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A legal update from Dechert's Business Restructuring and Reorganization Group

Bankruptcy Court Limits Applicability of Section 546(e) Securities Safe Harbor to Public Securities

Introduction

Section 546(e) of the Bankruptcy Code provides a "safe-harbor" for certain transfers involving the purchase or sale of securities and protects those transfers from avoidance as constructive fraudulent transfers or preferences. The safe-harbor protects, among other things, transfers that are "settlement payments,"[1] as used in the securities trade, as well as other transfers made to or from certain protected parties, including financial institutions, financial participants and stockbrokers, in connection with a securities contract.[2] On April 21, 2011, Judge Drain of the United States Bankruptcy Court for the Southern District of New York issued an opinion in *In re MacMenamin's Grill Ltd.*[3] restricting the application of this seemingly broad provision to transactions that have a risk of impacting the public securities markets, despite the fact that the plain language appears to reach private stock transactions. Additionally, Judge Drain held that the term "transfer" as used in 546(e) does not encompass "obligations incurred" and as such does not prevent avoidance of a loan obligation that would otherwise fit within the reach of § 546(e).

Background

MacMenamin's Grill, Ltd. (the "Debtor") was a restaurant and culinary institute in New Rochelle, New York. As of August 31, 2007 each of MacMenamin's three selling shareholders (the "Shareholders") owned 31% of the outstanding shares of the Debtor. On August 31, 2007 the Shareholders entered into a Stock Purchase Agreement with the Debtor by which they would sell all of their shares to the Debtor as part of a small leveraged buyout transaction. The Debtor also entered into a loan agreement with TD Bank by which it borrowed the $1.15 million necessary to consummate the Stock Purchase Agreement. Upon consummation of both agreements, the proceeds of the TD Bank loan were transferred directly from TD Bank to the Shareholders' respective bank accounts.

Owing in part to a decrease in business that began in 2006, the Debtor filed for chapter 11 bankruptcy in November of 2008. In March of 2009 a chapter 11 Trustee (the "Trustee") was appointed. In July of 2009 the Trustee initiated an adversary proceeding seeking to avoid and recover the payments made to the Shareholders under the Stock Purchase Agreement and to avoid the loan obligation the Debtor incurred to TD Bank, alleging that the Debtor was either insolvent or undercapitalized at the time of both transactions and that both were constructively fraudulent under Section

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1 Settlement payment, as used in 546(e), is defined in Section 741 of the Bankruptcy Code as, "a preliminary settlement payment, a partial settlement payment, an interim settlement payment on account, a final settlement payment or any other similar payment commonly used in the securities trade."

2 Securities contract is defined in section 741(7) as a "contract for the purchase, sale, or loan of a security." Security, in turn, is defined in section 101(49) to include, among other things, note, stock and transferable share.

3 Case No. 08-23660 (Bankr. S.D.N.Y. April 21, 2011).

548 of the Bankruptcy Code. Both the Shareholders and TD Bank filed motions for summary judgment that invoked the safe-harbor provision of § 546(e).

For the purposes of the motions for summary judgment, the parties stipulated that the Debtor did not receive adequate consideration for the payments made to the Shareholders, nor for the loan obligation the Debtor incurred to TD Bank and that the Debtor was insolvent on August 31, 2007 or became insolvent as a result of the incurrence of the loan and stock purchases. As to the Section 546(e) elements, the Shareholders asserted, and the Trustee did not deny, that both TD Bank and their respective banks are financial institutions within the meaning of § 546(e). The Shareholders further asserted that the transfers to the Shareholders fit within the meaning of "settlement payment" as it is used in that section. As an alternate basis for relief, the Shareholders asserted that the transfers were by and to a financial institution in connection with a securities contract. Either way, the Shareholders insisted that the payments from TD Bank directly to their respective banks fit within the § 546(e) safe-harbor and were not avoidable.

TD Bank also sought the protection of 546(e) to prevent the Trustee from avoiding the loan obligation the Debtor incurred to TD Bank. It asserted that it had made transfers directly to other financial institutions as "settlement payments" for the Shareholders' stock transaction. As such, TD Bank asserted that its loan was not subject to avoidance by the Trustee.

Analysis

Application of Section 546(e) to Non-public Securities

Judge Drain observed that, despite the plain meaning of the statute, some courts have interpreted § 546(e) to exclude private stock transactions, such as the one at issue, from protection. Nevertheless, he acknowledged authorities, including many Circuit court opinions, applying section 546(e) to shield from avoidance transfers made for privately traded securities. The Court noted that the legislative history evidences an intent to protect the financial markets from systemic risk and that small private stock transactions such as the one at bar pose little or no risk to the markets. Judge Drain then reasoned that the vague and self-referential definition of "settlement payment," as used in § 546(e), as well as other textual implications, justified looking past the plain meaning of the statute.

After evaluating the legislative history and the securities-market context of the various cross-references contained in § 546(e) Judge Drain determined that Congress did not intend § 546(e) to apply to a private leveraged buyout transaction that had no risk of affecting the stability of the financial markets: "[I]n light of section 546(e)'s textual context, which apparently focuses, in the midst of a circular and ambiguous set of definitions, on the trade or business of securities transactions, reference to the legislative history is warranted. That legislative history ... makes it clear that Congress intended section 546(e) to address risks that the movants failed to show conclusively are implicated by the avoidance of the transaction at issue here." As such, he concluded that the Shareholders were not entitled to the safe-harbor protections of § 546(e) and denied their motion for summary judgment.

Application of § 546(e) to Loan Obligations

While first noting that the safe-harbor did not apply to TD Bank for the same reasons it did not apply to the Shareholders, Judge Drain also explained that another ground existed to deny TD Bank the protections of the safe-harbor. The Trustee sought to avoid the loan *obligation* that the Debtor incurred to TD Bank, rather than a transfer similar to that made to the Shareholders. Judge Drain examined the language of § 546(e) and determined that it does not shield the incurrence of obligations from avoidance.

Judge Drain explained that both "transfer" and "obligation" are used in various parts of the Bankruptcy Code, including in the relevant avoidance sections, providing for the avoidance of a transfers made and obligations incurred. In contrast, the safe-harbor provision of § 546(e) does not contain the word "obligation," but only the word "transfer." Thus, by its plain meaning § 546(e) does not extend to obligations such as the one held by TD Bank. Since the Bankruptcy Code makes a clear distinction between the terms "transfer" and "obligation," Judge Drain concluded that the word "transfer" as used in § 546(e) cannot be read to encompass an "obligation." Thus, even if the safe-harbor extended to the transaction at issue TD Bank would not be entitled to its protection.

Judge Drain recognized that in a case of a transaction that is subject to section 546(e), the avoidance of the loan obligation could be argued to "blow[] such a hole in section 546(e)'s safe harbor that it would be absurd and clearly contrary to congressional intent to follow the statute's plain meaning." But Judge Drain went on to reject this argument finding that allowing the avoidance

of a loan obligation would not make section 546(e) meaningless because section 546(e) would still protect the lien granted to the lender (as the granting of a lien constitutes a transfer). What is left unanswered is whether a lender can retain a lien if the underlying payment obligation has been avoided. It would appear that if a debtor's obligation to repay a loan is avoided, the lien retains no economic or legal effect since it no longer secures an obligation.

Conclusion

The decision's limitation of the safe-harbor provisions of § 546(e) to transactions that pose a risk to the public securities markets could be extremely important when choosing venue for a bankruptcy filing, as the law in Delaware is to the contrary. Thus, if the scope of section 546(e) and other safe harbor provisions is expected to play an important role in the case, counsel should review venue choices carefully. In addition, courts and litigants will have to work through the difficulties resulting from allowing the avoidance of a loan obligation, but not the lien securing such obligation.

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/insolvency.

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