

Second Circuit Extends Reach of Section 546(e) to Redemption of Commercial Paper

Introduction

The Bankruptcy Code generally allows trustees and debtors-in-possession to seek to avoid and recover fraudulent and preferential transfers made prior to bankruptcy. One of the exceptions to this general rule is found in Section 546(e) of the Bankruptcy Code. That section provides that securities-related "settlement payments" made to or from certain parties, including financial institutions, financial participants and stockbrokers, are not subject to avoidance unless those payments were made with actual intent to defraud, hinder or delay creditors. On June 28, 2011 the Second Circuit issued an opinion in *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*¹ in which it read the term "settlement payments" to include the redemption of commercial paper by its issuer. In doing so, the Second Circuit refused to read a "purchase or sale" requirement into Section 546(e) and concluded that all that is necessary to constitute a settlement payment is that it be a payment to conclude a transaction involving securities, but that such a transaction need not be a sale in which the buyer takes title to the securities. Because commercial paper is a security under the Bankruptcy Code, and the payments were made to conclude a transaction in commercial paper, the payments were protected under Section 546(e).

Background

Enron Creditors Recovery Corporation ("**Enron**"), previously known as Enron Corporation, is the

former energy services firm that filed for chapter 11 bankruptcy in 2001 after a scandal-ridden fall from grace. After confirmation of its chapter 11 bankruptcy plan, Enron was charged with liquidating the corporation's remaining assets for the benefit of its creditors. In seeking to fulfill that mission Enron sought to recover certain pre-bankruptcy payments, asserting that they were preferential transfers and thus avoidable and recoverable under the Bankruptcy Code. One particular set of such payments that Enron sought to recover were made pre-bankruptcy to approximately 200 parties (the " **Holders**") that held commercial paper issued by Enron (the "**CP**"). Approximately one month prior to filing for bankruptcy, Enron paid more than \$1.1 billion to redeem some of its outstanding unsecured commercial paper. While the motivations behind the redemption were disputed, the method by which it was effectuated was not. The terms of the CP did not give Enron the right to redeem it prior to the maturity date, but a number of holders agreed to redemption (likely due to the fact that Enron was offering to redeem for well-above the current market price of the CP). Once the holders decided to allow Enron to redeem, three broker-dealers and the Depository Trust Company ("**DTC**") handled the process. The applicable broker-dealer would receive the CP from the holders and pay out the redemption price. The payments went from the broker-dealer's DTC account into the holder's DTC account. Once that payment was made, the broker-dealer would transfer the paper to the DTC account of Enron's issuing and paying agent, who then transferred payment into the broker-dealer's DTC account. The CP was extinguished immediately upon the broker-dealer receiving payment.

¹ Case No. 09-5122-bk (L) (2d Cir. June 28, 2011).

In November of 2003, approximately 2 years after redeeming the CP (and filing for bankruptcy), Enron brought adversary proceedings against the Holders seeking to recover the amounts paid to redeem the CP. The Holders moved to dismiss, asserting that the transfers were settlement payments and were thus protected from avoidance under the Section 546(e) “safe harbor.”

The Bankruptcy Court first examined the language of the statute,² specifically the definition of “settlement payment,”³ and concluded that the modifying phrase “commonly used in the securities trade” applied to the entire “settlement payment” definition. The Court stated that evidence was necessary to show whether pre-maturity redemption of commercial paper is common in the securities trade, which would determine whether such redemption payments fit within the safe harbor. The Court then concluded that a factual issue existed regarding Enron’s motivation for redeeming the CP; that motivation (whether it was to retire the debt or to purchase the CP) could affect whether Section 546(e) applies. As such, the Bankruptcy Court denied the motions to dismiss; most of the defendants settled after the motions to dismiss were denied.

The remaining defendants, after conducting discovery, moved for summary judgment, again asserting Section 546(e) as grounds. The Bankruptcy Court denied summary judgment, concluding that the term “settlement payment” only applies to transactions in which securities are bought or sold, and that the Holders had not shown that the payments were made to acquire title to the CP. As such, Section 546(e) did not protect the payments from avoidance.

The Holders appealed to the District Court, which reversed. The District Court framed the question as, “whether the 546(e) safe harbor applies to an issuer’s redemption of commercial paper prior to maturity,

² “[T]he 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 . . . stockbroker, financial institution, financial participant, or securities clearing agency . . . that is made before the commencement of the case, except under section 548 (a)(1)(A) of this title [which covers transfers made with actual intent to hinder, delay or defraud creditors].” 11 U.S.C. 546(e).

³ “[S]ettlement payment’ means 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).

effected through the customary mechanism of transacting in commercial paper through the [DTC], without regard to extrinsic facts, such as the motives and circumstances of the redemption.” Disagreeing with the Bankruptcy Court, the District Court found that (a) the phrase, “commonly used” did not modify the entire definition of “settlement payment,” (b) a “settlement payment” is any transfer that concludes a securities transaction, and (c) the redemption of the CP was a securities transaction because it involved the “delivery and receipt of funds and securities.” Enron then took an appeal to the Second Circuit.

Analysis

The Second Circuit, in a 2-1 decision (the “Majority”), affirmed the judgment of the District Court. In doing so, it addressed and rejected three distinct arguments asserted by Enron and ultimately held that Section 546(e) did protect the redemption payments from avoidance.

The Majority addressed Enron’s argument that there should be three limitations on the definition of “settlement payment.” Enron proposed that the definition be limited to (1) payments “commonly used in the securities industry,” (2) transaction in which title to the securities changes hands, and (3) transactions that involve financial intermediaries. The Majority rejected all three of Enron’s proposals, stating that there is no support in the Bankruptcy Code or in the case law for such restrictions.

“Commonly used in the securities trade” and the Rule of the Last Antecedent

The Majority addressed Enron’s argument that the modifying phrase, “commonly used in the securities trade” modifies the entire definition of “settlement payment.” If such a definition were accepted, it would only encompass payments that are in fact common in the securities trade (thus excluding the early redemption payments, as Enron argued such are extraordinary). Applying the rule of the last antecedent, the Majority held that the phrase “commonly used in the securities trade” only modifies the phrase “any other similar payment” that immediately precedes it, rather than the entire definition. Had “commonly used in the securities trade” been set off by commas, it would have modified the entire definition; since it was not set off, it does not do so. The Second Circuit went on to say that adopting Enron’s reading of the modifier would result in uncertainty and unpredictability, as every application would

require a factual determination as to how common the transaction is.

Redemption of the Debt Securities Completed a Transaction In Securities and Thus Constituted a Settlement Payment

Enron also argued that a purchase or sale requirement should be read into the definition of “settlement payment.” The Majority rebuffed, stating that there is no support in the Bankruptcy Code for such a reading. It went on to state that it agrees with the other circuits which have held that, in this context, “settlement” means the completion of a securities transaction, but that a securities transaction does not necessarily involve a purchase or sale. In other words, a securities transaction can occur without title to the securities actually changing hands. The Majority also rejected Enron’s argument, with which the Dissent agrees, that allowing commercial paper redemptions the protection of Section 546(e) would imperil the future ability of debtors and trustees to avoid debt-related payments. The Majority insisted that the fact that the term “settlement payment” is to be interpreted in the context of the securities trade will prevent Section 546(e) from protecting ordinary loan payments. Ultimately, it refused to read a purchase or sale requirement into the definition of “settlement payment.”

Lack of a Financial Intermediary is Not Fatal

The Majority also rejected Enron’s argument that the lack of a financial intermediary, one who would have taken title to the securities during the course of the transaction, is fatal to the argument that the redemption was a “settlement payment.” The Majority held that the transaction posed the same risks to the financial markets that transactions through a financial intermediary would. Specifically, the Majority relied on the fact that the transaction involved over 200 holders and over \$1 billion in commercial paper; it stated that undoing such a transaction could have a substantial impact on the financial markets.

Holding: The Redemption of the Commercial Paper was a Settlement Payment

Ultimately, the Second Circuit concluded that the payments were made to redeem commercial paper, which is a security under the Bankruptcy Code.⁴ The

⁴ The Majority refused to adopt the definition of security from the Securities Act of 1934, which would have excluded commercial paper.

transaction thus constituted a “transfer of cash . . . made to complete a securities transaction.” As such, the payments were “settlement payments” and Section 546(e) protects them from avoidance. The Second Circuit stated that its conclusion was based on the plain-language of the statute and as such the legislative history was irrelevant, though it would not lead to a different result.

Dissent

The Dissent agreed with Enron’s argument that the term “settlement payment” requires a purchase or sale of securities. It argued that the Majority threatens to upend routine avoidance actions because it too-broadly defines the term “settlement payment.” The Dissent went on to state that it believed that the statute is ambiguous and should be interpreted in accordance with its usage in the securities trade, which it asserts involves the purchase or sale of securities. Given that neither party argued that the transaction actually involved the purchase or sale of securities, the Dissent would have denied the protections of Section 546(e).

Further, the relevant legislative history does not support extending protection of Section 546(e) to the redemption, according to the Dissent. This is because the Dissent believes the legislative history indicates that Section 546(e) was designed to protect clearing agencies from the risks they take on as intermediaries; these risks are not implicated by the commercial paper market because there is no central clearing counterparty. Additionally, the Dissent cited legislative history from the enactment of Section 547(c)(2)⁵ which indicated that Congress intended that section to protect ordinary course redemptions of commercial paper; the Dissent argued that such would have been unnecessary had Congress intended, as the Majority holds, Section 546(e) to protect commercial paper redemptions.

Conclusion

The Majority’s expansion of Section 546(e) to encompass the redemption of commercial paper could have broad implications on the use of this safe-harbor. First, the reading of “settlement payment” as to not require a purchase or sale of a security appears to run counter to established case law in this area as noted by the Dissent. Second, the Majority appears to create some uncertainty as to what degree of potential impact on the

⁵ This section protects certain payments made in the ordinary course of business from avoidance.

securities market is necessary to successfully assert a Section 546(e) defense; here, the commercial paper did not pass through the securities market in the traditional sense (no clearing agencies or other financial interme-

diary involved), but it seems that the court felt that the size of the transaction (both in value and number of participants) was sufficient to potentially impact the markets.

Practice group contacts

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