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Alert Memo

AUGUST 11, 2011

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Bankruptcy Court Holds That Safe Harbor in Section 546(e) of the Bankruptcy Code for "Settlement Payments" Protects Recipients of Repurchase Payments for Privately Placed Notes

On July 27, 2011, the U.S. Bankruptcy Court for the Southern District of New York held in the bankruptcy proceeding of Quebecor World (USA) Inc. (the "Debtor", and together with its various debtor and non-debtor affiliates, "Quebecor") that the safe harbor for certain "settlement payments…in connection with … securities contract[s]" in Section 546(e) of the Bankruptcy Code (the "Code") protects recipients of prepetition repurchase payments on privately placed notes from an action for the avoidance and recovery of such payments.[1] The decision represents an application of the Second Circuit's holding in *In re Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, No. 09-5122-bk, 2011 WL 2536101 (2d Cir. June 28, 2011), which adopted a broad reading of the definition of "settlement payment" set forth in Section 741(8) of the Code based on the plain meaning of the statute in holding that prepetition payments made by Enron to redeem its commercial paper prior to maturity constituted "settlement payments" protected from avoidance by the Section 546(e) safe harbor.

Background

In July 2000, an affiliate of the Debtor raised $371 million by issuing a series of notes in a private placement to a group composed primarily of insurance company investors. The relevant note purchase agreement permitted the issuer to purchase, redeem, or prepay the notes at any time. In October 2007, faced with deteriorating financial circumstances, Quebecor arranged to draw on its credit facility in order to repurchase the notes. Quebecor made a draw in the amount of $426 million, which included $376 million for purposes of the repurchase payment and related make-whole premium (the "Disputed Transfer"). After receiving the $376 million, the Debtor transferred the funds to CIBC Mellon Trust Co. ("CIBC Mellon") as trustee for the notes, which wired to each noteholder its respective portion of the Disputed Transfer. The noteholders subsequently surrendered the notes by mailing them to Quebecor headquarters. Less than three months later, the Debtor and certain of its affiliates filed for Chapter 11 protection in the U.S. Bankruptcy Court for the Southern District of New York. Thereafter, the Official Committee of Unsecured Creditors

[1] *In re Official Committee of Unsecured Creditors of Quebecor World (USA) Inc. v. American United Life Insurance Company*, No. 08-10152, 2011 WL 3157292 (Bankr. S.D.N.Y. July 27, 2011).

of Quebecor World (USA) Inc. (the "Committee") commenced an action to avoid and recover the Disputed Transfer and disallow the noteholders' claims. The noteholder defendants moved for summary judgment, contending that Section 546(e) exempted the Disputed Transfer from avoidance as a matter of law.

The Decision

The court held that the safe harbor under Section 546(e) protected the noteholders from the Committee's avoidance claims and granted summary judgment in favor of the noteholder defendants. In rendering its decision, the court held that the Disputed Transfer constituted a "settlement payment" made to a "financial institution" as those terms are used within Section 546(e).

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 Committee argued that the Disputed Transfer was not made to a "financial institution" because CIBC Mellon was a "mere conduit" for the funds, and that the noteholder defendants should be deemed the true recipients for purposes of satisfying the "financial institution" requirement of Section 546(e). The court rejected this argument, noting the plain language of Section 546(e) only requires payment to a "financial institution" without any qualification as to the capacity of that recipient.

The key issue before the court was whether the Disputed Transfer constituted a "settlement payment" for purposes of the Section 546(e) safe harbor. In this regard, the standard set forth in *Enron* significantly influenced the court. The court noted that although the definition of "settlement payment" in Section 741(8) may be self-referential and circular, the direction given by the *Enron* majority with respect to that definition is both uncomplicated and crystal clear – a settlement payment is a transfer of cash made to complete a securities transaction. Under this formulation, the court concluded that the Disputed Transfer qualified for exemption under Section 546(e) where the Disputed Transfer consisted of a transfer of cash to a financial institution to repurchase and cancel securities, i.e., to complete a securities transaction.

The court noted that the "settlement payment" standard adopted in *Enron* "is a formula that appears to embrace every qualifying transfer that completes a securities transaction regardless of any systemic significance … Accordingly, even though the legislative history [of Section 546(e)] points to the policy objective of protecting the securities markets, a transfer will still qualify for exemption from avoidance under the language of section 546(e) without having to show anything more than that the transfer in question was made to a financial institution to complete a securities transaction." This stands in contrast to a decision issued by the U.S. Bankruptcy Court for the Southern District of New York in *In re MacMenamin's Grill Ltd.*, No. 08-23660, 2011 WL 1549056 (Bankr. S.D.N.Y. April 21, 2011), which predates the Second Circuit's *Enron* decision.

In *MacMenamin's Grill*, the court considered whether Section 546(e) protected from the bankruptcy trustee's avoidance powers a payment made by the debtor to repurchase its equity shares or the debtor's incurrence of a related loan obligation to finance the repurchase in the context of a private leveraged buy-out transaction. The court found that the definition of "settlement payment" for purposes of Section 546(e) was ambiguous, thus justifying an examination of the legislative history related to Section 546(e). Finding that Congress intended Section 546(e) to reduce risk in the public financial markets that would be occasioned by permitting bankruptcy trustees to avoid settled securities transactions, the court held that Congressional intent and legislative history did not support application of the Section 546(e) safe harbor in the context of a constructively fraudulent transfer arising from a private stock transaction. The standard established by the Second Circuit's *Enron* ruling appears to foreclose this line of argument. Because the *Enron* standard does not consider Congressional intent, the court in *Quebecor* observed that the *Enron* standard "may extend protection to transfers that Congress never intended to immunize," including transfers with no demonstrated connection to the securities markets. The court indicated that the *Enron* decision "effectively eliminates the need for any inquiry into the legislative history of section 546(e) or close attention to any distinguishing circumstances relating to settlement risk associated with the Disputed Transfer."

The court in *MacMenamin's Grill* also held that the Section 546(e) safe harbor did not apply to the debtor's incurrence of a loan obligation to fund the share repurchase because Section 546(e) applies only to "transfers" as defined under the Code, and does not apply to the incurrence of obligations. Neither *Enron* nor the *Quebecor* decision discussed in this memorandum addressed the application of Section 546(e) to an avoidance action with respect to the incurrence of an obligation.

Future cases regarding the Section 546(e) exemption may further clarify the scope of the safe harbor, particularly in cases involving relatively small transactions with minimal potential effect on the securities markets and cases in which the incurrence of an obligation is sought to be avoided.

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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.

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