Viewpoint

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Holes in 'Blanket' Protection for Securities Contract Payments

By Michael L. Bernstein and Charles A. Malloy

In a typical leveraged buyout, the target company's assets are pledged in order to obtain financing, which is then used to purchase the company's equity from the current owners. If a target company subsequently encounters financial trouble and files for bankruptcy, creditors of the company may seek to undo the LBO as a constructively fraudulent transaction and to recover payments from shareholders who cashed out while leaving behind an overleveraged company.

A formidable defense available to shareholders in these actions is found in § 546(e) of the Bankruptcy Code, which provides that a payment that qualifies as a "settlement payment" (a term that encompasses certain payments made in settlement of a securities trade or transaction) or a "transfer...made in connection with a securities contract" (a broadly defined term that includes contracts for the purchase or sale of securities and ancillary agreements) is protected from avoidance as a constructively fraudulent transfer if such payment or transfer is made by or to a "financial institution" or other entity specified in § 546(e).

Congress's purpose in enacting § 546(e) was to balance the rights of creditors to recover fraudulent transfers against the risks that bankruptcy presents to the securities markets. If securities settlement payments and similar transfers were generally avoidable, the ability of market participants to rapidly close out and replace positions could be impaired. The bankruptcy of a single broker or other institution could cause a ripple effect and threaten to collapse the entire industry. Thus, § 546(e) prohibits the avoidance of "settlement payments" and transfers in connection with a securities contract on grounds they are constructively fraudulent, while preserving the ability to avoid such transfers in cases of actual fraud.

While courts initially applied § 546(e) in the context of publicly traded securities, a series of appellate decisions recently applied it in cases where stock was privately held:

- In *Contemporary Industries Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009), § 546(e) protected a $26.5 million cash payment to the sharehold ers of a closely held corporation because the transfer qualified as a "settlement payment" for securities and was made by or to a financial institution, because both the purchaser and sellers of the stock deposited the cash and shares necessary to settle the transaction in escrow with a bank pending closing of the sale.
- Then, in *In re QSI Holdings Inc.*, 571 F.3d 545 (6th Cir. 2009), *cert. denied*, — U.S. —, 130 S.Ct. 1141 (2010), a $111.5 million cash payment to shareholders of a privately held corporation was shielded because it qualified as a "settlement payment" and a bank served as the exchange agent.
- Finally, in *In re Plassein International Corp.*, 590 F.3d 252 (3d Cir. 2009), *cert. denied*, — U.S. —, 130 S.Ct. 2389 (2010), § 546(e) protected $51.1 million in cash transferred through a bank to the shareholders of four companies that were acquired by a single purchaser pursuant to a series of LBOs.

Following these decisions, one could ask whether, in an LBO, *all* payments or transfers for stock are protected so long as the parties utilize a financial institution to effectuate the transfer. Recent decisions suggest, however, that there are limits to the § 546(e) defense:

- In *In re MacMenamin's Grill Ltd.*, 450 B.R. 414 (Bankr. S.D.N.Y. 2011), three stockholders sold their ownership interests in a bar and grill pursuant to an LBO for amounts ranging from $334,983.07 to $390,000. The payments were made to the stockholders by wire transfers from the bank that financed the LBO. Citing legislative history, the court held that § 546(e) was inapplicable because of the small size of the transaction, the lack of any evidence that the parties were acting as participants in a securities market and the fact that avoiding the transfers would not threaten the functioning of any securities market.
- In In re DEI Systems Inc., 2011 WL 1261603 (Bankr. D. Utah March 31, 2011), two individuals sold 44.8% of their shares in the target company to the purchaser for $3.92 million. The funds flowed from the purchaser's bank to an escrow account of the sellers' attorneys, and ultimately to the sellers. The court concluded that § 546(e) did not apply because of the small size of the transaction

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and the fact that the banks were involved merely as conduits for payments and not in their capacity as participants in any securities market.

- Also limiting § 546(e), but under much different facts, is In re Mervyn's Holdings LLC, 426 B.R. 488 (Bankr. D. Del. 2010), a case that involved an LBO comprised of series of securities and nonsecurities transactions. In addition to transfers of more than $1 billion in loan proceeds to the owner of the target corporation, the LBO involved transfers of real estate and grants of liens on property of the target company. As happens with some complex LBOs, the court determined that it was appropriate to collapse the transfers into a single transaction and look to the overall financial impact on creditors. As a result of collapsing the LBO, the court held that the protections of § 546(e) fell away because certain of the transactions that comprised the LBO — such as transfers of real estate — could not qualify as settlement payments or transfers in connection with a securities contract.

These cases indicate that participants in an LBO should not assume that § 546(e) offers blanket protection against actions to avoid and recover transfers to selling shareholders. This is particularly true where the size of the transaction is small enough that a court could conclude it would not impact securities markets, or where a single integrated transaction involves both securities and non-securities transfers.

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