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PWK ATTORNEYS | PEITZMAN WEG & KEMPINSKY LLP

Bankruptcy & Litigation newsletter

Bankruptcy and Litigation

CAN YOU SAIL INTO THE SAFE HARBOR?

By Howard Weg and Kathryn Russo

Section 546(e) of the Bankruptcy Code provides a "safe harbor" defense to a bankruptcy trustee's power to avoid pre-bankruptcy (i.e., prepetition) preferential and fraudulent transfers. Under 546(e), a trustee may not avoid a transfer by a debtor that is a settlement payment in connection with a securities contract, a commodities contract or a forward contract, made by, to, or for the benefit of, one of the following entities: a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency. Each of these terms is defined separately in the Bankruptcy Code.

Addressing an issue of first impression, the Second Circuit Court of Appeals recently held that a chapter 11 debtor's prepetition payments for early redemption of its publicly traded commercial paper were "settlement payments" under section 546(e) of the Bankruptcy Code. Accordingly, the hundreds of millions of dollars paid out by Enron to redeem its short-term commercial paper during the days before its bankruptcy filing were shielded from preference and fraudulent transfer avoidance actions in bankruptcy. *In re Enron Creditors Recovery Corp.*, 651 F.3d 329 (2d Cir. June 28, 2011).

Enron's Settlement Payment Argument

Enron argued that the redemption payments were not protected by section 546(e)'s safe harbor as "settlement payments" under the definition in section 741(8) of the Bankruptcy Code. Section 741(8) defines a settlement payment as "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." Enron maintained that the statutory definition imposed the following three limitations on the definition of settlement payment: 1) the phrase "commonly used in the securities trade" covers only payments that are common in the securities industry, which does not include the redemption of commercial paper; 2) the definition includes only a transaction in which title to a security is transferred, not to retirement or redemption of debt; and 3) the safe harbor only protects publicly traded transactions that, if avoided, would threaten the "domino" failure of multiple parties in the U.S. financial markets.

Rejecting Enron's arguments, the Second Circuit held the payments to redeem public commercial paper fell within the plain language of the definition of settlement payment and were protected from avoidance under section 546(e). The Second Circuit found that 1) the phrase "commonly used in the securities trade" is a catchall phrase that modifies only the term immediately before it: "any other similar payment," not the entire definition of settlement payment; 2) the definition of settlement payment does not include a purchase or sale requirement; and 3) there is no requirement that the safe harbor payment relate to a publicly traded security, the avoidance of which would risk damage to the U.S. financial markets. On this point, the Second Circuit followed the Third, Sixth, and Eighth Circuits, which "rejected similar arguments in the context of leveraged buyouts of private companies that involved financial intermediaries who served only as conduits."

Quebecor Case Extends Argument in New York

Expanding upon the Second Circuit's holding in *Enron*, the Bankruptcy Court for the Southern District of New York recently held

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that a chapter 11 debtor's prepetition payments for the repurchase and cancellation of privately placed promissory notes constituted "settlement payments" protected from avoidance under section 546(e)'s safe harbor. *In re Quebecor World (USA) Inc., et al.*, 453 B.R. 201 (Bankr. S.D.N.Y. July 27, 2011). In Quebecor, noteholders advanced unsecured credit to Quebecor pursuant to the terms of a private note purchase agreement. Prior to its chapter 11 filing, Quebecor repurchased and then canceled the notes.

During the subsequent chapter 11 case, the Creditors' Committee sought to clawback the redemption payments to the noteholders. The bankruptcy court, applying the Second Circuit's test in *Enron*, held that the repurchase of the private notes was a settlement payment because it involved a payment to a financial institution to complete a securities transaction. The bankruptcy court emphasized that the test does not include consideration of legislative history or the lack of any material impact the unwinding of the private note transactions would have on the U.S. financial market.

Madoff Case Applies 546(e) in New York

Following the Second Circuit's holding in *Enron*, the United States District Court for the Southern District of New York recently held that all payments made by Madoff Securities, a stockbroker, to its customers fell under the definition of "settlement payments." Section 546(e) expressly exempts payments by and to a stockbroker from avoidance attack by a bankruptcy trustee. Therefore, the trustee was precluded, pursuant to section 546(e)'s safe harbor, from bringing any action to recover any of the monies paid by Madoff Securities to its customers except for transfers made within two years prior to the bankruptcy filing with the actual intent to hinder, delay or defraud creditors under section 548(a)(1) of the Bankruptcy Code. *Picard v. Katz*, 2011 WL 4448638 (S.D.N.Y. Sept. 27, 2011). The *Picard* case is a forceful illustration of the limitation imposed on the trustee's avoidance powers by the 546(e) safe harbor defense.

New Considerations for Applying Section 546(e)

There remain a number of important unresolved issues in applying section 546(e). How private can a transaction be to qualify? The redemption of a note is, in substance, nothing more than a prepayment. If the redemption payments for multiple private notes in *Qubecor* are protected, can a prepayment of a single private note also be protected?

This raises another serious question: When does a note qualify as a "security" for purposes of creating a securities contract that gives rise to a payment that can qualify as a settlement payment? While the Bankruptcy Code's definition of "security" provides an illustrative list of the items that can qualify as a security, including a note, the catchall part of the definition refers to any claim or interest commonly known as a security. Under the securities laws, the Supreme Court and lower courts have for many years grappled with the question of when a note is or is not a security. These cases suggest that a long-term obligation that is dependent upon the success or failure of the business that is obligated on the note is more likely to be a security than a short-term fixed obligation that involves no trading or speculation on the success of the business.

Similarly, a payment must be, among other things, by or to a financial institution to qualify as a settlement payment. But unless actual currency – in dollar bills – is being exchanged in the transaction, the payment will almost certainly involve a wire transfer or check for payment. Does the wire transfer or check need to be expressly payable to the order of a financial institution to qualify? Both forms of payment are made by and to financial institutions as part of our banking system, even though they are, in fact, only payable to the holders of accounts at the financial institution involved. Wire transfers have been held to be payments by and to financial institutions for these purposes, even though actually made to an account holder at the financial institution rather than the institution itself. *See, e.g., In re Resorts Int'l, Inc.*, 181 F.3d 505, 515 (3d Cir. 1999).

If that is correct, then payments implemented by check from the holder of an account at one financial institution to the holder of an account at another financial institution, other than payments from one institution to another, would also seem to qualify as payments by or to financial institutions that would fall within the safe harbor protection of section 546(e). Resolution of that issue, however, will have to wait for future decisions.

Therefore, it is important to evaluate carefully every transaction that is the subject of a bankruptcy avoidance proceeding to determine whether the absolute safe harbor defense of section 546(e) may apply.

PWK ATTORNEYS PRESENT AT PRACTISING LAW INSTITUTE

PWK partners continued their long-running affiliation with the Practising Law Institute (PLI) with several CLE programs on the East and West coasts in the fall.

At PLI California Center in San Francisco on Nov. 17-18, "Nuts and Bolts of Corporate Bankruptcy 2011" was featured. This program was designed for attorneys of all experience levels and non-legal professionals who wanted to develop a strong working knowledge of business bankruptcy law and practice.

David Shemano joined a panel presentation with two judges from the U.S. Bankruptcy Court, Northern District of California. They provided an "Overview of U.S. Bankruptcy System and Procedural Basics." Shemano also presented "Practice Points: Commencing a Bankruptcy Case."

During the two-day event, Howard Weg, program co-chair, was also a panelist on "Assumption or Rejection of Executory Contracts and Unexpired Leases" and "Basic Ethical Considerations in Bankruptcy."

Couldn't be there? PLI makes its SF sessions available as a live webcast.

On the East Coast, Howard Weg will present his programs again at PLI New York Center in midtown Manhattan on December 12-13, 2011. For more information visit www.pli.edu.

Bankruptcy and Sales

CIRCUIT COURTS SPLIT DECISIONS ON CREDIT BIDDING

By Monsi Morales

Credit bidding is an important tool used by secured creditors to obtain possession of their collateral in situations where a cash sale may not yield a satisfactory price.

In the bankruptcy context, where sales are often conducted on an expedited basis or as part of liquidation, and where a secured creditor may receive little to no recovery on account of any deficiency claim remaining after such sale, the right of a secured creditor to credit bid takes on an even greater importance.

Generally, the sale of any property outside the ordinary course of the debtor's business is subject to a secured creditor's right to credit bid, pursuant to Bankruptcy Code section 363(k). If a sale occurs through a chapter 11 plan of reorganization, however, courts are split as to whether the sale process must afford the secured creditor the right to credit bid for the plan to be confirmable.

Seventh Circuit Upholds Secured Creditors Right to Credit Bid

In *In the Matter of River Road Hotel Partners, LLC, et al.*, 2011 WL 2547615 (7th Cir. June 28, 2011), the U.S. Court of Appeals for the Seventh Circuit held that secured creditors have the right to credit bid in free and clear sales of property, even if such sales are effectuated through a chapter 11 plan.

The *River Road* debtors filed reorganization plans that provided for the sale of substantially all of their assets to the highest bidder at an auction. The secured creditors objected on the basis that the proposed sale procedures did not allow for credit bidding, which is required for free and clear sales under a plan pursuant to Bankruptcy Code section 1129(b)(2)(A)(ii) where the secured creditor is impaired and has not accepted the plan.

The debtors argued that the plans were confirmable because they satisfied the alternative requirement for cramdown of a secured creditor's claim under section 1129(b)(2)(A)(iii). The bankruptcy court disagreed, stating that the plans were not confirmable under section 1129(b)(2)(A)(iii), and denied the bid procedures motion.

On direct appeal, the Seventh Circuit first reasoned that the sale of assets at an auction where the secured creditor is not permitted to credit bid does not provide any assurance that the winning bid constitutes the asset's true value. Thus, without the credit bid providing "a crucial check against undervaluation," it is not certain that the proceeds from the sale would provide the secured creditor with the indubitable equivalent of its secured claim, as required under section 1129(b)(2)(A)(iii).

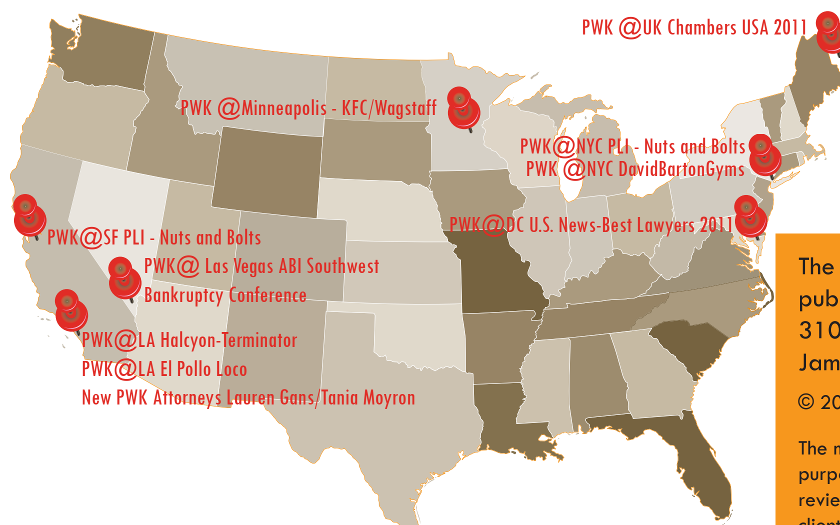
Relying on general principles of statutory construction, the court next determined that section 1129(b)(2)(A) should not be interpreted in a way that renders two of its three sections superfluous, as would be the case if a debtor were allowed to confirm a plan under section 1129(b)(2)(A)(iii) that sold assets free and clear without allowing for credit bidding. The court held that "cramdown plans that contemplate selling encumbered assets free and clear of liens at an auction [must] satisfy the requirements set forth in Subsection (ii) of the statute."

Third and Fifth Circuit Weigh In, Ninth Circuit Untested

The *River Road* decision is directly at odds with two other fairly recent decisions.

In *In re Philadelphia Newspapers*, 599 F.3d 298 (3d Cir. 2010), and *In re Pacific Lumber, Co.*, 584 F.3d 229 (5th Cir. 2009), the Courts of Appeals for the Third and Fifth Circuits, respectively, held that the application of section 1129(b)(2)(A)(iii) was not limited to situations in which neither subsection (i) or (ii) applied, and that the proceeds from a sale not subject to credit bidding could constitute the indubitable equivalent of the secured creditor's claim.

The U.S. Court of Appeals for the Ninth Circuit has not yet to address this issue and, given the new Circuit split, it is likely that debtors, secured creditors and their professionals will struggle with the current uncertainty.



PWK Attorneys in Action

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IN THE NEWS

DavidBartonGym. Partner David Shemano led reorganization counsel to Club Ventures Investments LLC, owner of the high-end health clubs, DavidBartonGym. The chapter 11 plan's confirmation, in the U.S. Bankruptcy Court, Southern District of New York., was reported by *Bloomberg Businessweek* and *The Deal Pipeline*. PWK attorneys Monsi Morales and Kathryn Russo were part of the chapter 11 team.

KFC-Wagstaff. PWK's Scott Gautier and Howard Weg continue their counsel to Wagstaff Management Corp. in connection with the chapter 11 of 78 KFC franchisees. The case includes significant issues on appeal before the U.S. District Court for the District of Minnesota.

El Pollo Loco Franchises. PWK provides ongoing chapter 11 counsel to these multiunit franchisees which includes assisting with the planned sale of certain units.

Halcyon Holding Group. The holder of rights to the "Terminator" movie franchise has confirmed a chapter 11 plan. Bankruptcy and related litigation counsel has been provided by a PWK powerhouse team of Howard Weg, David Shemano, Scott Gautier and James P. Menton, Jr. The successful case was featured in *Variety* newspaper.

Gans and Moyron - Our Newest Associates. PWK welcomes new associates Lauren N. Gans and Tania M. Moyron. Gans focuses on bankruptcy and bankruptcy-related litigation and Moyron practices in all aspects of corporate bankruptcy.

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U.S. News-Best Lawyers 2011 - 12. The firm retained its First Tier in LA spot, was one of the three most highly ranked bankruptcy boutiques for its national practice, and added the newly rated bankruptcy litigation practice to its accolades. Founding partner Larry Peitzman was named "Lawyer of the Year 2012" in Bankruptcy and Creditor Debtor Rights/Insolvency and Reorganization Law, LA. Founding partner Howard Weg earned recognition as a "Best Lawyer."

ABA Recognition. Litigation partner James Menton, Jr. was named Outstanding Newsletter Editor, Bankruptcy and Insolvency Litigation Committee of the American Bar Association. The quarterly publication was named **Best Newsletter of the Year** by the ABA section. Menton's transformation of the newsletter, in a single year, from moribund to an engaging presentation of topical issues, was praised.

ABI Southwest Bankruptcy Conference. Howard Weg presented on the panel program "Building Your Book of Business" on Sept. 9, 2011 at the 19th annual gathering in Las Vegas.

Chambers USA. PWK retains its ranking as a leading firm and the sole boutique in CA Bankruptcy/Restructuring Band 2 in the 2011 UK-based law firm directory. PWK partners Peitzman, Weg and Gautier were individually ranked.

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