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Expanding the Settlement Payments Exception in LBO's

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Questions Presented

Whether the settlement payment exemption pursuant to 11 USC § 546(e) in an LBO is limited to shares of a publicly traded company or might also protect LBO's in non-public companies as well.

Introduction

This memorandum will first give a statutory background of relevant bankruptcy code provisions and their effects on the bankruptcy proceeding. Next, the memorandum will present description of pertinent cases related to the 546(e) 'settlement payment' exemption. In particular, the memorandum will document the progression of cases interpreting the meaning of 'settlement payment' within 546(e) from a restrictive interpretation to an increasingly broad one. Finally, the memorandum will discuss the case *Brandt v. B.A. Capital* (*In re Plassein International*) and its implication on the 546(e) exemption in relation to transfers of stock made in an LBO for publicly-held and privately-held securities.

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General Information

I. Relevant Statutes

Section 544 of the Bankruptcy Code deals with the bankruptcy trustee's role as a lien creditor and the trustee's superiority over the claims of certain creditors in a bankruptcy proceeding. *See* 11 U.S.C. § 544 (2006). Section 544(a) states "[t]he trustee shall have, as of the commencement of the case…the rights and powers of, or may void any transfer of property of the debtor or any obligation that is incurred by the debtor that is voidable by" a creditor who extended credit to the debtor and obtained a judicial lien or an execution against the debtor, or the trustee shall have the rights and powers of "a bona fide purchaser of real property" who has perfected his interest in the property. 11 U.S.C. § 544(a)(1)(2)(3) (2006). Essentially, at the moment of bankruptcy, the trustee steps into the shoes of a judicial lien creditor or bona fide purchaser of real property. The trustee thus has superiority over any unsecured creditor in the bankruptcy proceeding. *See* 11 U.S.C. § 544(b)(1) (2006). Clearly, this power of the trustee has powerful implications on the rights of creditors and the progression of the bankruptcy proceeding. *See, e.g., In re* Musicland Holding Corp., 398 B.R. 761, 777–78 (Bankr. S.D.N.Y. 2008) (finding creditors whose claims are extinguished by section 544(b) are unable to raise certain claims for relief).

Section 548 of the bankruptcy code builds off of the status given to the trustee under section 544. *See* 11 U.S.C. § 548. Section 548(a)(1)(B) grants the trustee the power to avoid transfers "incurred by the debtor…on or within 2 years before the date of filing of the petition, if the debtor voluntarily or involuntarily received less than a reasonably equivalent value in exchange for such transfer or obligation and was insolvent on the date that such transfer was

made or such obligation was incurred, or became insolvent as a result of such transfer or obligation." 11 U.S.C. § 548(a)(1)(B) (2006).

While sections 544 and 548 of the Bankruptcy Code gives the trustee very expansive powers, section 546 places certain limitations on the trustee's ability to avoid transfer. *See* 11 U.S.C. § 546 (2006). Most relevant to the *Brandt* decision is section 546(e), which states that "[n]otwithstanding [section 548(a)(1)(B)], the trustee may not avoid a transfer that is a margin payment… or a settlement payment" made by or to, or for the benefit of, various financial entities, including stockbrokers, financial and securities agencies, and others. *See* 11 U.S.C. 546(e) (2006).

The term 'settlement payment' is defined in section 101 of the bankruptcy code. *See* 11 U.S.C. 101 (2006). A 'settlement payment' is defined as, "for the purposes of a forward contract provisions of this title, a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, a net settlement payment, or any other payment commonly used in the forward contract trade." 11 U.S.C § 101(51)(a) 2006. Another definition of 'settlement payment' is found in section 741 of the bankruptcy code. *See* 11 U.S.C. § 741. This section defines a settlement payment as "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) (2006).

II. Relevant Caselaw

Notwithstanding the definitions stated in sections 101 and 741, the term 'settlement payment', within the scope of the 546(e) exemption, has received considerable examination as to what is actually encompassed within the term. *Cf.* Robert Richardson, *Unsettled Settlement*

Payments in §546(e), 27 AM. BANKR. L. J. 12 (2008). The court in *Kaiser Steel Corp. v. Pearl Brewing Co. (In re Kaiser Steel Corp.)*, 952 F.2d 1230, 1239 (10th Cir. 1991), stated that the wide variety of securities transactions prohibits the term 'settlement payment' to be restricted to only one type of transaction. In particular, the court stated that "we will not interpret the term 'settlement payment' so narrowly as to exclude the exchange of stock for consideration in an LBO." *See Kaiser*, 952 F.2d at 1239. But while the 10th Circuit held transfers of stock in an LBO fell within the 'settlement payments' exemption of 546(e), other circuits were not quick to follow. In *Zahn v. Yucaipa Capital Fund*, 218 B.R. 656 (D.R.I. 1998), the court held opposite to the 10th Circuit, finding that the transfer of shares in an LBO should not fall under the 'settlement payment' exemption. *Zahn*, 218 B.R. at 676. The court found that though the payments did 'settle' a purchase and sale of securities; the intent of congress was not for such payments to be included. *See Zahn*, 218 B.R. 675–76. The *Zahn* decision noted that the view was supported by the court in *Wiedboldt Stores Inc. v. Schottenstein*, 131 B.R. 655 (N.D. Ill. 1991), which also found that LBO payments were not intended to be encompassed within the 'settlement payment' exemption of 546(e). *See Wiedboldt*, 131 B.R. at 663–66.

The *Zahn* court distinguished the *Kaiser* decision, explaining that the LBO in *Kaiser* involved the "clearance and settlement system", finding a relatively strong link to the securities industry, and that this connection was used to justify the payments to be considered 'settlement payments'. *Zahn*, 218 B.R. at 675–77. In *Zahn*, however, the corporation was not public like in *Kaiser*, but was instead privately held, and thus had no connection to the securities industry. Under these circumstances, the court could not justify the transfer payments in relation to an LBO for a private company to fall under the 546(e) 'settlement payments' exemption. Allowing

avoidance, the court notes, "would have no impact at all on [the clearance and settlement] system," and therefore would not be considered a 'settlement payment'. *See id.* at 676.

Since the *Zahn* decision, however, the 'settlement payments' exemption has been given a an increasingly broad interpretation. In *Lowenschuss v. Resorts International Inc.* (*In re Resorts International)*, 181 F.3d 505 (3d. Cir. 1999), the court dealt with a publicly traded company, but failed to distinguish between public and private when it declared, "[a] payment for shares during an LBO is obviously a common securities transaction, and [the court will] therefore hold that it is also a settlement payment for the purposes of section 546(e)." *See In re Resorts*, 181 F.3d at 516. This reflects a different interpretation of the purpose of 546(e), moving from a more restrictive reading to one that offers avoidance protection for a much broader range of transactions.

The *In re Resorts* decision was very important for its greatly expanded interpretation of the 546(e) safe harbor provision from the trustee's avoidance power. Not only did the court find that 'settlement payments' included payments made in a non-traditional transfer in an LBO, it failed to adhere to the limitations expressed in the *Zahn* decision that limited the 546(e) safe harbor to publicly-traded securities. *See In Resorts*, 181 F.3d at 516. It did not follow the congressional intent analysis, and instead read the plain language of the statute, where it failed to find a need for a distinction between publicly-traded securities in an LBO and privately-held securities in an LBO. Despite its importance for broadening the scope of the 546(e) safe harbor, the court never explicitly stated that transfer of shares in an LBO was to apply to both public and private companies, and therefore it (perhaps unintentionally) left the door open for future decisions to limit its holding to permit the 546(e) exemption only to transfers of *publicly*-held securities in an LBO. *See id.* at 516–17.

Subsequent decisions to *In re Resorts* adopted the broadened view of what was considered a 'settlement payment'. The court in *In re Loranger Manufacturing Corporation*, 324 B.R. 575 (Bankr. W.D.Pa. 2005), chose to not examine congressional intent and instead interpreted the plain language of the 546(e) 'settlement payment' exemption in the bankruptcy code. The court found the language of 546(e) made its coverage to be extremely broad, encompassing many types of transfers, including wire payments in an LBO. *See In re Loranger*, 324 B.R. at 585–86. Similarly, the court in *In re IT Group*, 359 B.R. 97 (Bankr. D. Del. 2006), found the term 'settlement payment' should "be applied broadly to any transaction of stock or cash to pay for stock." *See In re IT Group*, 359 B.R. at 101. The transfer in question in *In re IT Group* was for a sale of $500,000 for stock in a privately held corporation. Rejecting arguments to the contrary, the court found that the 'settlement payment' exemption "is to be applied broadly to any transfer of stock or cash to pay for stock." *Id.* The court noted that no distinction was made in *In re Resorts* between publicly-held and privately-held securities, but, like the court in *In re Resorts*, did not explicitly state that both would be permitted to fall under the 546(e) exemption. *Id.* Thus the window was still left open for a court to permit the exemption for a transfer of publicly-traded security but limit it from expanding to private-securities.

Overall, it appears that the interpretation of the term 'settlement payments' has gone through increasingly broad interpretation, with courts finding more and more transfers should be encompassed within the meaning of 'settlement payment' and thus could not be avoided by the bankruptcy trustee in a bankruptcy proceeding, avoiding the implications of the section 548 avoidance powers. The issue of public versus private securities, although greatly expanded in the *In re Resorts* decision, was still open for limitation. A court could easily restrict and limit the

safe harbor in regards to LBO's only to those transfers made of publicly-traded securities, putting the scope of 546(e) back towards the more restrictive *Zahn* interpretation.

Discussion

I. Bankruptcy Court Decision

The case that is the subject of this memorandum involves a Chapter 7 bankruptcy trustee suing defendant shareholders of a privately-held corporation, seeking to avoid transfers made to the shareholders under the trustee's powers pursuant to section 544 of the bankruptcy code. *See In re Plassein Intern. Corp.*, 366 B.R. 318, 320 (Bankr. D. Del. 2008).

The case was first heard by the district court in April of 2007. The debtor was Plassein International Corporation and it was formed in 1999 to acquire several private manufacturers of flexible packaging. *In re Plassein*, 366 B.R. at 320–21. Plassein was able to make these purchases through a series of LBO's, where lenders extended credit to Plassein to purchase the companies and took a security interest in the assets of the acquired companies, with the acquired companies being responsible for repaying the debt. Plassein then used the credit to purchase majority stakes in these private companies, and paid off the acquired companies' debt to the creditors. The companies did not merge with Plassein, but instead changed their names and operated as distinct business entities. *See id.* at 321. These acquisitions by Plassein occurred in two phases, with most acquisitions made in January of 2000, and a second phase, and final acquisition, occurring in August of 2000. The acquired companies were jointly and severally liable for the entire debt in purchasing the companies. *Id.* On May 14, 2003, Plassein and the acquired companies filed for Chapter 11 bankruptcy, and later converted to a Chapter 7 liquidation. *Id.* at 322.

In the lower court proceeding, Brandt, the trustee, claimed that the acquisition of shareholders' stock in acquiring the companies rendered the Plassein company insolvent. The trustee argued that since Plassein did not receive reasonably equivalent value for the stock, the transfers should be avoided pursuant to section 544 and the trustees avoidance powers. *See In re Plassein*, 366 B.R. at 322. In response, the shareholders of the acquired company raised three defenses. The first argument focused on the actual 'debtor' involved in the proceeding, and is beyond the scope of this memorandum. There was also an additional argument regarding the solvency of the Plassein corporation which the court refused to address. The defendant shareholders' finial argument, however, involved the 546(e) 'settlement payments' exemption and is the focus of this memorandum. *Id.*

The bankruptcy court agreed with defendants and found that the transactions between defendant shareholders and Plassein corporation were in fact 'settlement payments' under section 546(e). The bankruptcy court gave heavy emphasis to the very expansive interpretation the court in *In re Resorts* used for 'settlement payments', and agreed that it "encompasse[d] almost all securities transactions". *In re Plassein*, 366 B.R. at 318. Additionally, the court made note that a payment to a shareholder in exchange for shares in an LBO was to be considered a 'settlement payment'. *Id.*

The second prong of the analysis, the court noted, was that the payments must be made by or to a financial institution. As Fleet Bank was involved in the transfers, the court found that the second and final prong of the 'settlement payment' exemption had been satisfied. The trustee, however, argued that the 'settlement payment' exemption had to be limited to only publicly-traded companies. As Plassein and the target companies were privately-held, the exemption should thus not be available. *In re Plassein*, 366 B.R. at 324.

Unlike previous decisions which avoided directly addressing the issue of publicly-held vs. privately-held companies, the bankruptcy court in *In re Plassein* directly stated that the 'settlement payment' exemption in transfers to shareholders in an LBO applied to both public and private companies. *Id.* The court relied upon previous cases such as *In re Resorts* and *In re IT Group*, in which private company LBO payments were held as 'settlement payments' but the public/private distinction was not made clear, in reaching its decision. The court also pointed to the recent case of *In re Loranger Manufacturing Corp.* where payment for shares in a non-publicly traded company were found to be unavoidable under the 546(e) 'settlement payment' exemption. *See In re Loranger*, 324 B.R. at 585–86.

Though there was no case in the circuit limiting the *In re Resorts* holding solely to publicly-traded securities, the court noted that the holding was also not explicitly stated that 'settlement payment' exemption applied to private securities as well. The bankruptcy court in *In re Plassein* made sure there was no confusion, stating "[i]t is therefore certain that Defendants have met all the requirements for the section 546(e) safe harbor from fraudulent transfer liability. This broad application of what constitutes a settlement payment mandated in *Resorts* covers even transactions which, as here, are LBO purchases of non-public securities." *In re Resorts*, 366 B.R. at 325.

II. Appeal and District Court Holding

The trustee appealed the ruling of the bankruptcy court, and the case was dealt with by the District Court of Delaware in May of 2008 in *Brandt v. B.A. Capital (In re Plassein International Corporation)*, 388 B.R. 46 (D. Del. 2008). The thrust of the trustee's argument was that the 'settlement payment' safe harbor could not be applied to privately held companies, but it instead must be limited publicly-traded securities. The court outright rejected the trustee's

argument. It agreed with the Bankruptcy Court that previous holdings in the Third Circuit gave a very broad interpretation to 'settlement payments', and with no case to limit the *In re Resorts* holding to only publicly-traded securities, the court ruled that transfers made to shareholders of a non-public company in an LBO would fall under the 'settlement payment' exemptions. *See Brandt*, 388 B.R. at 48.

By holding that the 546(e) 'settlement payment' exemption in transfers of stock in an LBO applied to shares of both public and privately held corporations, the court put finality on an issue that had been in need of a concrete holding for years. Though this was not the first case to find that transfers privately-held securities fell under the 546(e) safe harbor to avoidance, this was case was the first in the Third Circuit to reject a limiting of the holding in *In re Resorts* and expressly expand the interpretation of 'settlement payments' to include privately-held corporations.

Conclusion

The holding in *In re Plassein Corporation*, and affirmation upon appeal in *Brandt v. B.A. Capital*, holds its significance for conclusively stating that both public and private securities transferred in an LBO would fall under the safe harbor 546(e) exemption and thus would be unavoidable by the bankruptcy trustee. While not being the first case to uphold a 'settlement payments' exemption for a transfer of private securities, it prevented future limitation to solely public securities and held it open to transfers of private securities as well.