

Three Approaches To Applying 11 U.S.C § 546(e)'s "Safe Harbor" To Private LBOs

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INTRODUCTION

The Bankruptcy Code gives a trustee and a debtor-in-possession the authority to avoid fraudulent transactions. However, 11 U.S.C. § 546(e) limits the trustee's avoiding powers by providing a safe harbor for "settlement payments." Generally, a "settlement payment" is a payment of cash or securities made to complete a securities transaction. For example, money that an individual pays to a stockbroker to buy publicly traded shares is a settlement payment. A recent issue that has arisen is whether payments made to former shareholders in connection with a private leveraged buyout (LBO) constitute a "settlement payment."¹

Depending on which jurisdiction a bankrupt corporation finds itself, a trustee may be able to avoid LBO payments. Courts are sharply divided on whether § 546(e) applies to private LBOs. There are three approaches to the issue, although courts have only adopted two of them. The first approach focuses on the legislative history of § 546(e). In contrast, the second approach strictly focuses on the plain meaning of § 546(e). Lastly, the third approach takes a middle-ground approach and harmonizes the plain meaning of § 546(e) with its legislative history. The

¹ Public LBOs are leveraged buyouts of publicly traded companies, while private LBOs are leveraged buyouts of closely-held companies. However, § 546(e) and its 2006 amendment do not distinguish between private and public LBOs. Indisputably, though, § 546(e) protects public securities transactions.

legislative history approach creates a bright-line rule that § 546(e)'s safe harbor does not apply to private LBO payouts. The plain meaning approach, however, holds that § 546(e)'s the safe harbor provision applies to a private LBO just as it would to a public LBO. Harmonizing these two approaches, the middle-ground approach holds that § 546(e) only protects large private LBOs but not small private LBOs. Many bankruptcy courts follow the first approach, while three circuit courts follow the second approach. Although the third approach has not yet been adopted by any court, some courts have intimated that it is a sound approach.

Part I of this memorandum explains the safe harbor provision of § 546(e). Part II discusses the legislative history approach. Part III discusses the plain meaning approach. Part IV discusses the middle-ground approach. Finally, this article concludes by discussing the implications that these three approaches might have on future LBO transactions.

I. 11 U.S.C. 546(e) AND SAFE HARBOR FROM AVOIDANCE

The Bankruptcy Code gives a trustee and a debtor-in-possession the authority to avoid fraudulent or constructively fraudulent transactions.² The Code limits the trustee's avoiding powers, however. Specifically, 11 U.S.C. § 546(e) provides a safe harbor for certain types of payments made by or to certain people and entities as described in the statute. In particular, the Code states that "the trustee may not avoid a transfer that is a...settlement payment."³ Section 741(8) defines a "settlement payment" as a preliminary, partial, interim, on account, or final settlement payment, or any other similar payment commonly used in the securities trade.⁴ This ambiguous definition is the subject of the dispute between the three approaches.

² *E.g.*, 11 U.S.C. § 548.

³ 11 U.S.C. § 546(e).

⁴ 11 U.S.C. §§ 101(51A), 741(8).

Proponents of the plain meaning approach argue that “settlement payment” clearly encompasses any payments made in the form of a settlement. Therefore, it is unnecessary to look beyond the plain meaning of the statute. However, § 741(8) defines “settlement payment” in a frustratingly self-referential way; essentially stating that a “settlement payment” is a “settlement payment.”⁵ Therefore, those opposed to the plain meaning approach argue that the plain meaning of § 546(e) is inconclusive and, therefore, courts must turn to § 546(e)’s legislative history. The legislative history of § 546(e) makes clear that the safe harbor was only intended to reduce systematic risk in the financial markets that would result by the undoing of settled securities transactions.⁶ Generally, public LBOs involve large payouts, while private LBOs involve small payouts because private companies naturally have limited funds. This distinction is important because unwinding small LBO payments would not pose a risk to the financial markets, unlike large LBO payments. Therefore, interpreting § 546(e) to encompass private LBOs goes against Congress’s intent because unwinding private LBO payments does not pose a systematic risk in the financial markets. This leads to the third approach, arguing that in order to harmonize the legislative history with the plain meaning of § 546(e), only LBOs involving large payouts are protected under the safe harbor provision. The rationale behind this approach is that Congress enacted § 546(e) to protect against a ripple effect in the securities market by the unwinding of settled securities transactions. Because only large LBOs would pose such a risk, and because the plain meaning of § 546(e) unambiguously includes private LBOs, only large, private LBOs are protected. This approach is a sensible balance between § 546(e)’s plain meaning and its legislative history.

⁵ § 741(8).

⁶ H. Rep. No. 97–420, at 1 (1982), and its 2006 Amendment H. Rep. 109–648 (Part 1), at 1(2006).

II. LEGISLATIVE HISTORY APPROACH

Bankruptcy courts⁷ and circuit courts⁸ disagree on whether § 546(e) applies to private LBOs. Most circuits have not had the chance to decide the issue yet. However, all the circuits that have decided the issue have held that § 546(e)'s safe harbor applies to private LBOs just as it would to public LBOs. This section and the following two sections of this article seek to further explore the case law that has developed with respect to applying § 546(e) to private LBOs.

In a recent case, *In re MacMenamin's Grill Ltd.*,⁹ the Bankruptcy Court for the Southern District of New York held that § 546(e)'s safe harbor for settlement payments does not apply to private LBOs.¹⁰ MacMenamin's, a closely-held corporation, funded a stock purchase agreement in the form of a LBO through a \$1.15 million loan secured by a security interest in substantially all of MacMenamin's assets.¹¹ The loan proceeds were transferred directly to the bank accounts of three former shareholders, who controlled 93% of MacMenamin's stock, in exchange for the

⁷ Many courts have held that § 546(e) does not apply to private securities transactions. *See, e.g.*, *Kipperman v. Circle Trust F.B.O.* (*In re Grafton Partners, L.P.*), 321 B.R. 527, 538–41 (9th Cir. BAP 2005); *Buckley v. Goldman, Sachs & Co.*, 2005 WL 1206865, at *7–8, 2005 U.S. Dist. LEXIS 9626, at *26–30 (D.Mass. May 20, 2005); *Jackson v. Mishkin* (*In re Adler, Coleman Clearing Corp.*), 263 B.R. 406, 478–80 (S.D.N.Y.2001); *Zahn v. Yucaipa Capital Fund*, 218 B.R. 656, 675–76 (D.R.I.1998); *Jewel Recovery L.P. v. Gordon*, 196 B.R. 348, 352–53 (N.D.Tex.1996); *Wieboldt Stores, Inc. v. Schottenstein*, 131 B.R. 655, 663–65 (N.D.Ill.1991); *Rushton v. Bevan* (*In re D.E.I. Systems, Inc.*), 2011 WL 1261603, 2011 Bankr.LEXIS 1143 (Bankr.D. Utah April 5, 2011); *Kapila v. Espirito Santo Bank* (*In re Bankest Capital Corp.*), 374 B.R. 333, 345–46 (Bankr.S.D.Fla.2007); *Official Comm. of Unsecured Creditors v. Lattman* (*In re Norstan Apparel Shops, Inc.*), 367 B.R. 68, 76–77 (Bankr.E.D.N.Y.2007); *Official Comm. of Unsecured Creditors v. ASEA Brown Boveri, Inc.* (*In re Grand Eagle Co.*), 288 B.R. 484, 494 (Bankr.N.D.Ohio 2003). However, this article will focus on the decision of the Bankruptcy Court for the Southern District of New York.

⁸ *Brandt v. B.A. Capital Co. LP* (*In re Plassein*), 590 F.3d 252 (3rd Cir. 2009); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009); *QSI Holdings, Inc. v. Alford* (*In re QSI Holdings, Inc.*), 571 F.3d 545 (6th Cir. 2009).

⁹ *In re MacMenamin's Grill Ltd.*, 450 B.R. 414 (Bankr. S.D.N.Y. 2011).

¹⁰ *Id.* at 425.

¹¹ *Id.* at 417.

privately held stocks.¹² A little over a year later, MacMenamin’s filed its Chapter 11 petition and the trustee commenced an action to avoid the LBO payouts to the shareholders.¹³ The shareholders acknowledged that the LBO payouts were avoidable under 11 U.S.C. §§ 544(a), 548(a)(1)(B), as constructively fraudulent because the parties agreed that MacMenamin’s did not receive fair consideration for the payments to the shareholders.¹⁴ The shareholders, however, moved for summary judgment, claiming that the entire transaction was insulated by § 546(e), which protects “settlement payments” from most of the trustee’s avoiding powers.¹⁵

The court held that the LBO payouts were not settlement payments under § 546(e) and were, therefore, avoidable as constructively fraudulent.¹⁶ Admittedly, the court acknowledged that the plain meaning of “settlement payment” in § 546(e) appears to exempt private stock transactions, or small private LBOs, from avoidance as constructively fraudulent transfers.¹⁷ However, the court noted that 11 U.S.C § 741(8) defines “settlement payment” in a frustratingly self-referential way by defining a “settlement payment” as a “settlement payment.”¹⁸ Additionally, although a statute’s plain meaning is usually controlling, courts often refuse to enforce the statute as written where it would lead to an absurd result.¹⁹ The court, therefore, looked to the legislative history of § 546(e).²⁰

¹² *Id.*

¹³ *Id.* at 418.

¹⁴ *Id.* at 417–18.

¹⁵ *Id.* at 418.

¹⁶ *Id.* at 425.

¹⁷ *Id.* at 418–19.

¹⁸ *Id.* at 422.

¹⁹ *United States v. Ron Pair Enters.*, 489 U.S. 235, 242 (1989); *see also Lamie v. U.S. Trustee*, 540 U.S. 526, 534 (2004) (recognizing the “absurd result” to rule of strict statutory construction).

²⁰ *In re MacMenamin’s Grill Ltd.*, 450 B.R. at 419–20.



Congress’s intent when enacting § 546(e) was clear: to reduce systematic risk in the financial markets that would result by the undoing of settled securities transactions.²¹ The court concluded that in light of § 546(e)’s legislative history, if courts were to follow the plain meaning approach, trustees would be prevented from avoiding LBO transactions involving small payouts.²² This would not correspond with Congress’s intent because small LBO payouts pose little, if any, danger to the financial markets.²³ Therefore, protecting these payments would lack any relation to the purpose behind § 546(e) and its 2006 amendment.²⁴ Thus, concerned that enforcing the plain meaning of § 546(e) would lead to an absurd result, the court concluded that private LBOs are not protected under § 546(e)’s safe harbor.²⁵

IV. PLAIN MEANING APPROACH

In contrast to the legislative history approach, a string of decisions in 2009 by the Third, Sixth, and Eighth Circuits all held that § 546(e) applies to private LBOs. While the Third and Tenth Circuits had concluded prior to 2009 that LBO payouts to shareholders fell within the § 546(e) exemption, the 2009 decisions expanded the safe harbor provision to include LBO payouts involving privately-held companies. These decisions expanded the scope of § 546(e) to encompass a broad reading of “settlement payment.”

The Eighth Circuit, in *Contemporary Indus. Corp.*, held that § 546(e) applies to private LBOs.²⁶ The shareholders of Contemporary Industries Corp. received approximately \$26.5

²¹ *Id.*

²² *Id.* Private LBOs naturally involve only small payouts because private companies are typically not involved in large valued transactions because of their limited funds.

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.* at 425.

²⁶ *Contemporary Industries Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009).

million in connection with a LBO.²⁷ Ultimately, Contemporary Industries filed for Chapter 11, which CIC²⁸ claimed was a direct result of the debt the corporation had undertaken in order to make the LBO payments.²⁹ Therefore, CIC sought to avoid the LBO payments to the shareholders on the ground that they were fraudulent transfers under 11 U.S.C. § 544.³⁰ In its analysis, the court stated that the term “settlement payment” is extremely broad and intended to encompass most payments that can be considered settlement payments.³¹ The court noted that both the Third and Tenth Circuits construed “settlement payment” broadly too, holding that payments made to shareholders selling their shares in the course of a LBO transaction qualify as settlement payments within the plain meaning of § 546(e).³² *Lowenschuss v. Resorts Int’l, Inc. (In re Resorts, Int’l, Inc.)*, 181 F.3d 505, 515–16; *Kaiser Steel Corp. v. Pearl Brewing Co. (In re Kaiser Steel Corp.)*, 952 F.2d 1230, 1238–40 (10th Cir.1991).

CIC argued that *Resorts* and *Kaiser* were distinguishable from this case because both of those cases involved payments for publicly traded securities, while this case involved payments for privately traded securities, which several courts had concluded are not included in “settlement payment.”³³ The court rejected this argument and held that “nothing in the relevant statutory language suggests that Congress intended to exclude these payments from the statutory definition of ‘settlement payment’ simply because the stock at issue is privately held.”³⁴ Additionally, the court interpreted the concluding phrase of § 546(e)—“or any other payment

²⁷ *Id.* at 983.

²⁸ Contemporary Industries Corporation and the Official Committee of Unsecured Creditors are collectively referred to as “CIC.”

²⁹ *Id.*

³⁰ *Id.* at 983–84.

³¹ *Id.* at 985.

³² *Id.*

³³ *Id.*

³⁴ *Id.* at 986.

commonly used in the securities trade”—as a catchall phrase intended to underscore the breadth of the § 546(e) exemption.³⁵ As a side note, the court pointed out that there was a significant amount of money at stake—\$26.5 million—and unwinding these payments could indeed affect the financial markets.³⁶ Therefore, protecting these payments from avoidance would not conflict with the legislative history. The court concluded that the text of § 546(e) “plainly and unambiguously encompasses these payments” and does not lead to an absurd result.³⁷ Therefore, the plain meaning of § 546(e) must be enforced to protect private LBO payments.³⁸

Similarly, in *In re QSI Holdings*, the Sixth Circuit agreed with the Eighth Circuit that § 546(e) is not limited to publicly traded securities.³⁹ The adversary proceeding in *In re QSI Holdings* arose from a leveraged buyout of Quality Stores, Inc.⁴⁰ QSI Holdings, Inc. and Quality (collectively, “Plaintiffs”) sought to avoid the payouts to approximately 170 shareholders of Quality.⁴¹ The court began its analysis by looking at the plain meaning § 546(e).⁴² Despite noting that numerous courts had concluded that the definition of “settlement payment” is somewhat circular, the court reviewed the Bankruptcy Code’s definition of “settlement payment.”⁴³ The critical phrase in the definition of “settlement payment” is that the payment must be one that is “commonly used in securities trade.”⁴⁴ Although this definition seems to include private LBO payouts, the plaintiffs urged the court to examine § 546(e)’s legislative history.⁴⁵ The court

³⁵ *Id.*

³⁶ *Id.* at 987.

³⁷ *Id.*

³⁸ *Id.*

³⁹ *In re QSI Holdings, Inc.*, 571 F.3d 545, 547 (2009).

⁴⁰ *Id.*

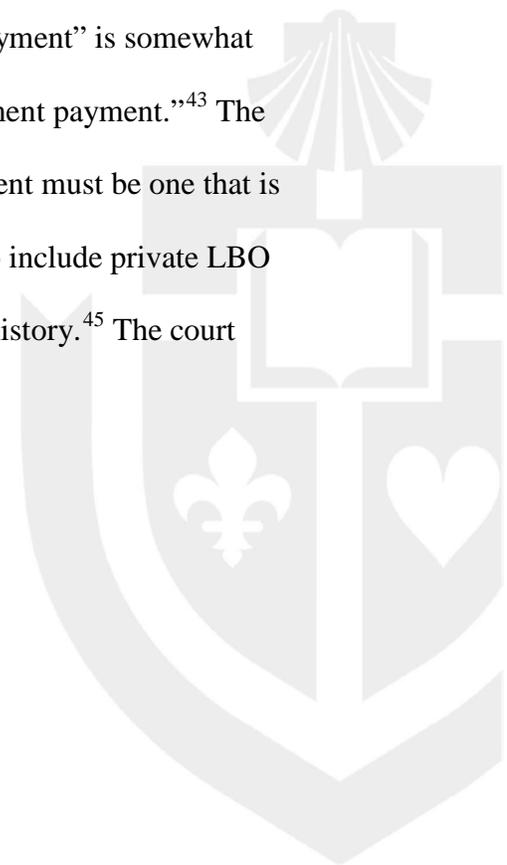
⁴¹ *Id.*

⁴² *Id.* at 549.

⁴³ *Id.*

⁴⁴ § 741(8)

⁴⁵ *In re QSI Holdings, Inc.*, 571 F.3d at 549.



declined to look at § 546(e)'s legislative history, agreeing with the Eighth Circuit that “[n]othing in the relevant statutory language suggests that Congress intended to exclude these payments from the statutory definition of ‘settlement payment’ simply because the stock at issue was privately held.”⁴⁶ Therefore, the court concluded, it was unnecessary to look at § 546(e)'s legislative history. Regardless, the court stated that protecting the LBO payouts here would not contradict § 546(e)'s legislative history because the value of the securities at issue was substantial, so there was no reason to think that unwinding these payments would have any less of an impact on the financial markets than publicly traded securities.⁴⁷ For these reasons, the court held that § 546(e) applies to private LBOs.⁴⁸

In light of the holdings of the Eight and Sixth Circuits, the Third Circuit followed suit.⁴⁹ In *Brandt v. B.A. Capital Co. LP (In re Plassein)*, the trustee for Plassein International Corporation argued that the LBO payments made to shareholders in exchange for their privately-held stock were fraudulent transfers.⁵⁰ Plassein was a corporation formed with the purpose of acquiring several privately-held manufacturing corporations through LBOs.⁵¹ Without analyzing the issue too deeply, the Third Circuit simply upheld its previous decision in *Resorts*,⁵² a case dealing with the same issue.⁵³ In *Resorts*, the Third Circuit stated that people who work in the securities trade use the term “settlement payment” when referring to a payment that completes a LBO. Therefore, the Third Circuit held that § 546(e) protects private LBOs.⁵⁴

⁴⁶ *Id.* at 550 (quoting *Contemporary Indus. Corp.*, 564 F.3d 981, 986 (2009)).

⁴⁷ *Id.* at 550.

⁴⁸ *Id.*

⁴⁹ *Brandt v. B.A. Capital Co. LP (In re Plassein)*, 590 F.3d 252 (3rd Cir. 2009).

⁵⁰ *Id.* at 255.

⁵¹ *Id.* at 254.

⁵² *In re Resorts Int'l, Inc.*, 181 F.3d 505 (3d Cir. 1999).

⁵³ *In re Plassein Intern. Corp.*, 590 F.3d at 258

⁵⁴ *Id.* at 259.

V. MIDDLE-GROUND APPROACH

Finally, a third approach is that § 546(e) only protects private LBOs involving large payouts to shareholders. In contrast, LBOs involving small payouts are not protected. Courts have not yet adopted this approach, but the *MacMenamin's* court and the Eighth and Sixth Circuits all intimated that this is a sensible dichotomy to applying § 546(e) to private LBOs.

The Eighth Circuit noted in dicta that because the LBO at issue involved a significant amount of money—\$26.5 million—unwinding those payments could affect the financial markets.⁵⁵ By implication, LBOs involving small payouts would not be protected because they would not pose a risk to the financial markets. Likewise, the Sixth Circuit made a similar statement in dicta,⁵⁶ which indicates its agreement with the Eighth Circuit. Similarly, in *MacMenamin's*, the court stated that its decision might be limited to its facts, considering the small purchase price paid in connection with the LBO.⁵⁷ This rationale implies that § 546(e) would apply if the LBO involved a larger payout because unwinding such a settlement would pose a risk to the financial markets. Therefore, according to this middle-ground approach, depending on the value of the LBO, § 546(e) can apply to private LBOs.

CONCLUSION

The three approaches to applying § 546(e) to private LBOs leaves parties with a sense of uncertainty. Bankruptcy courts may adopt any of the three approaches. Moreover, the circuit courts may reverse the bankruptcy courts, deciding to adopt a different approach. Even within the jurisdiction of the Eighth and Sixth Circuits, parties may be left with little guidance. The Eighth and Sixth Circuit might modify their approach if faced with a small, private LBO, because

⁵⁵ *Contemporary Industries Corp.*, 564 F.3d at 987.

⁵⁶ *In re QSI Holdings, Inc.*, 571 F.3d at 550.

⁵⁷ *In re MacMenamin's Grill Ltd.*, 450 B.R. at 425.

unwinding such a transaction will not pose a risk to the financial markets. Additionally, if a court decides to protect large LBO payouts from being avoided by a trustee, the court must then decide when private LBOs pass the tipping point from a small purchase price to a large purchase price. This will be an impracticable task because any dichotomy will naturally involve an arbitrary dollar amount. Furthermore, although LBOs are a very common solution to boosting revenue and making operational improvements, private companies may now be hesitant to arrange LBOs knowing that they are subject to avoidance as constructively fraudulent. Shareholders may also be less likely to enter into LBO transactions knowing that they may have to return the payments they will receive in exchange for their shares. Absent clarification by the United States Supreme Court or by Congress, bankruptcy courts and circuit courts will continue to disagree whether and to what extent § 546(e) applies to private LBOs.

