts and [are] thereby exempt."[41] Judge Peck's interpretation and application of § 546(e) in *Lehman* is of great significance as it expands what a lender can do to manage exposure to potential losses, including the ability to secure obligations that are connected to transfers under a protected transaction.

A pair of decisions, *Picard v. Katz*[42] and *Securities Investor Protection Corporation v. Bernard L. Madoff Investment Securities LLC*,[43] address whether the withdrawal of funds by innocent investors from their investment accounts are protected under the safe harbor of § 546(e). In 2011, the U.S. District Court for the Southern District of New York found that payments to Madoff investors, by way of withdrawals, within two years of the bankruptcy filing qualified as either "settlement payments" or "transfer[s]" made "in connection with a securities contract."[44] Recently, however, Trustee Irving Picard again sought avoidance of transfers made to innocent investors leading up to the exposure of Madoff and its subsequent bankruptcy filing under arguments not raised in the prior case.[45] It was argued that the transfer of funds to investors did not constitute settlement payments as required by § 546(e) because "Madoff Securities did not trade securities on behalf of its investment advisory clients."[46]

In considering whether the withdrawals were settlement payments, the court noted that the Second Circuit broadly interpreted settlement payments under § 546(e) and has applied it to "the transfer of cash or securities made to complete [a] securities transaction."[47] The court found that an investor who entered into agreements with, and transferred funds to, a broker that implemented "a discretionary strategy on behalf of a customer does not complete its transaction until the customer has regained control over whatever funds result from the implementation of the strategy."[48]
The trustee additionally argued that the safe-harbor regime of § 546(e) is inapplicable because such protection is only afforded to "legitimate brokerage firms and transactions."[49] The court disagreed. Observing that the statute expressly contains exceptions for certain kinds of fraud, namely those involving actual fraud under § 548(a)(1)(A), the court found that no specific rule should be created that would restrict the applicability of § 546(e) from fraudulent investment schemes.[50] This case further highlights the broad application of § 546(e)'s safe-harbor protection by the courts.

Conclusion
It is clear that the § 546(e) safe harbor is crucial to the ability of financial markets to protect themselves from failure in the wake of large corporate bankruptcies. These

decisions illustrate the impact that § 546(e) can have not only on debtors' reorganizations, but also the operations of those providing financial services. For these reasons, it is essential for practitioners to be aware of recent jurisprudence addressing § 546(e) and its steadily evolving scope.

1. Section 547(b) permits the trustee of a bankruptcy estate to avoid any transfer made by an insolvent debtor in the 90 days preceding bankruptcy where the transfer was made for (1) the benefit of a creditor, (2) for or on account of an antecedent debt owed by the debtor, and (3) that enabled the creditor to receive more than it otherwise would have under the Code. 11 U.S.C. § 547(b). Under § 548(a)(1)(B), a trustee may avoid any transfer or obligation incurred by a debtor within two years before the date of filing when made fraudulently or in exchange for less than reasonably equivalent value and that left the debtor insolvent. 11 U.S.C. § 548(a)(1)(B).

2. *See* 11 U.S.C. § 546(e).

3. 11 U.S.C. § 546(e).

4. *In re Enron Corp., et al., v. JP Morgan Securities Inc., et al., v. Mass Mutual Life Ins. Co., et al.*, 325 B.R. 671, 684 (Bankr. S.D.N.Y. 2005).

5. H.R. Rep. No. 97-420 (1982).

6. *In re Enron Corp.*, 325 B.R. 671 at 679.

7. *Id*. at 679-81.

8. *Id.* at 681; *see also* 11 U.S.C. §§ 547(b), 544(b), and 548(a).

9. *In re Enron Corp.*, 325 B.R. at 681.

10. *Id*.

11. *Id*. at 687.

12. *Id*.

13. *See generally In re Enron Corp.,* 325 B.R. 671.

14. 470 B.R. 289, 301 (D. Del. 2012).

15. *Id.* at 293.

16. *Id*. at 294-95.

17. *Id.* at 294.

18. *Id.*

19. *Id.*

20. *In re Appleseed*, 470 B.R 289.

21. *Id.* at 295.

22. *Id.*

23. *Id.* at 301.

24. *Id.* at 302; *see Lowenschuss v. Resorts Int'l Inc. (In re Resorts Int'l Inc.)*, 181 F.3d 505 (3d Cir. 1999).

25. *Id.* (citing *Mervin's LLC v. Lubert-Adler Group IV LLC (In re Mervyn's Holdings LLC)*, 426 B.R. 488 (Bankr. D. Del. 2010)).

26. 469 B.R. 415 (Bankr. S.D.N.Y. 2012).

27. *Id.* at 419.

28. *Id.* at 421.

29. *Id.*

30. *Id.* at 426.

31. *Id.* at 429.

32. *In re Lehman Brothers Holding Inc.*, 469 B.R. at 430.

33. *Id.*

34. *Id.* at 438

35. *Id.* at 440.

36. *Id.* at 442.

37. *Id.* at 442–43.

38. *In re Lehman Brothers Holding Inc.*, 469 B.R. at 443.

39. *Id.* at 444 (citing 11 U.S.C. § 101(54)).

40. *Id.* at 446.

41. *Id.* at 422–23.

42. 462 B.R. 447 (S.D.N.Y. 2011).

43. 476 B.R. 715 (Bankr. S.D.N.Y. 2012).

44. *Picard*, 462 B.R. at 452.

45. *Madoff*, 476 B.R. at 720.

46. *Id.* at 721.

47. *Id.* (internal citations omitted).

48. *Id.* at 721.

49. *Id.*

50. *Id.* at 722.