CLEARY GOTTLIEB

Alert Memo

MAY 6, 2011

www.clearygottlieb.com

# Bankruptcy Court Holds That Safe Harbor in Section 546(e) of the Bankruptcy Code for "Securities Contracts" Does Not Protect Sellers or Lender From Avoidance Actions in Private LBO Transaction

On April 21, 2011, the U.S. Bankruptcy Court for the Southern District of New York held in the bankruptcy proceeding of MacMenamin's Grill Ltd. (the "Debtor") that the safe harbor for certain transfers "in connection with … securities contract[s]" in Section 546(e) of the Bankruptcy Code (the "Code") did not protect from the bankruptcy trustee's powers to avoid constructively fraudulent transfers either the payment by the Debtor to repurchase its shares or the Debtor's incurrence of the related loan obligation to finance the repurchase in the context of a private leveraged buy-out transaction. The decision is particularly noteworthy because the Court, notwithstanding the unambiguous language of the 2006 Amendments to the Code which added protection for any "transfer… in connection with a securities contract," looked to legislative history and determined that this protection was not available for "private stock transactions."

## Background

More than a year prior to its November 18, 2008 bankruptcy filing, the Debtor entered into a Stock Purchase Agreement with three of its shareholders to repurchase all stock then held by such shareholders. Each shareholder held a 31% interest in the Debtor. The Debtor also entered into a Loan and Security Agreement with Commerce Bank, N.A. (the "Bank") under which the Bank agreed to lend the Debtor USD 1.15 million to fund the stock repurchase. The Debtor's obligations to the Bank under the loan were secured by a lien on substantially all of the Debtor's assets. The loaned funds were wired directly to the shareholders' bank accounts.

After the Debtor filed for bankruptcy, the Chapter 11 trustee (the "Trustee") filed a complaint against the three shareholders and the Bank seeking to avoid, as constructive fraudulent conveyances under Sections 548(a)(1)(B) and 544(b) of the Code, the Debtor's purchase of stock from the shareholders and its incurrence of the related loan obligation to the Bank. The shareholders and the Bank moved for summary judgment on the basis that Section 546(e) of the Code shielded them from the Trustee's avoidance claims. The parties

stipulated, for purposes of the summary judgment motions, that the Debtor did not receive fair consideration or reasonably equivalent value for the payments to the shareholders or for the incurrence of the loan obligation and the related grant of the security interest to the Bank and that the Debtor was insolvent prior to, or became insolvent as a result of, the stock purchase and the loan, and that therefore the stock purchase and loan were constructively fraudulent.

**The Decision**

The Court held that the safe harbor under Section 546(e) did not protect the shareholders or the Bank from the Trustee's avoidance claims and denied the motions for summary judgment.

Section 546(e) establishes a safe harbor from avoidance claims for certain kinds of transfers that are not intentionally fraudulent. It provides, in relevant part, that:

> "the trustee may not avoid a transfer that is a margin payment … or settlement payment … made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, … commodity contract, … or forward contract, that is made before the commencement of the case."

The parties did not dispute that the shareholders' banks and the Bank were "financial institutions," that the stock purchase constituted a "securities contract," or that the payment to purchase stock may be viewed as a "settlement payment."

The issue before the court was whether the Section 546(e) safe harbor was applicable to constructively fraudulent transfers arising from private stock transactions. Courts that have extended the safe harbor have emphasized the provision's plain meaning; courts that have declined to extend safe harbor protection to private stock transactions have interpreted the provision in light of Congress's stated purpose for enacting the safe harbor — i.e., to reduce risk in the public financial markets and their related clearing systems that would be occasioned by allowing bankruptcy trustees to avoid long-settled securities transactions.

The Court ultimately sided with courts that have looked to the legislative history of Section 546(e) and decided not to extend the safe harbor to private stock transactions. In doing so, the Court acknowledged that Congress did not expressly limit the safe harbor's reach to public or market transactions and, in fact, broadened the safe harbor's reach when it amended Section 546(e) in 2006 to include any "transfer…in connection with" a "securities contract." Nevertheless, the Court held that the safe harbor did not protect the shareholders or the Bank from the Trustee's avoidance claims:

> "[I]n the light of section 546(e)'s textual context, which apparently focuses, in the midst of a circular and therefore ambiguous set of definitions, on the trade or business of securities transactions, reference to the legislative history is warranted. That legislative history, including the history of the 2006 Amendment, makes it clear that Congress intended section 546(e) to address risks that the movants have failed to show conclusively are implicated by the avoidance of the transaction at issue here. The Court should not, therefore, impose a result contrary to Congressional intent. The movants in fact have not provided any evidence that the avoidance of the transactions at issue involved any entity in its capacity as a participant in any securities market, or that the avoidance of the transactions at issue poses any danger to the functioning of any securities market. Thus, section 546(e)'s safe harbor does not apply. This result… [is]… required by Congressional intent as discerned from, first, the applicable statutory provisions, including their context within the Code, and, second, clear and consistent legislative history." [emphasis added]

This decision is troubling: although the "settlement payment" definition may, as other courts have held, be circular and ambiguous, thus justifying an examination of legislative history, in this case the parties did not dispute that the transaction was a "securities contract" and the court still looked to legislative history notwithstanding unambiguous statutory language. According to the court the basis for doing so is "section 546(e)'s textual context, which apparently focuses…on the trade or business of securities transactions." This is troubling not only in the particular context – avoidance of payments in "a classic LBO, although writ small" – but also for other safe harbor analysis of statutory language that would appear to be unambiguous.

The decision includes a further holding regarding the Debtor's loan obligation to the Bank. Here, the Court held that Section 546(e)'s safe harbor applies only to the avoidance of "transfers" as defined under the Code, not the incurrence of obligations. The Court noted that unlike Sections 544(a) and 548(a)(1) of the Code, which authorize trustees to avoid both transfers and obligations incurred, the Section 546(e) safe harbor refers only to the avoidance of "transfers." Thus even were the safe harbor available to protect payments made to the selling shareholders, it would not have been available to protect the incurrence of the loan obligation. The court suggests that payments actually received by the Bank and the security interest itself would, as transfers, be protected under Section 546(e) but does not analyze the potential commercial law implications of the avoidance of the obligation the security interest was created to secure.

* * *

If you have any questions about this case, this alert memorandum or the implications of this decision more generally, please contact any of your regular bankruptcy, restructuring or structured finance contacts, or any of our partners and counsel listed under "Bankruptcy and Restructuring" or "Derivatives" in the "Practices" section of our website at http://www.clearygottlieb.com.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

CLEARY GOTTLIEB

# Office Locations

New York
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

Washington
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

Paris
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

Brussels
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

London
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

Moscow
Cleary Gottlieb Steen & Hamilton LLC*
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax
* an affiliate of Cleary Gottlieb Steen & Hamilton LLP

Frankfurt
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

Cologne
Theodor-Heuss-Ring 9
50688 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

Rome
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

Milan
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

Hong Kong
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

Beijing
Twin Towers – West (23rd Floor)
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax

Buenos Aires
CGSH International Legal
Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
54 11 5556 8900
54 11 5556 8999 Fax