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ALERT MEMORANDUM

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Circuit Court Affirms Broad Reading of the Bankruptcy Code Safe Harbor for Transfers in Connection with a Securities Contract in In re Quebecor World (USA) Inc.

A recent decision of the United States Court of Appeals for the Second Circuit affirmed decisions of the district and bankruptcy courts holding that section 546(e) of the Bankruptcy Code precluded a creditors committee from avoiding a debtor's $376 million purchase of private placement notes issued by one of the debtor's affiliates as a preferential transfer made within 90 days of the debtor's chapter 11 filing. In In re Quebecor World (USA) Inc., No. 12-4270-bk, 2013 WL 2460726 (2d Cir. June 10, 2013), the Second Circuit held that the payment was shielded from preference avoidance pursuant to section 546(e) because it was a " transfer made by or to (or for the benefit of) a . . . financial institution . . . in connection with a securities contract." Although the lower courts also held that the payment was protected as a "settlement payment" "made by or to" a "financial institution," the Second Circuit declined to adopt this ruling, finding that the payment fell squarely within the plain wording of the alternative "securities contract" safe harbor. In addition, the Second Circuit – following the United States Courts of Appeals for the Third, Sixth and Eighth Circuits – expressly held that a transfer may qualify for the section 546(e) safe harbor even if the financial intermediary is merely a conduit without a beneficial interest in the transfer.

In its decision, the Second Circuit affirmed the broad reading and literal application of the section 546(e) safe harbors that it had applied in In re Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V., 651 F.3d 329 (2d Cir. 2011) ("Enron"), which held that early redemption payments made to holders of commercial paper qualified as "settlement payments" under section 546(e). This decision is likely to have significant impact on avoidance litigation because it provides transferees of constructive fraudulent and preferential transfers with another safe harbor defense that is arguably broader than the "settlement payment" defense outlined under Enron and its progeny.

The Decision

1. The Facts

In July 2000, Quebecor World Capital Corp. ("QWCC"), an affiliate of the Quebecor commercial paper printing group, raised $371 million in a series of private placement notes (the "Notes," and the holders thereof, the "Noteholders") pursuant to two Note Purchase Agreements (the "NPAs"). The Notes were guaranteed by Quebecor World (USA) Inc. ("QWUSA") and Quebecor World Inc. ("QWI," and with its affiliates, "Quebecor").

In 2007, Quebecor began having financial difficulty and was in danger of breaching a debt-to-capitalization ratio covenant in the NPAs, which would have resulted in a breach under

its larger credit facility. Quebecor attempted to avoid such a breach by modifying the covenant through a tender offer, but the Noteholders unanimously rejected the offer and instead entered into a cooperation agreement under which they agreed not to sell the Notes outside the group of the then-existing Noteholders. This agreement had the effect of requiring Quebecor to redeem all of the Notes, which was permitted by the NPAs, or risk default.

In September 2007, Quebecor issued a notice of redemption for all of the Notes. To fund the redemption, Quebecor drew down on a separate bank facility in the amount of approximately $376 million, which represented principal, interest and a make-whole premium due on the Notes. For tax reasons, the transaction was structured so that QWUSA would purchase the Notes for cash and then QWCC would redeem the notes from QWUSA in exchange for forgiveness of debt owed by QWUSA to QWCC. On October 29, 2007, QWUSA wired $376 million from its bank account at Bank of America to CIBC Mellon, the trustee for the Notes. CIBC Mellon distributed the cash to the Noteholders, and the Noteholders returned the Notes to QWI. As a result of the transaction, CIBC Mellon neither took title to the Notes nor utilized any type of clearing mechanism to complete the transaction.

Less than ninety days later, on January 21, 2008, QWUSA filed for chapter 11 protection in the United States Bankruptcy Court for Southern District of New York. The official committee of unsecured creditors commenced an adversary proceeding to avoid the $376 million payment as a "preference" under section 547(b) of the Bankruptcy Code because the Noteholders received full payment for their Notes while other creditors received significantly less.

2. The Lower Court Decisions

On July 27, 2011, Judge Peck, the bankruptcy judge presiding over QWUSA's chapter 11 case, found that under the Second Circuit's Enron decision, QWUSA's payment was a "settlement payment," or alternatively, the payment was a transfer "in connection with a securities contract."[1] Accordingly, the bankruptcy court held that the payment was shielded from avoidance under section 546(e) of the Bankruptcy Code on two independent grounds.[2] QWUSA appealed the ruling. On September 28, 2012 District Court Judge Furman affirmed the Bankruptcy Court's ruling in all material respects.[3] In affirming, Judge Furman first held that QWUSA's payment qualified as a "settlement payment," where (a) QWUSA transferred cash to purchase the Notes, (b) the cash was wired from QWUSA's account at Bank of America to CIBC Mellon, which qualifies as a "financial institution" for purposes of section 546(e), and (c)

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1 In re Quebecor World (USA) Inc., 453 B.R. 201 (Bankr. S.D.N.Y. 2011).

2 Section 546(e) of the Bankruptcy Code provides, in relevant part, that: "[n]otwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a . . . settlement payment . . . made by or to (or for the benefit of) a . . . financial institution . . . , or that is a transfer made by or to (or for the benefit of) a . . . financial institution . . . in connection with a securities contract . . . that is made before the commencement of the case . . . ." 11 U.S.C. § 546(e).

3 In re Quebecor World (USA) Inc., 480 B.R. 468 (S.D.N.Y. 2012).

the payment was made to "complete" a securities transaction because the Notes are "securities" under the Bankruptcy Code. Judge Furman alternatively held that QWUSA's payment was also a transfer made to a "financial institution" "in connection with a securities contract," noting that (a) the transaction was structured as a "purchase" of the Notes by QWUSA rather than a redemption by QWCC, and (b) the purchase was made in connection with the NPAs, which qualify as securities contracts. QWUSA appealed to the United States Court of Appeals for the Second Circuit.

3. The Circuit Court Decision

The Second Circuit affirmed the lower court rulings, concluding that the securities safe harbor provisions of section 546(e) apply to shield the challenged transaction from avoidance as a preferential transfer. While the Second Circuit ruled only on the grounds that the transfer was made "in connection with a securities contract" within the meaning of section 546(e),[4] its decision reaffirmed a broad reading and literal application of the section 546(e) safe harbors. The court found that QWUSA's wire to CIBC Mellon on October 29, 2007 satisfied all requirements for the "securities contract" safe harbor. The transfer was made to a "financial institution" (CIBC Mellon) "in connection with securities contracts" (the NPAs). The court further explained that "[t]he NPAs were clearly 'securities contracts' because they provided for both the original purchase and 'repurchase' of the Notes."

The Second Circuit declined to address whether the transfer would be exempt if QWUSA had "redeemed" its own notes rather than "purchased" its affiliate's notes, holding that the transaction was clearly a purchase rather than a redemption. In making this determination, the court focused on the objective structure of the transaction, dismissing arguments regarding the Noteholders' subjective understanding of the transaction.

Finally, the Second Circuit reiterated Enron's holding that a "financial institution" as defined in section 546(e) need not have a beneficial interest in the transfer, but may be a mere conduit for the transfer, in order for the safe harbor to apply. In support of this finding, the court cited both the plain language of the statute, which includes transfers either "for the benefit of" or "to" a financial institution, and the purpose behind the safe harbors. The court concluded that "[a] clear safe harbor for transactions made through these financial intermediaries promotes stability in their respective markets and ensures that otherwise avoidable transfers are made out in the open, reducing the risk they were made to defraud creditors."

This decision is likely to have far-reaching impact as further affirmation of the limitations on the ability to avoid certain pre-bankruptcy financial transactions and payments, especially when read together with the expansive plain-language view other courts have taken in interpreting and applying the section 546(e) safe harbors. This decision also provides transferees of constructively fraudulent and preferential transfers with an another independent safe harbor defense that does not require defendants to prove that the transfer sought to be

[4] The Second Circuit explicitly stated that it "need not decide whether the payments fall within the 'settlement payments' safe harbor, because we conclude that they clearly fall within the safe harbor for 'transfers made . . . in connection with a securities contract." Quebecor, 2013 WL 2460726, at *1.

avoided was a "settlement payment," which had been the primary focus in section 546(e) litigation in the Second Circuit until this case was decided below.

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If you have any questions, please feel free to contact Lisa Schweitzer at (212) 225-2629, any of your regular contacts at the firm or any of our partners and counsel listed under "Bankruptcy and Restructuring" in the "Practices" section of our website (www.clearygottlieb.com).

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