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Section 546(e) Safe Harbor Defense: When to Utilize and When to Preclude

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# Section 546(e) Safe Harbor Defense: When to Utilize and When to Preclude

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## Introduction

The Bankruptcy Code allows trustees and debtors-in-possession to invoke certain provisions of the United States Bankruptcy Code ("Bankruptcy Code") to "avoid" particular types of transfers.[1] The types of transfers that a debtor can "avoid" are defined rather broadly.[2] However, one significant exception to this "avoidance power" is section 546(e) and its safe harbor defense.[3] Courts have often wrestled with how to settle the meaning of section 546(e) and how to define the boundaries of the provision's safe harbor defense. First and foremost, it is important to note that Congress enacted section 546(e) as the safe harbor defense statute in 1982 to be used as a means of "minimizing the displacement caused in the commodities and securities markets in the event of a major bankruptcy within those industries."[4]

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[1] 11 U.S.C. § 546(e) (2012). *See* Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V. (*In re* Enron Creditors Recovery Corp.), 651 F.3d 329, 333 (2d Cir. 2011); *see also* QSI Holdings, Inc. v. Alford (*In re* QSI Holdings, Inc.) 571 F.3d 545 (6th Cir. 2009).
[2] *See* Mary K. Warren, *Recent Developments in Section 546(e) Safe Harbor Litigation*, CITY BAR CTR. FOR CONTINUING LEGAL EDUC. (Feb. 9, 2012).
[3] 11 U.S.C. § 546(e).
[4] *In re* Enron Creditors Recovery Corp., 651 F.3d at 333.

Originally, the safe harbor defense exclusively applied to "margin payments made by commodities clearing organizations."[5] However, the nature of the financial markets became increasingly complex and the issues that emerged became more difficult to handle; therefore, Congress needed to broaden the safe harbor defense's scope to encompass the newly emerging complexities.[6] Through the enactment of section 546(e), the safe harbor defense's scope was broadened to expand its protections "beyond the ordinary course of business transactions to include margin and settlement payments to and from brokers, clearing organizations, and financial institutions."[7] Ultimately, Congress sought to prevent catastrophic risks to the financial markets and to thwart spiraling effects that may ensue from unwinding certain security transaction.[8]

Regardless of the uncertainties about when to utilize the safe harbor defense and what limitations should be imposed, Congress has been reluctant to clarify the outer limits of the safe harbor defense.[9] Essentially, these issues have become problematic for judges when trying to determine whether permitting a party to assert the safe harbor defense is appropriate.

Section 546(e) has been amended throughout the years, which has enhanced the difficulties that emerge when a party asserts the safe harbor defense.[10] In 2005, the scope of the term "securities contract" was significantly broadened to encompass various types of securities transactions.[11] Further, in 2006, section 546(e) was amended by the Financial Netting

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[5] *See* Warren, *supra* note 2.
[6] *See id.*
[7] *See id.*
[8] *See* Daniel J. Merrett and Danielle Barav-Johnson, *Taking Stock: United State Supreme Court Presented with Opportunity to Settle Meaning of Section 546(e)*, NORTON J. BANKR. L. AND PRAC. (2016).
[9] *See id.*
[10] *See* Warren, *supra* note 2.
[11] *See id.*

Improvements Act to exclude from avoidance "transfers made in connection with a securities contract, commodity contract or forward contract."[12]

Throughout this memo, I will address what the safe harbor defense is, pursuant to section 546(e), and explain when such a defense may be asserted. In addition, I will discuss the caveat created between the safe harbor defense and 11 U.S.C. § 548(a)(1)(A)[13], and I will address the safe harbor defense's limitations when actual knowledge of fraud can be established.

## I. What is the "Safe Harbor" Defense?

Section 546(e) provides that a debtor or a "trustee may not avoid a settlement payment or transfer made by or to a commodity broker, financial institution, financial participant or securities agent."[14] The safe harbor defense may extend to any avoidance action pursuant to 11 U.S.C. §§ 544, 547, 548(a)(1)(B) & (b)[15] of the Bankruptcy Code.[16] However, the safe harbor defense limits the powers of a trustee or a debtor to avoid certain types of transfers, unless these transfers were made with the actual intent to "hinder, delay, or defraud creditors" pursuant to section 548 (a)(1)(A).[17] Further, a trustee may not avoid a "settlement payment" as a preference or a constructive fraudulent transfer.[18] The ultimate purpose of the safe harbor defense is to protect the financial markets from instability caused by the reversal of already settled securities transactions.[19]

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[12] *Id.*
[13] 11 U.S.C. § 548 (2012).
[14] 11 U.S.C. § 546(e).
[15] 11 U.S.C. § 544 (2012); 11 U.S.C. § 547 (2012); 11 U.S.C. §§ 548(a)(1)(B) & (b).
[16] 11 U.S.C. § 546(e).
[17] *Id.*; 11 U.S.C. § 548 (a)(1)(A).
[18] *See* Craig M. LaChance, *Major Event Litigation: Madoff Securities Fraud Litigation Under Securities Investor Protection Act (SIPA) 15 U.S.C.A. §§ 78aaa et seq.*, AM. LAW REP. (2015).
[19] *See* 3A BANKR. SERV. LAW. EDITION § 32:199 (Apr. 2017).

A transfer may qualify for the safe harbor defense even if the financial institution is merely a conduit.[20] Typically, the section 546(e) safe harbor is available to protect a settlement payment when a transferee can prove that the payments he or she received were settlement payments made by the stockbroker.[21] However, generally, a court will not allow for such a safe harbor defense when there is systemic fraud since fraudulent transactions are not commonly used in the securities industry and section 546(e) specifically excludes "actual fraudulent transfers" from the safe harbor defense.[22]

Generally, the safe harbor defense will apply to both publicly traded securities, as well as nonpublicly traded securities.[23] But such a defense will not apply unless a security is involved. *See id*. Therefore, the safe harbor defense will not apply to the "acquisition of assets, dividend distributions . . . or the payment of taxes." *See id*.

Some courts have noted that a party must assert section 546(e)'s safe harbor as an affirmative defense.[24] When courts are determining the appropriate application for a safe harbor defense, it is proper to draw such a conclusion in the context of a dispositive motion, such as a motion for summary judgment.[25] If courts were to extend safe harbor protection to fraudulent securities schemes, that would utterly undermine the goals of such a provision, which are to protect or to promote investor confidence.[26]

## II. How Should "Settlement Payments" be Defined?

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[20] *See id.*
[21] *See id.*
[22] *See id.*; *see also* 3 COLLIER ON BANKRUPTCY, ¶546.06[1], at 546-47 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2009).
[23] *See* Peter Spero, *§4:37 Securities and transactions that implicate financial markets*, FRAUDULENT TRANSFERS, PREBANKRUPTCY PLANNING AND EXEMPTIONS (Aug. 2016).
[24] *See id.*
[25] *See supra* note 19.
[26] *See* Picard v. Merkin (*In re* Bernard L. Madoff Inv. Sec. LLC), 440 B.R. 243, 267 (Bankr. S.D.N.Y. Nov. 17, 2010).

The term "settlement payment" within section 546(e) is defined by 11 U.S.C. § 741(8).[27] Section 741(8) of the Bankruptcy Code states that a settlement payment is 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."[28] This broad, non-descriptive definition causes substantial sources of tension when defining the safe harbor's scope.[29] Courts have noted that the settlement payment definition from section 741(8) is merely "unhelpful" because of its "inherent circularity."[30]

**a. "Settlement Payments" Shall be Read According to the Plain Meaning**

The definition of settlement payment should not be restricted because the intended purpose of the definition was meant to be broad; the plain meaning of the words from section 546(e) should be utilized.[31] According to most courts, the text of section 741(8) is "plain and unambiguous."[32]

The Court of Appeals for the Second Circuit in *In re Enron Creditors Recovery Corp*. had to decide whether section 546(e) would extend to issuer's redemption payments for its commercial paper prior to maturity.[33] Between October 25, 2001 and November 6, 2001, Enron paid out more than $1.1 billion to retire certain unsecured and uncertified commercial paper prior to maturity.[34] However, there was an offering memoranda accompanying the commercial paper

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[27] 11 U.S.C. § 741(8) (2012).
[28] *Id.*
[29] *See* Jonathan S. Feldmen, Joshua A. Marcus, and Elan A. Gershoni, *Recent Developments in Section 546(e) of the Bankruptcy* Code, NORTON J. BANKR. L. AND PRAC. (2012).
[30] *See* Kaiser Steel Corp. v. Charles Schwab & Co., Inc., 913 F.2d 846, 848 (10th Cir. 1990); *see also* Geltzer v. Mooney (*In re* MacMenamin's Grill Ltd.), 450 B.R. 414, 422 (Bankr. S.D.N.Y. Apr. 21, 2011); *see also* Feldmen, Marcus & Gershoni, *supra* note 29.
[31] *See In re* Enron Creditors Recovery Corp., 651 F.3d 330.
[32] *See id.*
[33] *See id.*
[34] *Id.* at 331.

that indicated that the notes were not redeemable prior to maturity.[35] But Enron redeemed the commercial paper before it's moment of maturity at the accrued par value, plus accrued interest, making the redemption price higher than the paper's market value.[36] The Court found that because Enron's redemption payments fell within the "plain language" of section 741(8), those payments were protected by section 546(e)'s safe harbor defense.[37] The Court noted that Enron completed a transaction that involved the "exchange of money for securities," which satisfies the meaning of a settlement payment pursuant to section 741(8).[38]

The District Court in *In re Enron Creditors Recovery Corp*., discussed "five key factors to determine the applicability of the safe harbor defense to any particular transaction" that Judge Marrero declared in *Jackson v. Mishkin* (*In re* Adler, Coleman Clearing Corp.).[39] The five key factors are as follows: (1) the transactions have long settled by means of actual transfers 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 securities or property interest as part of a settlement of the transaction; (3) the transfer of cash or securities effected contemplates consummation of a securities transaction; (4) the transfers were made to financial intermediaries involved in the national clearance and settlement system; (5) the transactions implicated participants in the system of intermediaries and guarantees which characterize the clearing and

[35] *Id.*
[36] *Id.*
[37] *Id.* at 333–35.
[38] *Id.*
[39] *See In re Enron Creditors Recovery Corp.*, 422 B.R. 423 (S.D.N.Y. Bankr. Nov. 20, 2009); Jackson v. Mishkin (*In re* Adler, Coleman Clearing Corp.), 263 B.R. 406 (S.D.N.Y. Bankr. June 11, 2001).

settlement process of public markets and create the potential for adverse impacts on the functioning of the securities market if any of those guarantees in the chain were involved.[40]

Generally, the phrase in section 741(8), "commonly used in the securities industry," is read as only modifying the words "any other similar payment."[41] The Court of Appeals for the Second Circuit in *In re Enron Creditors Recovery Corp*. reasoned that the "rule of last antecedent" helped conclude how to interpret the phrase "commonly used in the securities trade" because that rule informs us that a limiting clause or phrase should be read as modifying only the phrase that it immediately follows.[42] Additionally, it has been established that such a phrase was not meant to limit the way in which "settlement payments" could be defined, but rather a "catchall phrase intended to underscore the breadth of the section 546(e) exemption."[43]

**b. Leveraged Buyouts are "Settlement Payments" Pursuant to Section 546(e), Even when Privately Traded**

To further extend the breadth of not restricting the definition of "settlement payments," courts have found that leveraged buyouts will also qualify for section 546(e) protection.[44] Further, the statutory definition of "settlement payment" should not be limited and will sometimes apply to privately held trading securities.[45]

In *Contemporary Indus. Corp*., the Court of Appeals for the Eighth Circuit found that "nothing in the relevant statutory language suggests Congress intended to exclude these payments from the statutory definition of 'settlement payment' simply because the stock at issue

[40] *See id.*
[41] *See In re* Enron Creditors Recovery Corp., 651 F.3d. at 335.
[42] *See id*.
[43] *See id.* at 336.
[44] *See In re* QSI Holdings, Inc., 571 F.3d at 547; *Kaiser Steel Corp.,* 913 F.2d at 846.
[45] *See* Contemporary Indus. Corp v. Frost, 564 F.3d 981, 986 (8th Cir. 2009).

was privately held."[46] Additionally, this court noted that the phrase "or any other similar payment commonly used in the securities trades" evinces Congress' intent to incorporate a "catchall phrase" to emphasize the expansive breadth of section 546(e) exemptions.[47] It must be recognized that "where statutory language is plain and does not lead to an absurd result, we must enforce it as written."[48]

The Court of Appeals for the Sixth Circuit in *In re QSI Holdings, Inc.*, was presented with an issue that involved a leveraged buyout of the debtor's store. 571 F.3d at 547. The court had to determine whether section 546(e) would apply to such privately traded securities. *Id.* The plaintiff in this case sought to "avoid and recover the leveraged buyout transfers as constructively fraudulent conveyances." *Id.* at 548. However, the defendants asserted that because the leveraged buyouts were settlement payments made by a financial institution, the proceeding should be dismissed because these payments were exempt from avoidance under section 546(e). *Id.* When determining how to best read section 546(e), the court noted to first look at the text, and if the language is plain, "the sole function of the courts . . . is to enforce it according to its terms." and that there was "nothing in the text of section 546(e) precludes its application to settlement payments involving privately held securities." *Id.* at 549–50. Therefore, the Court of Appeals for the Sixth Circuit determined that leveraged buyouts fell within the definition of settlement payments and that those payments were protected by the safe harbor defense, even if the company was privately traded. *See id.*; *see also Contemporary Indus. Corp.*, 564 F.3d 981.

[46] *Id.*
[47] *See id.*
[48] *Id.* at 987.

Although many courts have reemphasized expansive definitions for the terminology within section 546(e), it is important to be aware that some courts seek to restrict the terminology and limit the breadth of section 546(e). For example, in another case decided by the Court of Appeals for the Eighth Circuit, the court sought to limit the application of section 546(e) to publicly traded securities and not privately traded securities.[49] However, the facts of that case lacked "many of the indicia of transactions" to qualify as a transaction "commonly used in the securities trade,"[50] and being a transaction "commonly used in the securities trade" is a necessary aspect to qualify as a "settlement payment" under section 546(e)'s safe harbor defense.

## III. Courts Must Consider "Actual Knowledge" When Determining Whether to Apply the Safe Harbor Defense

Actual knowledge is "direct and clear knowledge" that "implies a high level of certainty and absence of any substantial doubt regarding the existence of a fact."[51] However, establishing one's "actual knowledge" is rather difficult to prove because it is challenging to pinpoint exactly what someone knew or did not know.

The United States Court of Appeals for the Second Circuit, as well as the District Court for the Southern District of New York, has restricted a trustee's ability to avoid and recover transfers.[52] In light of the safe harbor defense pursuant to section 546(e), "the trustee may only avoid and recover intentional fraudulent transfers under section 548(a)(1)(A) made within two years of the filing date, *unless* the transferee had actual knowledge of Madoff's Ponzi scheme, or

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[49] *See In re* QSI Holdings, Inc., 571 F.3d at 550 (citing *In re* Norstan Apparel Shops, Inc., 367 B.R. 68, 79 (Bank. E.D.N.Y. 2007).
[50] *See id.*
[51] Picard v. Avellino (*In re* Bernard L. Madoff Inv. Sec. LLC) 557 B.R. 89, 113 (Bankr. S.D.N.Y. July 21, 2016); Picard v. Merkin (*In re* Bernard L. Madoff Inv. Sec. LLC), 515 B.R. 117, 138 (Bankr. S.D.N.Y. Aug. 12, 2014); Picard v. Legacy Capital Ltd. (*In re* Bernard L. Madoff Inv. Sec. LLC) 548 B.R. 13, 28 (Bankr. S.D.N.Y. Mar. 14, 2016).
[52] *See Legacy Capital Ltd.* (*In re* BLMIS), 548 B.R. 13; *see also Avellino* (*In re* Bernard L. Madoff Inv. Sec. LLC) 557 B.R. 89.

more generally, 'actual knowledge that there were no actual securities transactions being conducted.'"[53]

Pursuant to section 548(a)(1)(A) of the Bankruptcy Code, a trustee may avoid any transfer of an interest of the debtor in property that was made or incurred within two years of the petition filing date if the debtor, voluntarily or involuntarily, made such transfer with the actual intent to hinder, delay, or defraud any creditor.[54] The breakdown of the requirements for a trustee to establish such an action are as follows: (1) the debtor transferred an interest in property or incurred a debt; (2) on or within two years before the petition filing date; (3) with actual intent to delay, defraud, or hinder a present or future creditor.[55]

Further, if a trustee files a claim under section 548(a)(1)(A), then the section 546(e) defense is unavailable.[56] A transferee who has actual knowledge of fraudulent transfers, i.e., a Ponzi scheme, cannot avail itself of the section 546(e) safe harbor defense.[57] A Ponzi scheme is defined as "a fraudulent arrangement in which an entity makes payments to investors from monies obtained from later investors rather than any 'profits' of the underlying business venture."[58] Such fraud consists of "funneling proceeds received from new investors to previous investors in the guise of profits from the alleged business venture, thereby cultivating an illusion that a legitimate profit-making business opportunity exists and inducing further investment."[59] Essentially, transfers made in furtherance of Ponzi schemes are sufficient to establish that the

[53] *See Legacy Capital Ltd.* (*In re* BLMIS), 548 B.R. at 28.
[54] 11 U.S.C. § 548(a)(1)(A).
[55] *Id.*
[56] *See* Spero, *supra* note 23.
[57] *See Merkin* (*In re* BLMIS), 515 B.R. at 138.
[58] *See* Kathleen March, Alan Ahart and Janet Shapiro, *H. Avoidance of Fraudulent Transfers and Debts* (11 U.S.C. § 548), CAL. PRAC. GUIDE: BANKR. (2016).
[59] *Id.*

transfer was fraudulent and to illustrate that the transferor did have intent to hinder, delay or defraud creditors.[60]

Ultimately, the drafters of the Bankruptcy Code provided a limitation on safe harbor defense through section 548(a)(1)(A) by indicating that any avoidance action that concerns transfers made with actual intent to hinder, delay or defraud will be exempt from safe harbor protection under section 546(e).[61]

## IV. Second Circuit Courts Will Dismiss a Transferee's Motion to Dismiss via Safe Harbor Protection if the Transferee has Actual Knowledge of Fraud

The issue of whether safe harbor protection should apply to transfers made by Bernard L. Madoff Investment Securities' ("BLMIS") accounts to its investment advisory customers was hotly contested for several years.[62] Over the years, several courts have found that section 546(e) is inapplicable in situations where a trustee is seeking to avoid transfers that were made to further fraudulent activities.[63]

The safe harbor defense will not be available to a transferee who had actual knowledge of fictitious activity.[64] In *Picard v. Katz*, the Bankruptcy court "implicitly suggested" that those who were actual participants in the fraud would not be "entitled to invoke the protections of section 546(e) because, unlike innocent customers, they could not have believed that settlement payments were entirely bona fide."[65]

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[60] *See id.*
[61] *See* Hoskins v. Citigroup, Inc. (*In re* Viola), 469 B.R. 1, 3 (Bankr. S.D.N.Y. Apr. 6, 2012).
[62] *See, e.g.,* Picard v. Estate of Mendelow (*In re* Bernard L. Madoff Inv. Sec. LLC), 506 B.R. 208, 222 (Bankr. S.D.N.Y. Sept. 28, 2016).
[63] *See Picard v. Avellino*, 557 B.R. 89; *Picard v. Merkin*, 515 B.R. 117; *Picard v. Legacy Capital Ltd.*, 548 B.R. 13; Sec. Inv'r. Protection Corp. v. Bernard L. Madoff Inv. Sec. LL*C*, No. 12 MC 115(JSR), 2013 WL 1609154 S.D.N.Y. 2013); Picard v. Katz, 462 B.R. 447 (Bankr. S.D.N.Y. Sept. 27, 2011); s*ee also* Warren, *Recent Developments in Section 546(e) Safe Harbor Litigation.*
[64] *See Sec. Inv'r. Protection Corp.* 2013 WL 1609154 at *4.
[65] *Id.*; *see Picard v. Katz*, 462 B.R. 447.

It is important for judges to bear in mind that the goal of section 546(e) is to protect the reasonable expectations of *bona fide* investors who believed that they were signing legitimate securities contracts.[66] However, a transferee who had actual knowledge that Madoff's BLMIS was a Ponzi scheme did not have any such expectations, other than the desire to obtain greater rates of monetary return while he or she could.[67] That is why courts were reluctant to grant safe harbor protection to BLMIS transferees who were found to have had actual knowledge of the fraudulent circumstances.

The court in *Sec. Inv'r Protection Corp.* acknowledged that a defendant cannot be permitted to "launder what he or she knows to be fraudulently transferred funds through a nominal third party and still obtain the protections of section 546(e)."[68] Therefore, the court established that once a trustee sufficiently establishes that a transferee has actual knowledge of a fraudulent transfer, that transferee cannot assert safe harbor protection.[69] Additionally, if a transferee has actual knowledge of such fraud, the transferee's motion to dismiss the claims on the basis of the safe harbor defense must be denied.[70]

## V. Cases that Illustrate Preclusions of Safe Harbor Defense Due to Defendants Actual Knowledge of Fraud

There are many cases where courts have outright held that a transferee will be precluded from taking advantage of the safe harbor defense if that individual had actual knowledge of fraudulent activity. It is important to know the particular facts of a situation because a court will consider all relevant facts and circumstances when determining whether to grant a transferee safe harbor protection, especially if the situation involves allegedly fraudulent acts.

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[66] *See Sec. Inv'r. Protection Corp.* 2013 WL 1609154 at *4.
[67] *See id.*
[68] *Id.* at *7.
[69] *See id.*
[70] *See id.* at *10.

In the Bankruptcy Court's second major decision in the long list of BLMIS-related cases, the court set a precedent for these proceedings that certain "fraudulent transfer claims relating to distributions" would not be protected by section 546(e) safe harbor defense.[71] The court for *Picard v. Madoff* (*In re* BLMIS) rejected arguments that "BLMIS was a stockbroker 'engaged in the business of effecting transactions in securities'" because it was evident that those engaged in a Ponzi scheme did not make legitimate "securities transactions happen."[72] Through BLMIS, Madoff never "purchased any of the securities he claimed to have purchased for customer accounts."[73] Furthermore, the court concluded that BLMIS payments did not constitute satisfactory "settlement payments" worthy of safe harbor protection. *See id*. Moreover, the court noted that such settlement payments "must be made in the context of real securities transactions, not fake ones."[74]

Recently, in *Avellino* (*In re* BLMIS), the United States Bankruptcy Court for the Southern District of New York held that actual knowledge of any fraudulent nature of security trading will preclude a transferee from using the safe harbor defense of section 546(e).[75] This case illustrated particular facts of a situation where a court disallowed the safe harbor defense because of the particular involvement transferees had with fraudulent activity.

Avellino and Bienes (collectively, "the defendants") were accountants who were actively involved with Madoff and BLMIS.[76] The defendants tracked returns and side payments, and

[71] Picard v. Madoff (*In re* BLMIS) 458 B.R. 87 (Bankr. S.D.N.Y. Sept. 22, 2011); *Legacy Capital Ltd.* (*In re* BLMIS), 548 B.R. 13; *Avellino* (*In re* BLMIS) 557 B.R. 89.
[72] *See Picard v. Madoff*, 458 B.R. at 115.
[73] *See id.*
[74] *See id.*
[75] *See Avellino*, 557 B.R. 89.
[76] *See id.* at 102.

commanded BLMIS employees how to allocate payments amongst specific accounts.[77] The money was paid to these accounts through fictitious payments that amounted to a specific predetermined dollar amount that guaranteed a particular rate of return.[78] Ultimately, the court considered those actions and the extent of the defendants' actual knowledge of Madoff's Ponzi scheme, as well as their direct and active participation on such fictitious payments, and ultimately determined that the defendants were not entitled to the safe harbor protection.[79]

Subsequent to *Avellino* (*In re* BLMIS), the court analyzed issues with an extremely similar factual situation. In *Estate of Mendelow* (*In re* BLMIS), the court again had to determine whether it was appropriate to award a transferee the safe harbor defense.[80] Like Avellino and Bienes, Mendelow was also an accountant who opened accounts at BLMIS for himself, his family, and various clients.[81] Allegedly, Mendelow was close with Madoff and there were records of numerous phone calls that occurred between Mendelow and BLMIS.[82] Additionally, Mendelow's name and phone number were written in Madoff's address book.[83] Mendelow received particularly high rates of return that consistently met pre-determined rates.[84] Ultimately, Mendelow knew that these types of return rates were impossible if Madoff was *actually* involved in legitimate trading securities.[85] Like Avellino and Bienes, Mendelow was actively involved in ensuring that his accounts met the pre-determined guaranteed rate of return.[86] Further, like Avellino's and Bienes' payments, Mendelow's payments were ensured through fictitious

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[77] *See id.*
[78] *See id.* at 102, 116.
[79] *See id.* at 116–19.
[80] *See Estate of Mendelow* (*In re* BLMIS), 560 B.R. 208.
[81] *Id.* at 213–14.
[82] *Id.* at 214.
[83] *Id.*
[84] *Id.* at 215.
[85] *Id.*
[86] *Id.* at 226.

trades.[87] Like the court in *Avellino* (*In re* BLMIS), the court here held that the facts of the situation illustrated that Mendelow had actual knowledge that BLMIS was not engaged in actual trading securities, and that there was apparent evidence that fictitious trading was frequently occurring.[88]

**Conclusion**

Various courts disagree about whether the language of section 546(e) is ambiguous or whether the statute is clear on its face.[89] Generally, the types of payments that allow a party to invoke the safe harbor defense are broad. The explicit definition of the term "settlement payment," defined in section 741(8) is qualified by a catchall phrase that encompasses a broad breadth of payments that can satisfy implementation of the safe harbor defense. However, that is not to say that there are no limitations imposed on the implementation of section 546(e)'s safe harbor defense.

Although not always, there are circumstances where the safe harbor defense may not be asserted for fictitious payments; for example, the Second Circuit has found that when a transferee has actual knowledge of the fraudulent activity, the safe harbor defense will not apply. Throughout the years, there have been debates and contentious case proceedings involving the issue of what to make of transferees who were involved with fraudulent security trading; particularly, whether the transfers made by BLMIS to the investment advisory customers were protected by the safe harbor defense of section 546(e). The Second Circuit courts have continuously disallowed section 546(e) safe harbor protection for individuals involved in Ponzi scheme activity, or other forms of fraudulent activity, and will fully consider the extent of one's knowledge in the activity

[87] *Id.*
[88] *See id.* at 225–26.
[89] *See* Resnick & Sommer, *supra* note 22.

when determining whether safe harbor will be granted. Ultimately, it appears, at least for the Second Circuit, that when there is actual knowledge of fraudulent transfers, and there actually is no involvement with trading securities, a transferee will not be allowed to utilize the safe harbor defense.