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In re Enron: Second Circuit Expands "Settlement Payment" Exemption to the Redemption of Commercial Paper (and Beyond?)

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The authors of this article discuss a Court of Appeals for the Second Circuit case that expands on previous appellate decisions broadly construing the scope of the § 546(e) exemption, and that has significant implications for bankruptcy cases nationwide.

The Court of Appeals for the Second Circuit recently decided an issue of first impression in the federal courts of appeals: whether 11 U.S.C. § 546(e), which shields "settlement payments" from avoidance actions in bankruptcy, extends to an issuer's payments made through the Depository Trust Company (the "DTC") to redeem its commercial paper prior to maturity. In *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.* ("*In re Enron*"),[1] the court held that such redemption payments are eligible for the § 546(e) exemption, broadly defining "settlement payment" to include any payment that completes a transaction in securities and declining to read a "purchase or sale" requirement into the definition. The court also found that the payments were protected by the safe harbor

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even though the DTC did not take a beneficial interest in the securities at any point in the transaction. *In re Enron*, which expands on previous appellate decisions broadly construing the scope of the § 546(e) exemption, has significant implications for bankruptcy cases nationwide.

BACKGROUND

In the final months before its collapse in late 2001, Enron used $1.1 billion to redeem certain unsecured commercial paper that had not yet reached its maturity date. Enron redeemed the commercial paper at the accrued par value (calculated as the price originally paid plus accrued interest), which was considerably higher than market value.

The noteholders, Alfa and ING, transferred their commercial paper to Enron's broker-dealer JPMorgan in exchange for the redemption price through accounts held at the DTC. This is the customary mechanism of transacting in commercial paper. After filing for Chapter 11 bankruptcy in December 2001, Enron sought to avoid these redemptions as constructively fraudulent transfers, pointing to their above-market price. The noteholders moved for summary judgment against Enron on this claim, arguing that the redemption payments qualified as unavoidable settlement payments under § 546(e) of the Bankruptcy Code, which provides, in pertinent part:

> Notwithstanding sections…547 [and] 548(a)(1)(B)…of this title [which empower the trustee to avoid preferential and constructively fraudulent transfers], 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…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 [which empowers the trustee to avoid transfers made with actual intent to hinder, delay or defraud creditors].[2]

Section 741(8) of the Bankruptcy Code, in turn, defines "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."[3]

The bankruptcy court ruled that the redemptions were not settlement payments because they were not "made to acquire title to the commercial paper" — that is, they were not purchases or sales — but were, rather, intended to retire debt.[4] The bankruptcy court supported its decision by referencing facts that showed the unusual nature of the Enron redemptions, including "the above-market price Enron paid, the alleged insistence of the broker-dealers to act as intermediaries instead of principals, and the supposed rarity of commercial paper prepayments in general."[5]

The noteholders filed an interlocutory appeal with the district court, which reversed, finding that "a settlement payment is any transfer that concludes or consummates a securities transaction," and that the redemptions qualified as securities transactions even though they did not result in title transfers, because they "involved the delivery and receipt of funds and securities."[6] The district court also held that the definition of "settlement payment" is not limited to payments that are "commonly used," and thus the circumstances of a particular payment do not bear on whether that payment fits within the definition.[7] Enron appealed to the Second Circuit.

THE SECOND CIRCUIT'S DECISION

In a divided opinion, the Second Circuit rejected each of the three limitations that Enron sought to impose on the definition of "settlement payment," that: (1) the payment must be of a type commonly used in the securities industry; (2) title to the securities must change hands (*i.e.*, the payment must involve a purchase or sale of a security); and (3) the transaction must involve a financial intermediary that at some point takes a beneficial interest in the securities.[8]

First, the court held that the "commonly used in the securities industry" language in the definition of "settlement payment" applies only to the catch-all provision at the end of the definition, not to the preceding provisions.[9] Thus, a partial settlement payment, for example, is a settlement payment whether or not it is of a kind commonly used in the securities industry.[10] The court emphasized that the catch-all provision was meant to "underscore the

breadth of the § 546(e) exemption," not to restrict it by requiring proof of common use for each of the enumerated types of settlement payment.[11] The court explained that Enron's proposed reading of the statute would "make application of the safe harbor in every case depend on a factual determination regarding the commonness of a given transaction," a reading that would result in commercial uncertainty and unpredictability.[12]

Second, the court declined to read a purchase or sale requirement into the definition of "settlement payment."[13] Rather, the court adopted an expansive definition of "settlement payment" that includes any payment that completes a transaction in securities.[14] Under this definition, the court found that the safe harbor protected Enron's payments made through the DTC to redeem its tradable debt securities.[15] Enron argued (and, as discussed below, the dissent agreed)[16] that applying § 546(e)'s safe harbor to non-purchase or -sale transactions would undermine decades of case law allowing avoidance of payments made on ordinary loans. The majority, however, distinguished the non-tradable bank loans involved in those prior cases from the "widely issued debt securities" at issue in *In re Enron*, and concluded that interpreting the term "settlement payment" in the context of the securities industry would exclude from the safe harbor payments made on ordinary loans.[17] The majority pointed out that, in any event, Enron's proposed purchase or sale requirement would not necessarily exclude from the safe harbor all payments on ordinary loans, since a party seeking to characterize the early repayment of a loan evidenced by a promissory note as a settlement payment might simply structure it as a *repurchase* of the promissory note.[18]

Finally — although agreeing with Enron that the DTC acted as a conduit and a recordkeeper rather than a clearing agency that took title to the securities during the course of the transactions — the Second Circuit joined the Third, Sixth, and Eighth Circuits in rejecting the argument that a settlement payment can only take place if a financial intermediary acquires a beneficial interest in the securities.[19] After taking note of its sister circuits' holdings that "undoing long-settled leveraged buyouts would have a substantial impact on the stability of the financial markets, even though only private securities were involved and no financial intermediary took a beneficial interest in the exchanged securities during the course of the

transaction," the majority concluded that there is "no reason to think that undoing Enron's redemption payments, which involved over a billion dollars and approximately two hundred noteholders, would not also have a substantial and similarly negative effect on the financial markets."[20]

JUDGE KOELTL'S DISSENT

Judge John G. Koeltl of the U.S. District Court for the Southern District of New York, sitting by designation, dissented.[21] Judge Koeltl opined that the majority's decision not to read a purchase or sale requirement into the definition of "settlement payment" would "threaten[] routine avoidance proceedings in bankruptcy courts"[22] because the definition "would seem to bring virtually every transaction involving a debt instrument within the safe harbor."[23] Because notes, bonds, and debentures are all defined as "securities" under the Bankruptcy Code irrespective of whether they are widely issued or tradable, Judge Koeltl criticized the majority's opinion that the context of the securities industry would exclude from the safe harbor payments made on ordinary loans.[24]

PRACTICAL IMPLICATIONS

Because *In re Enron* addressed an issue of first impression among the circuits, its holding is likely to be influential in bankruptcy cases where trustees seek to avoid payments that do not involve a traditional purchase or sale of securities. Specifically as to commercial paper, bondholders will likely be immune from preference actions under the Bankruptcy Code where their pre-maturity redemption is effectuated through the DTC. In addition, the Second Circuit is now the fourth of the federal circuits to apply § 546(e) to transactions in which no central intermediary ever takes beneficial ownership of the securities at issue, while two circuits have declined to apply § 546(e) in such circumstances. This widening split means that the Supreme Court may take up the issue in the near future.

NOTES

[1] — F.3d —, 2011 WL 2536101 (2d Cir. June 28, 2011).
[2] 11 U.S.C. § 546(e). Section 548(a)(1)(A) was not at issue in *In re Enron*.
[3] 11 U.S.C. § 741(8).
[4] 2011 WL 2536101, at *3.
[5] *Id*.
[6] *Id*. at *4 (internal quotation marks omitted).
[7] *Id*.
[8] *See id*. at *6.
[9] *Id*. at *6-*7.
[10] *See id*.; *see also* 11 U.S.C. § 741(8).
[11] 2011 WL 2536101, at *6 (internal quotation marks omitted) (emphasis in original).
[12] *Id*. at *7.
[13] *Id*. ("we find little support for the contention that a securities transaction necessarily involves a purchase or sale").
[14] *Id*.
[15] *Id*. at *8-*9.
[16] *See id*. at *8 (citing Dissent at 11, 19-20).
[17] *Id*.
[18] *See id*.
[19] *Id*. at *9.
[20] *Id*. (footnote omitted).
[21] *See id*. at *10-*17 (Koeltl, Dist. J., dissenting).
[22] *Id*. at *10.
[23] *Id*. at *16.
[24] *Id*.