

## The Evolution of the Settlement Payment Defense?

Tianja Samuel, J.D. Candidate 2013

Cite as: *The Evolution of the Settlement Payment Defense?*, 4 ST. JOHN'S BANKR. RESEARCH LIBR. NO. 22 (2012)

### INTRODUCTION

Each year U.S. bankruptcy courts decide hundreds of cases in which debtors, or their trustees, seek to avoid preferential payments.<sup>1</sup> In many of these cases, creditors successfully defend themselves by convincing the court that a statutory safe harbor provision is applicable.<sup>2</sup> The settlement payment defense is one safe harbor provision that—although frequently utilized by creditors—has consistently raised questions about its own scope and applicability.<sup>3</sup> The Second Circuit answered some of these questions, for the first time, in *In re Enron Creditors Recovery Corp.*<sup>4</sup> In what some believe was an expansive decision,<sup>5</sup> the court held that the settlement payment defense is broad enough to cover the redemption of commercial paper. This

---

<sup>1</sup> A Westlaw search of preference actions from 2001 through 2011 produced an average of over 200 cases per year. This result only includes the cases with reportable opinions that are available on Westlaw.

<sup>2</sup> See, e.g., *infra* notes 4, 11, 14, 24, 33, 36, 46, 52, and accompanying text. In all of those cases, creditors convinced the court that the settlement payment safe harbor was applicable.

<sup>3</sup> *Id.*

<sup>4</sup> 651 F.3d 329 (2d Cir. 2011).

<sup>5</sup> The dissenting judge believed that “the Court’s definition of a settlement payment would seem to bring virtually every transaction involving a debt instrument within the safe harbor of Section 546(e).” *Id.* at 346. See also Dechert LLP, Second Circuit Extends Reach of Section 546(e) to Redemption of Commercial Paper, DECHERT ON POINT, July 8, 2011, available at <http://www.jdsupra.com/post/documentViewer.aspx?fid=bf5369ae-e338-4305-b13e-6a9ebc9fb251>.

memorandum analyzes the history of the settlement payment defense and decides that *Enron* is really not as expansive as it appears.

Part I of this memorandum identifies the relevant sections of the Bankruptcy Code (“the Code”) and describes the policy concerns behind them. Part II discusses the facts, rules, and rationales of six circuit court decisions that have interpreted the scope of the settlement payment defense. Finally, Part III concludes by comparing *Enron* to the six decisions discussed in Part II and decides that *Enron* did not expand the scope of the defense, but merely restated a rule that was already being applied in other circuits.

## **I. THE BANKRUPTCY CODE - AVOIDANCE AND SETTLEMENT PAYMENTS**

Cases that have interpreted the settlement payment defense generally implicate three sections of the Code: 547, 546, and 741.<sup>6</sup> Section 547(b) creates the right to avoidance while section 546 limits the right, in defined circumstances. Section 741 is intended to clarify both of these sections, by providing definitions of terms that may be ambiguous. Strangely, the primary section at issue in many of the settlement payment cases is the section that is meant to clarify, not create, the law.

Section 547(b) of the Code codifies the equitable principle that “any act of preferring one creditor over another is invalid.”<sup>7</sup> Specifically, this section allows trustees to recover certain transfers that were made up to 90 days before the bankruptcy petition was filed.<sup>8</sup> Recovered funds may be added to the debtor’s estate and equitably distributed between similarly situated creditors. This satisfies the equitable principle by ensuring that creditors who pressure insolvent

---

<sup>6</sup> See, e.g., *supra* note 4 and accompanying text. See also *infra* notes 11, 14, 24, 33, 36, 46, 52 and accompanying text.

<sup>7</sup> *Armstrong v. Rickey*, 1 F.Cas. 1144 (N.D. OH. 1869).

<sup>8</sup> See 11 U.S.C. 547(b) (2006).

debtors into making pre-petition payments are not rewarded with higher payments than they would receive had they not coerced the debtor.

Section 546 of the Code places limitations on the trustee's avoidance powers by creating safe harbors for creditors whose transactions fall within specified criteria. Specifically, section 546(e) provides that: "the trustee may not avoid a transfer that is a . . . settlement payment . . . made by or to a . . . financial institution, financial participant, or securities clearing agency."<sup>9</sup> The premise behind this safe harbor is that allowing avoidance of certain transactions can have a large, negative impact on the stability of the financial markets.<sup>10</sup> Therefore, "when the securities markets are involved, it is better not to disturb certain prepetition transfers than it is to collect assets for equitable distribution to creditors."<sup>11</sup>

Finally, section 741(8) of the Code gives a very circular definition of the term "settlement payment." It is defined 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."<sup>12</sup> Given this definition, trustees have been arguing to limit the meaning of the term while creditors have been arguing for an expanded meaning.<sup>13</sup> Several circuit courts have already weighed in on these arguments.

---

<sup>9</sup> 11 U.S.C. 546(e).

<sup>10</sup> *Kaiser Steel Corp. v. Charles Schwab & Co.*, 913 F.2d 846, 848 (10th Cir. 1990) (stating that the legislative intent behind section 546 was "to protect the nation's financial markets from the instability caused by the reversal of settled securities transactions.").

<sup>11</sup> *In re Quebecor World (USA) Inc.*, 453 B.R. 201, 204 (Bankr. S.D.N.Y. 2011).

<sup>12</sup> 11 U.S.C. 741(8).

<sup>13</sup> *See e.g., supra* notes 4, 11, and accompanying text. *See also infra* notes 14, 24, 33, 36, 46, and 52 and accompanying text.

## II. JUDICIAL INTERPRETATION OF THE TERM “SETTLEMENT PAYMENT”

### A. *In re Bevill, Bresler & Schulman Asset Management Corp.* – Third Circuit

In 1989, the Third Circuit was the first circuit to interpret the meaning of the term “settlement payment,” in *In re Bevill*.<sup>14</sup> *Bevill* was a securities dealer that sold securities to several banks and local governments, with an agreement to repurchase the securities on a specific date, for a specific amount.<sup>15</sup> Pursuant to the repurchase agreement, *Bevill* retained custody of the securities but several weeks after the transaction it, nevertheless, transferred the securities to the purchasers. Within 90-days of these transfers, *Bevill* filed for Chapter 11 protection.<sup>16</sup> The trustee then sought to recover either the securities or cash as preferential transfers, avoidable under section 547 of the Code; however, the creditors argued that the transfers were settlement payments pursuant to section 546(f)<sup>17</sup> of the Code.<sup>18</sup>

The court ultimately concluded that the debtor’s pre-petition transfer of securities, pursuant to the repurchase agreement, was a settlement payment within the meaning of section 546(f) of the Code.<sup>19</sup> In reaching this conclusion, the court noted that because the definition of settlement payment in section 741(8) is “extremely broad” it needed to look to Congressional intent to determine the true meaning.<sup>20</sup> After evaluating the 1982 House Report, the Securities

---

<sup>14</sup> 878 F.2d 742 (3rd Cir. 1989).

<sup>15</sup> *Id.* at 743.

<sup>16</sup> *Id.* at 744.

<sup>17</sup> See *Infra* note 19 and accompanying text.

<sup>18</sup> *In re Bevill*, at 744–5.

<sup>19</sup> *Id.* at 752–3. At the time this case was decided 11 U.S.C. § 546(f) read: “the trustee may not avoid a transfer that is a margin payment . . . or settlement payment . . . made by or to a repo participant in connection with a repurchase agreement.” *Id.* at 744. It has since been amended and reads as follows: “the trustee may not avoid a transfer made by or to (or for the benefit of) a repo participant or financial participant, in connection with a repurchase agreement.” 11 U.S.C. § 546(f) (2006).

<sup>20</sup> *In re Bevill*, at 751. The court made sure to qualify its use of congressional intent to determine the meaning by quoting Learned Hand who said, “it is one of the surest indexes of a

Exchange Act of 1934, and both the 1982 and 1984 amendments to the Code, the court found that Congress intended:

That a “settlement payment” may be the deposit of cash by the purchaser or the deposit or transfer of the securities by the dealer, and that it includes transfers which are normally regarded as part of the settlement process, whether they occur on the trade date, the scheduled settlement day, or any other date in the settlement process for the particular type of transaction at hand.<sup>21</sup>

Therefore, in this case, it was not determinative that the transfer occurred weeks after the agreement was made because it was still considered part of the settlement “process” and thus eligible for safe harbor protection as a settlement payment.

Notably, although repurchase agreements—like the one at issue here—are structured as purchase and sale agreements they are essentially short term, secured loans. These agreements are made to finance the short term liquidity needs of organizations, at lower rates than traditional bank loans.<sup>22</sup> Viewed in this light, these agreements are no different than traditional bank notes, commercial paper, or even bonds.<sup>23</sup>

#### B. *In re Kaiser Steel Corp.* – Tenth Circuit

In 1990, the Tenth Circuit became the second circuit to interpret the meaning of the term “settlement payment” in *Kaiser Steel Corp. v. Charles Schwab & Co.*<sup>24</sup> Here, Kaiser’s board used a leveraged buyout to sell the company to a group of investors. According to the terms of the agreement, shareholders were to tender each share of Kaiser stock in exchange for \$22 in

---

mature and developed jurisprudence not to make a fortress out of the dictionary; but to remember that statutes always have some purpose or objection to accomplish, whose sympathetic and imaginative discovery is the surest guide to their meaning.” *Id.* at 750.

<sup>21</sup> *Id.* at 751.

<sup>22</sup> *Id.* at 746.

<sup>23</sup> Notes, commercial paper, and bonds are all instruments used to finance short term liquidity needs. An individual or entity pays another and receives a promise of repayment of a higher amount in the future.

<sup>24</sup> 913 F.2d 846.

cash and two shares of preferred stock in the new company.<sup>25</sup> Because many Schwab customers owned Kaiser shares, Schwab acted as a conduit, completing these transactions on behalf of its customers.<sup>26</sup> Two years after the transaction, Kaiser filed for bankruptcy protection and sought to avoid the transfers as fraudulent conveyances.<sup>27</sup> Schwab defended this action by arguing that the leveraged buyout transactions were exempt from avoidance as settlement payments under section 546(e) of the Code.<sup>28</sup>

The court ultimately made three conclusions: (1) a “settlement is the completion of a securities transaction,”<sup>29</sup> (2) the leveraged buyout was a securities transaction, and (3) Schwab’s transfer of money and stock were done to complete the transaction, and where therefore settlement payments.<sup>30</sup> In reaching these conclusions, the court relied heavily on the intent of Congress when it amended section 546 in 1982. The court noted that before the amendment, section 546 only applied to commodities markets.<sup>31</sup> However, the section was expanded to include margin and settlement payments because congress was concerned about the ripple effect of the bankruptcy of a market participant.<sup>32</sup> Thus, the court found no reason to exclude leveraged buyout transactions because there is as much danger of a ripple effect in those transactions as there is in a routine stock sale.

---

<sup>25</sup> *Id.* at 847.

<sup>26</sup> *Id.*

<sup>27</sup> 11 USC 548 allows debtors/trustees to avoid fraudulent transfers made within two years of the bankruptcy petition.

<sup>28</sup> Schwab also argued that it was not liable because it was not the benefactor and was merely a conduit under section 550(a) of the Code but the court did not decide the case on this issue. *Kaiser Steel Corp.*, at 848.

<sup>29</sup> *Id.* at 849.

<sup>30</sup> *Id.* at 850.

<sup>31</sup> *Id.* at 848.

<sup>32</sup> *Id.*

When Kaiser commenced its avoidance action against Schwab it also commenced a similar action against individual stockholders who did not use a broker to participate in the leveraged buyout. This action, *In re Kaiser Steel Corp.*,<sup>33</sup> made it to the Tenth Circuit a year after the circuit had already decided *Schwab*. Kaiser argued that *Schwab* was distinguishable because Schwab was a mere conduit while the defendants here were beneficial owners of the stock.<sup>34</sup> Nevertheless, the court stood by its prior holding and found no reasons why the defendants should be treated any different from Schwab merely because they had a beneficial stake in the stock. In reaching this conclusion it expressly rejected the proposition that the settlement payment defense is only available to market participants, such as Schwab.<sup>35</sup>

### C. *In re Comark* – Ninth Circuit

The Ninth Circuit addressed the settlement payment issue for the first time in 1992, when it decided *In re Comark*.<sup>36</sup> Comark entered into six repurchase agreements with Great American, in which it agreed to purchase securities and Great American agreed to repurchase them at a later date, with interest.<sup>37</sup> For each of these agreements, Great American delivered more securities than the agreement provided for, because it was company practice to provide additional margin in the event that the value of the securities decreased.<sup>38</sup> These additional securities were valued

---

<sup>33</sup> 952 F.2d 1230 (10th Cir. 1991).

<sup>34</sup> *Id.* at 1236.

<sup>35</sup> *Id.* at 1240–1. Here Kaiser argued that the settlement payment defense “does not protect settlement payment by a stockbroker, financial institution, or clearing agency, unless that payment is to another participant in the clearance and settlement system and not to an equity security holder.” *Id.* The court rejected this argument by pointing out that the language of the statute clearly includes payments made “by or to” market participants, therefore including individuals with equity interest. *Id.*

<sup>36</sup> 971 F.2d 322 (9th Cir. 1992).

<sup>37</sup> *Id.* at 323.

<sup>38</sup> *Id.*

at over nine million dollars.<sup>39</sup> To further hedge the risk of these transactions, and secure additional revenues, Comark later entered into six matching repurchase agreements with other organizations.<sup>40</sup> Several months after these transactions, and before the due date of the repurchase agreements, Comark began having financial difficulties. Ultimately, both Great American and the organizations that Comark entered the matching agreements with, agreed to release Comark from its obligations and concluded the transactions directly with one another. The additional securities were then returned to Great American. Within 90-days of these returns, Comark filed for bankruptcy protection and sought to avoid the transfers as preferential. Comark made two key arguments: (1) settlement payment is defined in the code by reference to common knowledge and therefore requires a factual inquiry and is not a question of law and (2) in this case the trades never settled, because Comark backed out of the agreement, and; therefore, the transfers were not settlement payments.<sup>41</sup>

The court rejected both of these arguments and concluded that “a settlement payment clearly includes a transfer of securities that completes a securities transaction”<sup>42</sup> and “includes any transfer that occurs during the settlement process.”<sup>43</sup> The court rejected Comark’s first argument by reasoning that two other circuits, the tenth and the third, had already treated the definition of settlement payment as a question of law.<sup>44</sup> As a practical matter, the second argument was rejected because the court found that “neither party reasonably could consider Comark’s withdrawal settled until Great American received the over \$9 million dollars worth of

---

<sup>39</sup> *Id.*

<sup>40</sup> Comark normally made matching agreements because it could profit off of the underlying transaction as well as the matching transaction.

<sup>41</sup> *Id.* at 324–5.

<sup>42</sup> *Id.* at 326.

<sup>43</sup> *Id.*

<sup>44</sup> *Id.* Here the court references both *Bevill* and *Kaiser*.



securities Comark had in its possession.”<sup>45</sup> Therefore, when Comark backed out of the agreements it created a settlement that could not have been completed until Comark returned the additional securities to Great American.

D. *Contemporary Industries Corp. v. Frost* – Eight Circuit

In *Contemporary Industries Corp. v. Frost*,<sup>46</sup> the Frosts sold their shares in Contemporary Industries, a privately held corporation, during the course of a leveraged buyout. Several years later, Contemporary filed for bankruptcy protection and sought to avoid the transfers as fraudulent. Based on these facts, the Eight Circuit was asked to decide two settlement payment issues: (1) whether the term applied only to publicly held securities and (2) whether it applied only to transactions in which market intermediaries have a beneficial interest.

On the first issue, Contemporary argued that this case is distinguishable from *Kaiser* because *Kaiser* involved publicly traded securities.<sup>47</sup> Specifically, because the avoidance of privately held securities will not cause the type of ripple effect that Congress intended to prevent, transactions involving these securities should not be afforded the benefit of the settlement payment defense. The court rejected this argument by finding that the language of the statute is “sufficiently plain and unambiguous” so that it was not necessary to inquire into congressional intent.<sup>48</sup> On the second issue, Contemporary used an Eleventh Circuit decision to argue that because the financial intermediary did not obtain a beneficial interest in the transaction, the settlement payment defense is not applicable.<sup>49</sup> The court rejected this argument finding that the

---

<sup>45</sup> *Id.*

<sup>46</sup> 564 F.3d 981 (8th Cir. 2009).

<sup>47</sup> *Id.* at 985.

<sup>48</sup> *Id.* at 986.

<sup>49</sup> *Id.* Here, Contemporary referenced *Munford v. Valuation Research Corp.*, 98 F.3d 604 (11th Cir. 1996) where the court concluded that the settlement payment defense was not applicable “because the transaction did not involve an actual transfer of beneficial interest by or

statute “protects settlement payments made by or to a financial institution, and does not expressly require that the financial institution obtain a beneficial interest in the funds.”<sup>50</sup> The court ultimately concluded that “the term settlement payment encompasses most transfers of money or securities made to complete a securities transaction.”<sup>51</sup> Because the transactions at issue met these requirements, they could not be avoided.

E. *In re QSI Holdings, Inc.* – Sixth Circuit

In *In re QSI Holdings, Inc.*,<sup>52</sup> the Sixth Circuit was asked to decide the same issues that the Eighth Circuit decided in *Contemporary*, in the same year. Like *Contemporary*, QSI was also a privately held corporation that engaged in a leveraged buyout. Within two years of the buyout, the new company filed for bankruptcy protection and sought to avoid the transfers made to shareholders under the buyout agreement. QSI essentially made the same arguments as *Contemporary*: (1) the Congressional intent of preventing ripple effects is not furthered by sheltering transactions involving privately held securities and (2) the “by or to a financial institution” requirement of the statute does not include transactions in which the financial intermediary does not have a beneficial interest.

Unlike the Eighth Circuit in *Contemporary*, this court did not use the plain language of the statute to reject these arguments. Rather, the court agreed that the language was circular and used Congressional intent to conclude that avoidance of privately held securities can cause as much of a ripple effect as avoidance of publicly held securities. Specifically, the court noted that “the value of the privately held securities at issue is substantial and there is no reason to think

---

to the financial institution involved.” *Munford*, at 610. Thus far this circuit has been the only one to read this requirement into the statute.

<sup>50</sup> *Contemporary*, at 987.

<sup>51</sup> *Id.* at 986.

<sup>52</sup> 571 F.3d 545 (6th Cir. 2009).

that unwinding that settlement would have any less of an impact on financial markets than publicly traded securities.”<sup>53</sup> Additionally, the court found that several circuits had already addressed the contention that the settlement payment defense is only applicable when financial intermediaries have a beneficial interest and it agreed with these circuits in finding that the statute does not expressly require such an interest.<sup>54</sup> Ultimately, the court found that much like in *Contemporary*, the transactions at issue were settlement payments and cannot be avoided.

### **III. CONCLUSION – DID ENRON REALLY EXPAND THE SETTLEMENT PAYMENT DEFENSE?**

#### *A. In re Enron Creditors Recovery Corp. – Second Circuit*

In 2011, the Second Circuit became the most recent circuit to officially define the term “settlement payment,” in *In re Enron Creditors Recovery Corp.*<sup>55</sup> This case stemmed from a series of transactions in which Enron used a clearing agency to retire commercial paper before its maturity date. Within 90 days of these transactions, Enron filed for bankruptcy protection and sought to avoid the more than \$1.1 billion it paid to retire the commercial paper.<sup>56</sup> Enron’s two key arguments were that: (1) settlement payments only include purchase and sale transactions and (2) the settlement payment defense does not apply where a financial intermediary does not take title to the securities.<sup>57</sup>

The Second Circuit rejected both of these arguments and found that the redemption of commercial paper is a settlement payment within the meaning of the Bankruptcy Code. As to the first argument, the court concluded that “nothing in the text of § 741(8) or in any other

---

<sup>53</sup> *Id.* at 550.

<sup>54</sup> *Id.* at 551. Here the court references the Eight Circuit in *Contemporary* and the Tenth Circuit in *Kaiser*.

<sup>55</sup> 651 F.3d 329.

<sup>56</sup> *Id.* at 331.

<sup>57</sup> *Id.* at 335.

provision of the Bankruptcy Code supports a purchase or sale requirement.”<sup>58</sup> As to the second argument, the court found this to merely be a variation of the “beneficial interest” arguments that were already rejected by three other circuits in *Kaiser*, *Contemporary*, and *QSI Holdings*. It found that there was “no reason to think that undoing Enron’s redemption payments . . . would not also have a substantial and similarly negative effect on the financial markets.”<sup>59</sup>

## B. Comparing Enron to Earlier Decisions

Many have argued that Enron has expanded the scope of the settlement payment defense by opening the door for debt instruments to be sheltered.<sup>60</sup> To determine whether these arguments are valid, it is important to compare *Enron* to the previous settlement payment cases and decide whether there is truly a large variation in the holdings. In comparing *Enron* to its predecessors, three things become apparent: (1) commercial paper is similar to a repurchase agreement, (2) the Second Circuit was not the first to reject the beneficial interest argument, and (3) the only true expansion that occurred in *Enron* was in applying the settlement payment defense to transactions that did not involve a purchase or sale.

As to the first, *In re Bevill* was the first case to interpret the Code’s definition of the term settlement payment.<sup>61</sup> That case involved repurchase agreements that are often used, by organizations, to solve liquidity problems. Essentially, one organization sells securities to raise capital but signs an agreement to repurchase those securities with interest. Therefore, these arrangements are similar to secured loans. With commercial paper, securities are not used as collateral; rather, the organization merely borrows money from investors and agrees to pay them back with interest. Ultimately, the only difference between the repurchase agreements in *Bevill*

---

<sup>58</sup> *Id.* at 336.

<sup>59</sup> *Id.* at 340.

<sup>60</sup> See *supra* note 5 and accompanying text.

<sup>61</sup> See *supra* note 14 and accompanying text.

and the commercial paper in *Enron* is that the commercial paper is unsecured debt.<sup>62</sup> Thus, *Enron* did not expand the settlement payment defense to include securities written on debt instruments because the defense was already being used for securities written on debt instruments, the securities simply were not explicitly labeled debt.

Second, the Second Circuit was not the first to hold that a financial intermediary does not have to have a beneficial interest in the transaction for the settlement payment defense to be applied. As noted earlier, the Eighth and Sixth Circuits had already reached these conclusions in *Contemporary* and *QSI*.<sup>63</sup> Furthermore, the Tenth Circuit reached this conclusion 18 years prior to both *Contemporary* and *QSI*, in *Kaiser*.<sup>64</sup> The Second Circuit expressly referenced these decisions and made it clear that it was following them.<sup>65</sup> Ultimately, this result was no great expansion of the settlement payment defense.

Finally, the only true expansion that occurred in *Enron* was applying the settlement payment defense to transactions that did not involve purchases or sales. All of the previous settlement payment cases heard by circuit courts involved purchase or sale transactions.<sup>66</sup> Thus, this circuit was the first to decide that the settlement payment defense could still be applied even though there was no purchase or sale. Although this may appear to be a sweeping result, this was not the major grievance of those that disagreed with the decision. In fact, many commentators disagreed with the result because it created a way to shelter debt, not because it

---

<sup>62</sup> See *supra* note 23 and accompanying text.

<sup>63</sup> See *supra* notes 50 and 54 and accompanying text.

<sup>64</sup> See *supra* note 35 and accompanying text.

<sup>65</sup> *Enron*, at 338.

<sup>66</sup> *Bevill*, *Kaiser*, *Comark*, *Contemporary*, and *QSI* all involved purchase or sale transactions. See *supra* notes 15, 25, 37, 15, 51, and accompanying text. See also *In re Resorts International, Inc.*, 181 F.3d 505 (3rd Cir. 1999) (regarding settlement payment defense for sale of stock in a leveraged buyout); *In re Plassein Int'l Corp.*, 590 F.3d 252 (3rd Cir. 2009) (regarding settlement payment defense for sale of stock in leveraged buyout).

sheltered transactions that did not involve a transfer of title.<sup>67</sup> Therefore, although this was the only distinct decision that the Second Circuit reached, many argue the non-distinct conclusions as to why the decision has broad implications.

### C. Conclusion

Ultimately, the Second Circuit did not expand the scope of the settlement payment defense in *In re Enron Creditors Recovery Corp.* It merely placed its stamp of approval on conclusions that were already made by other circuit courts. The idea that *Enron* is an expansion of the settlement payment defense is merely a mirage that becomes clear once you delve into the history of the defense.

---

<sup>67</sup> See *supra* notes 5 and 60.

