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Second Circuit's Opinion May Insulate Payments Previously Beyond Bounds Of Bankruptcy Code Section 546(e)

On June 28, 2011, the Second Circuit, in a 2-1 decision, held that Bankruptcy Code section 546(e) shields from avoidance in bankruptcy cases an issuer's payments to redeem its commercial paper prior to maturity. See *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de CV, Enron Creditors Recovery Corp. v. ALFA, S.A.B. de C.V.,* Nos. 09-5122-bk(L), 09-5142-bk (Con), 2011 U.S. App. LEXIS 13177 (2d Cir. June 28, 2011). The decision marks the first time an appeals court has considered whether redemption payments constitute "settlement payments" under section 546(e).

Section 546(e) provides, in pertinent part, as follows:

Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) . . ., the trustee may not avoid a transfer that is a . . . settlement payment, as defined in section . . . 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, 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.

Section 741(8), in turn, defines a "settlement payment" as a "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."

Factual Background

Before its collapse, Enron reacquired more than $1.1 billion of its unsecured and uncertificated commercial paper prior to maturity at a price considerably higher than market value. Following its Chapter 11 filing, Enron sued approximately two hundred financial institutions seeking to avoid and recover the payments. Many of the defendants moved to dismiss Enron's complaints based on section 546(e), claiming that the payments were exempt from avoidance as settlement payments. The bankruptcy court denied those motions on the ground that the phrase "commonly used in the securities trade" in section 741(8) modifies all the terms in its definition and, as a result, relevant factual issues remained as to whether the payments in dispute were "commonly used." Most of the defendants then settled, except for Alfa, S.A.B. de CV and certain ING entities (referred to herein as "Alfa").

Alfa conducted discovery and then moved for summary judgment. The bankruptcy court held that settlement payments include only payments to purchase or sell securities, not payments made by Enron in "redeeming" its commercial paper. On appeal, the district court reversed and Enron appealed.

The Second Circuit Opinion

On appeal, Enron argued that the final phrase of section 741(8) – "commonly used in the securities trade" – excludes all payments, including Enron's payments, that are not common in the securities industry. The Second Circuit disagreed, finding under the "rule of the last antecedent" that section 741(8)'s final phrase only modifies the term immediately preceding it – "any other similar payment."

Enron also argued that its payments did not implicate the systemic risks contemplated by Congress when enacting section 546(e) because a financial intermediary does not take a beneficial interest in the securities during the transactions. Congress's fear, according to the Second Circuit, was that "[i]f a firm is required to repay amounts received in settled securities transactions, it could have insufficient capital or liquidity to meet its current securities trading obligations, placing other market participants and the securities markets themselves at risk." The Second Circuit saw "no reason to think that undoing Enron's redemption payments, which involved over a billion dollars and approximately two hundred noteholders, would not . . . have a substantial and . . . negative effect on the financial markets."

Enron's next argument was to read into section 546(e) that a transaction must involve a purchase or sale to be a "settlement payment" covered by section 546(e). The Second Circuit limited its analysis to the plain meaning of sections 546(e) and 741(8) and refused to impose a purchase or sale requirement in order for a completed securities transaction to qualify as a "settlement payment." The Court noted that "[n]othing in the text of § 741(8) supports a purchase or sale requirement," instead requiring only an exchange of money or securities that completes a securities transaction.

In response, the dissent pointed out that Bankruptcy Code section 101(49)(A) defines "securities" to include "notes, bonds, and debentures." Thus, the dissent reasoned that if the completion of a transaction involving securities need not involve a purchase or sale, the majority's decision "would seem to bring virtually every transaction involving a debt instrument within the safe harbor of Section 546(e)[.]" The majority replied that the avoidance of transfers made in connection with "ordinary loans" will not be frustrated by the majority's definition of settlement payments because the term will be interpreted in the context of the securities industry. The dissent, however, found no such interpretation requirement in the majority's definition.

Conclusion

Will the dissent's concerns become reality? Prior to the Second Circuit's decision, courts often examined the purpose behind section 546(e)—reducing systemic risk to the financial markets—to guide their application of the safe harbor. In *Enron's* wake, at least one court has concluded that examination of the legislative history of section 546(e) is unnecessary and that for section 546(e) to apply, only three elements need be present: (1) a transfer of cash or securities (2) to a financial institution or intermediary (3) made to complete a securities transaction. *See In re Quebecor World (USA) Inc*., --- B.R. ---, 2011 WL 3157292 (Bankr. S.D.N.Y. July 27, 2011) (Peck, J.). In *Quebecor World*, Judge Peck found that, pursuant to *Enron,* Quebecor's payments to noteholders in exchange for its reacquisition of notes were shielded from bankruptcy avoidance powers, even though the transaction did not clear through the Depository Trust Company or other securities clearing agency. Judge Peck acknowledged that the case before him was an example of litigation anticipated (and feared) by the dissent in *Enron*. Only time will tell what other transferee defendants and courts will make of the *Enron* majority's seemingly expansive reading of section 546(e).

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