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Settlement Payment Exception to Avoidance Powers in Bankruptcy: An Unsettling Method of Avoiding Recovery from Shareholders of Failed Closely Held Company LBOs

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PART I. INTRODUCTION

The recent financial crisis has been referred to as the worst crisis since the Great Depression.\(^1\) Severe recession was caused in part by the dysfunctional banking industry, with its irresponsible lending practices.\(^2\) Failing to thoroughly investigate credit risks prior to the completion of loans resulted in unprecedented residential foreclosure rates.\(^3\) Many commercial loans were, and still are, in danger of default.\(^4\) The government has undertaken significant efforts

to fix the problems that contributed to the crisis. As a preventive measure in commercial lending, borrowers and lenders must scrupulously review the borrower’s credit risk and prospects of repayment.

Without such careful planning on the part of lenders and borrowers, the debt burden may be impossible for a company to withstand, and in some circumstances default will eventually lead to bankruptcy. Once in bankruptcy, the debtor estate is subject to a clear scheme of priority of estate distribution, with the secured creditors’ liens satisfied first, then paying the claims of unsecured creditors, and finally distributing what is left to the shareholders. To protect creditors and to preserve the hierarchy of priority, bankruptcy law employs several mechanisms designed to restore to the creditors the value of fraudulent transfers made on the verge of bankruptcy. These powers to unwind fraudulent transfers are referred to as avoidance powers.

Unfortunately, three recent decisions by federal appellate circuits impede bankruptcy avoidance powers, allowing the shareholders to siphon cash away from an entity on the verge of collapse. Broadly interpreting the literal language of Bankruptcy Code sections 546(e) and 741(8), these courts shield from avoidance powers all payments made to shareholders in connection with leveraged buyouts (“LBOs”). The problem is that many failed LBOs are a

http://www.brookings.edu/~media/Files/rc/papers/2009/0615_economic_crisis_baily_elliott/0615_economic_crisis_baily_elliott.pdf (noting that in this recession the commercial real estate loans may reach very high rates of delinquency as they did in the early 90s).

5 See, e.g., DEPARTMENT OF TREASURY WHITE PAPER, supra note 2 (reviewing the main objectives of the reform efforts).


result of irresponsible lending and borrowing without well-developed strategies, which contributed, in part, to the current financial turmoil.\(^1\) Stripping the bankruptcy trustee or debtor-in-possession ("DIP")\(^1\) of avoidance powers for payments in connection with an LBO potentially encourages poorly planned LBOs and may facilitate funneling cash away from failing companies to the detriment of the creditors.\(^1^3\)

The language that now serves as a shield for virtually all failed LBOs is contained in sections 546(e) and 741(8) of the Bankruptcy Code, or the so-called “settlement payment” exception provisions.\(^1^4\) This exception was originally enacted by Congress to protect the securities market from the ripple effects of bankruptcy of a stock trade participant.\(^1^5\) The sale of public stock is a complex process with more than just a buyer and seller; rather it involves several stages and several intermediaries, each of whom guarantees the completion of the transaction.\(^1^6\) Furthermore, several governmental and non-governmental entities regulate the intricate process referred to as the clearing and settlement system.\(^1^7\) Because each system participant, such as a broker or a clearing house, is an integral part of the system, allowing a trustee to recover from one of the participants would impact the rest of the clearing and

\(^1^1\) See Garfinkel, supra note 6, at 51; see generally Emily L. Sherwin, Creditors’ Rights Against Participants in a Leveraged Buyout, 72 MINN. L. REV. 449, 490–91 (1988) (discussing the impact of LBOs on the creditor’s ability to collect). See also DEPARTMENT OF TREASURY WHITE PAPER, supra note 2 (discussing factors that contributed to the crisis).
\(^1^2\) The terms “trustee” and “DIP” will be used interchangeably for purposes of this Article.
\(^1^3\) Irving E. Walker & G. David Green, Structuring a Sale of Privately-Held Stock to Reduce Fraudulent-Transfer Risk, 28–7 AM. BANKR. INST. J. 16, 72 (September 2009) (advising companies about ways to minimize the risk of avoidance).
\(^1^4\) 11 U.S.C. §§ 546(e), 741(8) (2010).
\(^1^6\) See discussion infra Part II.2.a.
\(^1^7\) JAMES D. COX ET AL., SECURITIES REGULATION 2–18 (6th ed. 2009) (reviewing the legal framework of securities regulation, discussing the federal securities laws, state blue sky laws, and self-regulatory organizations).
settlement system and could bring the whole stock market to a halt.\textsuperscript{18} To prevent the negative effect on the stock market, Congress enacted section 546(e).\textsuperscript{19}

The application of the settlement payment exception is problematic because of the contradiction between the literal wording of the exception and its legislative purpose. The language of the statute is very broad and arguably exempts all stock transactions from avoidance, while the legislative history indicates that the statute meant to protect only the market for publicly traded stock.\textsuperscript{20} This inconsistency has caused circuit courts of appeal to reach different results when analyzing the settlement payment exception. The three recent appellate decisions expand the scope of section 546(e) to shield consideration received by former holders of private stock in an LBO, which in effect shields all LBOs from avoidance.\textsuperscript{21} Other courts restrict the application of the settlement payment exception to sales of publicly held stock,\textsuperscript{22} and the narrowest reading of the settlement payment exception limits its protection to intermediaries in the clearing and settlement system, i.e. stock brokers and clearing houses.\textsuperscript{23} The resulting circuit split leaves market participants perplexed: the only common point in all circuits is that a trustee cannot recover from the market intermediaries. As for the former shareholders of a bought-out company, the impact of an avoidance action on the consideration they receive in an LBO will


\textsuperscript{19} 11 U.S.C. § 546(e); H.R. REP. 97-420, at 1.

\textsuperscript{20} 11 U.S.C. §§ 546(e), 741(8); H.R. REP. 97-420, at 1.


\textsuperscript{22} See, e.g., Kaiser Steel Corp. v. Pearl Brewing Co. (\textit{Kaiser Steel II}), 952 F.2d 1230, 1237 (10th Cir. 1991) (holding that the settlement payment exception shields all payments to shareholders of public companies. The Tenth Circuit has yet to address whether the application of section 546(e) can be extended to closely held stock).

\textsuperscript{23} See, e.g., Munford v. Valuation Research Corp. (\textit{In re Munford, Inc.}), 98 F.3d 604 (11th Cir. 1996) (concluding that the protections of section 546(e) are limited to brokers and other intermediaries).
depend on the court interpreting the settlement payment exception. Lack of uniformity among the circuits creates confusion.

As the world slowly recuperates from the turmoil of a financial crisis, it is necessary to fight its causes. Shielding all LBOs from avoidance would encourage reckless lending and borrowing practices. Knowing that the transaction will not be unwound in bankruptcy creates a perverse incentive not to evaluate long-term strategy for the bought-out company. Indisputably, LBOs are a valuable vehicle for the economy because investment in healthy growth is crucial to the recovery of global economy. Nonetheless, not all LBO transactions need to be encouraged. Allowing the trustee to use her avoidance powers would serve as a deterrent for poorly planned LBOs and promote more accountability in lending and borrowing.

This Article calls for a revision of section 546(e) and its definitional counterpart, section 741(8), to clarify that the settlement payment exception is limited to publicly traded stock. Part II reviews trustee avoidance powers and their purpose; it provides the background of clearing and settlement system and explains why Congress needed to protect this system from avoidance powers in bankruptcy. Part III outlines the elements of the settlement payment exception, focusing on its application to LBO payments to intermediaries, shareholders of public companies, and shareholders of closely held companies. Part III further provides a synthesis of the jurisprudence interpreting sections 546(e) and 741(8). Part IV proposes a simple amendment to the Bankruptcy Code, which would clarify that the settlement payment exception applies only to publicly traded securities. Part V offers a brief conclusion.

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24 BAILY & ELLIOTT, supra note 4, at 2–3.
II. BACKGROUND

American bankruptcy law includes sophisticated devices whose purpose is to prevent fraud and abuse by debtors in relation to their creditors, one example being avoidance powers.\(^{26}\)

1. Trustee Avoidance Powers

Avoidance powers encompass fraudulent conveyance actions, which bring back to the estate payments transferred away from the estate.\(^{27}\) The goal of avoidance is to maintain the hierarchy between claims of creditors and interests of shareholders.\(^{28}\) One of the fundamental principles in bankruptcy requires that all classes with higher priority be paid in full before lower priority claims are satisfied.\(^{29}\) The lowest on the totem pole are the interests of shareholders.\(^{30}\) Shareholders may realize that in the event of bankruptcy their chances of recovery are bleak and attempt to siphon away funds to third parties to the detriment of the creditors. The Bankruptcy Code recognizes this potential for abuse and provides a remedy in the form of avoidance powers.\(^{31}\) Typical examples of avoidable transfers are “gifts, transfers for inadequate consideration, . . . a public record of the ownership change, transfers of possession with secret retention of ownership interests, assumptions of obligations of third parties without equivalent

\(^{26}\) See, e.g., 11 U.S.C. §§ 544, 548 (allowing the trustee to unwind fraudulent transfers made on the eve of bankruptcy).

\(^{27}\) 8A C.J.S. Bankruptcy § 689 (2010); 4-65 COLLIER BANKRUPTCY PRACTICE GUIDE P 65.02.

\(^{28}\) 8A C.J.S. Bankruptcy § 689.

\(^{29}\) See generally 8B C.J.S. Bankruptcy §§ 1101–02 (discussing claim priority). In Chapter 11, a plan cannot be confirmed unless it complies with the rule of absolute priority, i.e. each class in the hierarchy must be paid in full, or must agree to accept less than full payment, before any junior class of creditors receives or retains any property under the plan. Rosemary Williams, Annotation, Special Commentary: Construction and Application of Absolute Priority Rule in Confirmation of Plan Under Chapter 11 of Bankruptcy Code of 1978 (11 U.S.C.A. § 1129(b)(2)), 175 A.L.R. FED. 485 (2002).

\(^{30}\) 8B C.J.S. Bankruptcy §§ 1102.

consideration to the debtor, and payments upon equity interests when creditor interests go unpaid.”

The proceeds from avoidance actions are preserved for the estate and benefit the unsecured creditors who do not have a lien to secure their claims in bankruptcy and ordinarily get paid pennies on the dollar. Avoidance allows the trustee to recover from the initial transferee or, in some circumstances, from a subsequent transferee as well.

a. In General

Avoidance powers can be found in several sections of the Bankruptcy Code. Under section 544 (the “strong arm” statute), a trustee can resort to the applicable state law to avoid a transfer of an interest of a debtor in property or any obligation incurred by the debtor, where such state law would permit an unsecured creditor to avoid the relevant transfer. In the vast majority of states, this law is based on Uniform Fraudulent Transfer Act (UFTA) or Uniform Fraudulent Conveyance Act (UFCA). Although the terminology of the two acts contains slightly different language, the application is substantively almost the same. The modern laws—UFTA and UFCA—allow a creditor to void any actually fraudulent transfer, i.e. a transfer by the debtor made with the intent to hinder, delay, or defraud the creditor undo. These laws also permit

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32 4-65 COLLIER BANKRUPTCY PRACTICE GUIDE P 65.02
33 11 USC § 551.
34 11 USC § 550.
37 Garfinkel, supra note 6, at 55. The origin of fraudulent conveyance statutes is the Statute of 13 Elizabeth, which was enacted by the English Parliament in 1571. Id. at 53–54.
38 Id. at 55. See generally 4-65 COLLIER BANKRUPTCY PRACTICE GUIDE P 65.05 (comparing the two acts).
39 Garfinkel, supra note 6, at 53–4.
creditors to act upon constructive fraud by the debtor.\textsuperscript{40} In fact, the constructive fraud provisions are prevalent today because no proof of scienter of required.\textsuperscript{41}

For instance, Delaware law provides that a transfer by a debtor is fraudulent as to a creditor if such transfer was made with actual intent to hinder, delay or defraud, i.e. actual fraud.\textsuperscript{42} A transfer is constructively fraudulent if two conditions are met.\textsuperscript{43} First, the debtor must not have received a reasonably equivalent value in exchange for its property during the transfer.\textsuperscript{44} The second condition is either that the debtor was engaged in a transaction for which the remaining assets of the debtor were unreasonably small, or the debtor knowingly incurred debts beyond his or her ability to pay them as they became due,\textsuperscript{45} or if the debtor was insolvent at the time of the transfer or became insolvent as a result of the transfer.\textsuperscript{46} The Delaware statute uses the balance sheet insolvency test, defining insolvency as debts exceeding assets.\textsuperscript{47} Also, there is presumption of insolvency if the debtor is not paying debts as they become due.\textsuperscript{48} In a Delaware bankruptcy case, the trustee may resort to the “strong arm” provision—section 544 of the Bankruptcy Code—which allows the trustee to use the Delaware fraudulent transfer laws.\textsuperscript{49}

In addition to incorporation of state law remedies under the “strong arm” provision, section 548 of the Bankruptcy Code contains language very similar to traditional state law

\footnotesize
\textsuperscript{40} Id. at 55.  
\textsuperscript{41} Id. However, avoidance suits based on actual fraud are still significant because they “may provide a bypass for problematic issues engrained in constructive fraud, such as reasonably equivalent value.” Oscar N. Pinkas, \textit{No Collateral and No Cash: Fraudulent Avoidance in Private Equity-Leveraged Buyouts}, 27–8 \textit{AM. BANKR. INST. J.} 18, 18 n.4 (2008).  
\textsuperscript{42} \textsc{Del. Code Ann. tit.} 6, \textsection{} 1304 (2010).  
\textsuperscript{43} Id.  
\textsuperscript{44} Id.  
\textsuperscript{45} Id.  
\textsuperscript{46} Id. at \textsection{} 1305.  
\textsuperscript{47} Id. at \textsection{} 1302.  
\textsuperscript{48} Id. at \textsection{} 1302.  
\textsuperscript{49} 11 U.S.C. \textsection{} 544(b) (2010).
remedies.\textsuperscript{50} It permits the bankruptcy estate to recover property that was transferred within two years before the filing of the bankruptcy petition, if the transfer was made with actual intent to hinder, delay, or defraud.\textsuperscript{51} Further, a transfer can be avoided if it is constructively fraudulent, which, like the Delaware law, requires two conditions be met.\textsuperscript{52} First, the debtor must have received less than a reasonably equivalent value in exchange for property.\textsuperscript{53} Second, the debtor must have been insolvent on the date of the transfer or became insolvent as a result thereof, or was engaged in a transaction that left him with an unreasonably small capital, or the debtor must have knowingly incurred debts that the debtor would be unable to pay upon their maturity; or made such transfer to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.\textsuperscript{54}

The state-law remedy under section 544 is substantially the same as the federal bankruptcy fraudulent transfer provision in section 548. Trustees in bankruptcy have a choice between sections 544 and 548. The main factor that influences the remedy selection is the time within which the suit is allowed.\textsuperscript{55} The federal avoidance action can be brought to recover property transferred within two years of bankruptcy.\textsuperscript{56} Some state law allows a trustee to go back more than two years.\textsuperscript{57} A trustee can also use fraudulent transfer provisions to avoid payments to shareholders in connection with certain LBOs.\textsuperscript{58}

\begin{itemize}
\item \textsuperscript{51} 11 U.S.C. § 548.
\item \textsuperscript{52} Id.
\item \textsuperscript{53} Id.
\item \textsuperscript{54} Id.
\item \textsuperscript{55} GINSBERG ET AL., supra note 35, at § 9.03, 9–25 n.104.
\item \textsuperscript{56} 11 U.S.C. § 548.
\item \textsuperscript{57} 4-65 COLLIER BANKRUPTCY PRACTICE GUIDE P 65.05 n.12 (citing N.Y. C.P.L.R. 213(1) and (8) (2010), with a six- year statute of limitations).
\item \textsuperscript{58} Trustees may also sue the LBO lender to recover some funds for the estate. See Comment, Prudent Lenders Need Not Fear O’day: A Case Comment On The Application Of Fraudulent Conveyance Law To LBO Lenders, 74 B.U.L.
b. Avoidance Powers Application to LBOs

Many courts recognize a failed LBO as one example of an avoidable transfer. In a typical LBO, the acquirer finances its purchase of a target company with a loan, the repayment of which is secured with the assets of the target company. As a result, the acquired entity is saddled with large amounts of debt and encumbered assets. Frequently, companies that were acquired in an LBO are forced to file for bankruptcy as the onerous loan repayment obligations leave little operating cash. Ordinarily, once the debtor is in bankruptcy, equity interest holders are not entitled to any payment until all the creditors’ claims are satisfied. In an LBO, we see a reversal of this order. The shareholders receive their cash payments and abandon the sinking ship, leaving the unsecured creditors behind. What makes the outcome all the more unfair is that most companies’ unsecured creditors, unlike the shareholders, do not get to vote on whether the LBO should proceed. But if they did have a choice, many unsecured creditors would vote against it, granted LBOs’ long and turbulent history.

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60 See generally 8B C.J.S. Bankruptcy §§ 1101–02 (discussing claim priority).

Although it is difficult to pinpoint when the idea of a leveraged buyout first came to fruition, undoubtedly one of the most successful LBOs was the 1933 acquisition of United Parcel Service ("UPS") by its management. The early buyouts, commonly referred to as "bootstrapping," were financed through the funds of the target company. The stagnant economy of the 1970s, with overwhelming concerns about oil prices and inflation, caused many companies to accumulate assets that were underpriced on their balance sheets. Recognizing the depressed market value of such companies' stock, investment groups such as Kohlberg, Kravis and Roberts ("KKR") and corporate raiders such as Ron Perelman and Carl Icahn jumped at this opportunity. In the 1980s, LBOs became widespread and institutionalized, with high rates of pension funds involvement. Many successful buyouts of that era generated returns of 30% or more. The LBOs continued to grow in size and value. A new market for junk bonds, created by Drexel Burnham Lambert ("Drexel") investment banker Michael Milken, enabled buyers to quickly access capital through subordinated financing. Availability of junior capital further facilitated the LBO market. Acquirers of the 1980s transformed asset-rich, yet mismanaged companies into efficiently functioning businesses, which generated high returns.

After the 1987 market crash, LBOs received bad publicity, in part due to the securities fraud conviction of Ivan Boesky—a high profile insider trading case involving Drexel. As a result of this incident, Milken himself was convicted, and the junk bond market collapsed

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65 Id. at 110.
66 Id.
67 Id. at 111.
68 Id. at 111–12.
69 Id. at 112.
70 Id.
71 Id.
72 Id. at 112–13.
73 Id. at 113.
74 Id.
75 Id. at 114.
without his flagship.\textsuperscript{76} “Greed is good”—the quote by a fictional financier Gordon Gecko from Oliver Stone's film Wall Street—was perceived to be the motto of the corporate raiders.\textsuperscript{77} Furthermore, the financial recession and the collapse of the savings and loan business gave rise to more stringent regulation of market transactions, which forever altered the leveraged buyout market.\textsuperscript{78} The stock prices more accurately reflected market value of the companies, so it was not quite so easy any more to find a target that could be quickly turned around.\textsuperscript{79} LBO-generated return potential significantly decreased.\textsuperscript{80} The painful experience of the 1980s forced the buyers to revise their strategy, with recent buyouts using a lower debt-to-asset ratio and buyers pledging their own assets so as not to overload the target with debt.\textsuperscript{81} Nevertheless, the economic recession and credit crisis will likely result in an increased number of post-LBO bankruptcies.

Indeed, many LBOs fail within a short period of their commencement.\textsuperscript{82} Such failure is no surprise: too often even companies that have economic potential are financially unsound because of the burden associated with high amounts of debt.\textsuperscript{83} Thus, even though many target companies are stable at the time of the buyout, they become insolvent shortly thereafter.\textsuperscript{84} Moreover, the high debt-to-equity ratio changes the risk structure as among creditors and shareholders.\textsuperscript{85} The former shareholders walk away with a significant premium over the pre-bankruptcy market value of their shares, while the unsecured creditors of failing companies

\textsuperscript{76} Id. at 115.
\textsuperscript{78} Ablum & Burgis, supra note 64, at 115–16.
\textsuperscript{79} Id. at 116.
\textsuperscript{80} Id.
\textsuperscript{81} Id.
\textsuperscript{82} See Garfinkel, supra note 6, at 51.
\textsuperscript{83} Id.
\textsuperscript{84} Id.
\textsuperscript{85} Id.
recover pennies on the dollar.\textsuperscript{86} As for the new owners, most of the financing for the buyout comes from a loan, so the worst case scenario for them is the possibility that the bank will seize and resell the target’s assets.\textsuperscript{87} Thus, the biggest harm will be to the unsecured creditors, such as debenture holders, employees, and suppliers.

Paying equity holders before creditors disrupts the traditional priority of claims in bankruptcy, unless the trustee can exercise her avoidance powers to get the money back from the former shareholders.\textsuperscript{88} LBOs can prejudice unsecured creditors because in a buyout shareholders receive a large cash payment, while the company arguably gets nothing in return.\textsuperscript{89} To the contrary, its assets are encumbered and its debt-to-equity ratio is increased.\textsuperscript{90} This makes it possible to meet the elements of an avoidance action, so long as the LBO occurred within the statutory time frame (which is two years under section 548 and may be longer under some state law).\textsuperscript{91} Arguably, the debtor entity receives less than reasonably equivalent value when it takes on large amounts of debt, with its assets encumbered to secure the repayment of the debt.\textsuperscript{92} If the debtor is rendered insolvent as a result of the LBO, the elements of an avoidance action are satisfied.\textsuperscript{93} An example is the best illustration of how LBOs may fit the scheme of fraudulent conveyances.

\textsuperscript{86} Id.
\textsuperscript{87} Id. at 53.
\textsuperscript{88} See Sherwin, supra note 11, at 453–64 (discussing other theories used by creditors to challenge leveraged buyouts).
\textsuperscript{89} Carlson, supra note 60, at 75; Ginsberg et al., supra note 35, at § 9.03, 9–56.
\textsuperscript{90} Garfinkel, supra note 6, at 51.
\textsuperscript{91} See 11 U.S.C. § 548 (2010) (providing that the transfer must have occurred within two years of the bankruptcy petition); N.Y. C.P.L.R. 213(1) and (8) (2010) (containing a six-year statute of limitations).
\textsuperscript{92} 9C AM. JUR. 2D Bankruptcy § 2278 (2010).
\textsuperscript{93} Id.
In 2002, a successful closely held women’s apparel retailer Norstan Apparel Shops, Inc. ("Norstan") was bought by an investment group for more than $55 million. Out of the total purchase price, $38.4 million was borrowed from a bank, with the assets of Norstan pledged as collateral to secure the loan. The shareholders of Norstan—the Lattman family and their trusts—received the proceeds from the sale in exchange for their interests in the company. Overburdened with debt and having little operating funds, Norstan’s financial condition quickly declined after the LBO, culminating with its bankruptcy in 2005. The committee of unsecured creditors sued the Lattmans as former shareholders, asserting that the payments the Lattmans received in the LBO transaction were constructive fraudulent conveyances under the “strong arm” section 544(b) of the Bankruptcy Code and the relevant provisions of New York Debtor & Creditor Law.

Under New York law, a transfer may be avoided as constructively fraudulent if it was made with no fair consideration and “(1) and the debtor is insolvent or will be rendered insolvent; (2) the debtor is engaged in business and will be left with unreasonably small capital; or (3) the debtor intended or believed that it would incur debts beyond its ability to pay them as they mature.” The creditors’ committee’s complaint averred that during the LBO Norstan did not get fair consideration: the assets of Norstan were encumbered while Norstan did not receive anything in exchange, unlike the shareholders who collected all the sale proceeds. The court denied the shareholders’ motion to dismiss finding that the complaint was sufficient in showing

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95 Id. at 73.
96 Id. The Lattmans received an additional cash distribution before the LBO. Id.
97 Id.
98 Id. at 73–74, 77.
99 Id. at 77.
100 Id. at 78.
that Norstan did not receive fair consideration, which under New York law creates a presumption of insolvency, thereby shifting the burden to the shareholders to show that Norstan was solvent after the LBO.\textsuperscript{101} The court also noted that even without the presumption, the complaint was sufficient because it alleged that Norstan was rendered insolvent by the LBO: its assets were encumbered and it took on large amounts of debt in connection with the transaction.\textsuperscript{102}

Proving that Norstan did not receive fair consideration and that it was either insolvent or was rendered insolvent in the LBO would be enough for the creditors’ committee to prevail because the requirements in the statute are stated in the alternative.\textsuperscript{103} However, on this motion to dismiss, the court addressed other alternatives as well. Addressing the issue of unreasonably small capital, the court noted the sufficiency of capital is determined through several factors: “company’s debt to equity ratio, its historical capital cushion, and the need for working capital in the specific industry.”\textsuperscript{104} The court again found the committee pleading was sufficient after analyzing the fast deterioration of the company’s financial condition.\textsuperscript{105} Finally, the court held that it was possible to infer that the shareholders knew that Norstan would be unable to pay debts as they mature because of the asset encumbrance and increased debt-to-equity ratio.\textsuperscript{106} Thus, the court found that plaintiffs’ complaint was sufficient to assert an actionable fraudulent conveyance claim and denied defendants’ motion to dismiss.\textsuperscript{107}

\textsuperscript{101} Id.
\textsuperscript{102} Id. at 79.
\textsuperscript{103} Id. at 77.
\textsuperscript{104} Id. at 79 (citing MFS/Sun Life Trust-High Yield Series v. Van Dusen Airport Servs. Co., 910 F. Supp. 913, 944 (S.D.N.Y. 1995)).
\textsuperscript{105} Id. at 79–80.
\textsuperscript{106} Id. at 80.
\textsuperscript{107} Id. at 80.
Courts realize that the poor financial condition of a company that underwent an unsuccessful LBO impairs the ability of unsecured creditors to collect what is owed to them.\(^{108}\) The company itself receives less than reasonably equivalent value in an LBO because the cash goes directly to the shareholders and the company is left with debt and its assets are encumbered.\(^ {109}\) Additionally, as is clear from the example above, it would be fairly easy to meet one of the three alternative conditions: insolvency, unreasonably small capital, or inability to pay debts when due. Therefore, if the transaction occurred within a statutory time frame, a trustee may have an actionable claim for avoidance of LBO payments to shareholders in connection with LBOs.\(^ {110}\)

Ordinarily, if the elements of an avoidance action are met, the trustee or debtor-in-possession will recover the payments.\(^ {111}\) This result, with all its attendant consequences for the shareholders, aims at protection of unsecured creditors. Avoidance powers are broad and as long as the elements of a fraudulent transfer action are met, payments should ordinarily be reversed, with the *status quo ante* restored. Any exception to the rule should be interpreted narrowly.

2. 546(e) as an Exception to Avoidance Powers

Not all transfers meeting the elements of an avoidance action will or can be avoided. Section 546 of the Bankruptcy Code provides for several exceptions. Specifically, under section 546(e) a bankruptcy estate cannot recover payments that qualify as “settlement payments made

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\(^{108}\) See, e.g., id.; see generally 9C AM. JUR. 2D Bankruptcy § 2278 (discussing analysis of LBOs as fraudulent conveyances).

\(^{109}\) Reasonably equivalent value is the most problematic element of a fraudulent conveyance action. See generally Pinkas, *supra* note 41, at 18 (discussing risks avoidance inherent in private equity LBOs).

\(^{110}\) See GINSBERG ET AL., *supra* note 35, at § 9.03, 9–58 (outlining various efforts to avoid fraudulent transfer liability).

\(^{111}\) The recovered transfers are automatically “preserved for the benefit of the estate.” 11 U.S.C. § 551 (2010).
by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency.”

a. History of the Clearance and Settlement Payment Exception

By enacting section 546(e) Congress attempted to protect the market for publicly traded stock. Shares of publicly-owned companies are sold and bought on various stock exchanges, in the over-the-counter (“OTC”) market, or in what is now referred to as the “third market”—electronic communications networks. Before the establishment of the national clearance and settlement system, state law governed the transfer process for purchases of securities. In the absence of a centralized system of consolidated records, “brokers still exchanged paper certificates and checks for each trade, sending hundreds of messengers scurrying throughout Wall Street clutching bags of checks and securities.” The New York Stock Exchange was growing rapidly in the 1960s and 1970s, its volume of trade increasing to 10–12 million shares a day. The Wall Street’s “paperwork crisis” hit when the brokers were so behind that they were unable to keep up their records to reflect the daily trades. During the crisis, each securities

114 Stock exchanges are centralized markets where securities are traded. Examples include the New York Stock Exchange (NYSE) and American Stock Exchange (AMEX). See generally Cox, supra note 17, at 93–98, 1004–05.
115 OTC securities are not listed on any exchange; instead they are purchased either from “market-makers,” who keep an inventory of various securities, or directly from broker. Cox, supra note 17, at 95. Nasdaq was originally an OTC market, although today it is considered an exchange. Id.
116 Id. at 96. See generally Jerry W. Markham & Daniel J. Harty, For Whom the Bell Tolls: The Demise of Exchange Trading Floors and the Growth of ECNs, 33 J. CORP. L. 865, 866 (2008) (noting that exchange trading floors may soon become obsolete due to the convenience of electronic communications networks (ECNs) that match trades electronically through algorithms).
118 THE DEPOSITORY TRUST AND CLEARING CORPORATION (DTCC), http://www.dtcc.com/about/history.
119 Id.
120 Id.
transaction required a brokerage firm to process about 33 different documents.\textsuperscript{121} In the late 1960s, many brokerage firms went out of business due to back-logs and operational deficiencies.\textsuperscript{122}

In 1975, Congress determined that “securities markets are an important national asset which must be preserved and strengthened” and directed the SEC “to use its authority . . . to facilitate the establishment of a national market system.”\textsuperscript{123} The proposed solutions were two-fold: immobilization and netting.\textsuperscript{124} On the one hand, the physical stock certificates were to be kept in a central location or depository.\textsuperscript{125} Instead of physically transferring certificates at each sale, the depository would “immobilize” the certificates and merely record changes of ownership.\textsuperscript{126} One of the most prominent depositories—Depository Trust Company (“DTC”)—was established in 1973.\textsuperscript{127} In addition to immobilization of physical stock certificates, the second part of the solution to “paperwork crisis” was multilateral netting.\textsuperscript{128} Although a broker may be entering into multiple transactions with many other brokers, all of the money and securities to be exchanged will settle as one single transaction with a clearing house acting as a central counterparty.\textsuperscript{129} As a result of this system of net money settlements only one transfer of money is required.\textsuperscript{130}

\textsuperscript{121} Bergmann, supra note 117.
\textsuperscript{122} Id.
\textsuperscript{124} THE DEPOSITORY TRUST AND CLEARING CORPORATION (DTCC), supra note 118.
\textsuperscript{125} Id.
\textsuperscript{126} Id.
\textsuperscript{127} Id.
\textsuperscript{128} Id.
\textsuperscript{129} Id.
\textsuperscript{130} Id.
Today, shareholders rarely keep stock certificates in their possession; instead various depository trusts maintain meticulous records of ownership.\(^{131}\) Thus, most of the stock certificates are held in “street name,” i.e. they do not signify the name of the actual shareholder, but rather list the broker as the owner.\(^{132}\) The SEC recently approved dispensing with the requirement of maintaining paper certificates altogether, allowing Depository Trust Company to keep only electronic account records, which is consistent with the securities market efforts of reducing paperwork.\(^{133}\)

The following are the basic steps for a sale and purchase of publicly traded stock. When an investor decides to buy or sell stock, she will contact her broker, who will determine whether the stock trades on a stock exchange, or whether it is available over-the-counter. If the broker uses the stock exchange, he will obtain a quote from the stock exchange’s electronic market data system.\(^{134}\) If the price of stock is within the range the investor had in mind, she will instruct the broker to go ahead with the transaction.\(^{135}\) The order from the investor’s broker will be transmitted to a floor broker of the stock exchange.\(^{136}\) The floor broker will match up the purchase and sale orders and execute the order.\(^{137}\) The clearing agency verifies and adjusts the records to reflect the day’s transactions.\(^{138}\) After that the transaction will be recorded, with the record transmitted to the original broker and saved on the consolidated tape displays accessible

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\(^{132}\) Id. Originally, only 15% of all stock was held in “street name.” See Wall Street: Attack on the Snarl, TIME MAGAZINE (May 24, 1968), available at http://www.time.com/time/magazine/article/0,9171,844480,00.html. See generally DTCC’S NO MORE PAPER CAMPAIGN, http://www.dtcc.com/leadership/issues/nomorepaper/index.php


\(^{134}\) Id.

\(^{135}\) Id.

\(^{136}\) Id.

\(^{137}\) Id.

\(^{138}\) Garfinkel, supra note 6, at 64.
around the world. The investor will receive a notice of trade confirmation and the investor’s account will be “settled” within three business days so as to reflect the transaction. The settlement consists of the brokers transferring funds and securities.

Thus, an ordinary purchase of securities involves more than just a buyer and seller: several intermediaries are an inherent part of the “clearing and settlement” system. Because the transfer of securities does not happen instantaneously, the intermediaries provide a series of guarantees, all of which “inspire[ ] confidence in the trading system and permit[ ] lightning-fast trading.” The buyer’s broker guarantees the payment of money in exchange for stock, while the seller’s broker promises to deliver the securities. Moreover, the intermediary between the two brokers, or the clearing agency, guarantees the prompt transfer of money and securities. Should any link in this chain break down because of a default, the clearing agency must nonetheless perform its obligations, which is normally done through the use of a backup clearing fund maintained by the clearing agency’s members. The clearing and settlement system guarantees inevitably constitute huge financial exposure of clearing houses: in 2009, DTC alone settled securities transactions worth more than $299 trillion, and was responsible for processing 299.5 million book-entry deliveries. The inherent risks of the system are offset through collateralization in the form of margin payments.

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139 NEW YORK STOCK EXCHANGE EDUCATIONAL MATERIALS, supra note 134.  
140 Id.  
141 Garfinkel, supra note 6, at 64.  
143 Garfinkel, supra note 6, at 64.  
144 Id. at 64–65.  
145 Id. at 65.  
147 Garfinkel, supra note 6, at 65.
Thus, the effective functioning of the clearing system depends on the guarantees provided by the clearing agency and its members.\(^{148}\) If one of the market participants goes bankrupt, others must go through with their obligations.\(^{149}\) Allowing the trustee to undo the entire transaction may put other participants in financial jeopardy by creating a “ripple effect” threatening the stock market.\(^{150}\) For the clearing and settlement system to operate as designed, each participant in the system must be assured that the margin and settlement payments are valid, and will not be subsequently undone.\(^{151}\) Congress realized that “[c]ertain protections are necessary to prevent the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market”\(^{152}\) and in 1982 adopted the settlement payment exception to trustee’s avoidance powers.\(^{153}\)

b. The Language of Sections 546(e) and 741(8) and Elements of Analysis

After the adoption of section 546(e), it has been amended\(^{154}\) and the present-day version reads as follows in pertinent parts:

\[
\text{Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a . . . settlement payment, as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency . . . .}
\]

\(^{148}\) Id.
\(^{149}\) Id.
\(^{151}\) Garfinkel, supra note 6, at 65.
\(^{152}\) H.R. REP. 97-420, at 1.
\(^{153}\) PL 97-222 (H.R. 4935) (July 27, 1982).
\(^{154}\) 5–546 COLLIER ON BANKRUPTCY P. 546.LH (noting that section 546(e) underwent only minor revisions since its adoption).
Further, section 741(8)\textsuperscript{155} contains the definition of 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.”\textsuperscript{156} Thus, to fall under this exception to trustee avoidance powers a payment must be a “settlement payment” as defined in section 741(8) and it must be made by or to (or for the benefit of) one of the clearing and settlement system participants.

Because of the phraseology of these sections and because of the circular definition in section 741(8) the interpretation of “settlement payment” exception is far from uniform. Considering the purpose for the enactment of the statute and its language, it appears at first glance that the meaning of it is clear: Congress wanted to protect the securities trade from the negative effects of bankruptcy of one of the markets participants.\textsuperscript{157} However, approximately twenty years of irreconcilable jurisprudence reveal that the meaning of settlement payment exception is far from settled.\textsuperscript{158} One aspect not subject to debate is that this exception does not shield payments that involve actual fraud, as is clear from the last clause of the provision.\textsuperscript{159} As for the application of section 546(e) to constructively-fraudulent transfers, it remains murky territory, with a few recent decisions reaching very surprising results.\textsuperscript{160}

It remains ambiguous what exactly must the settlement payment exception shield in order to protect the markets. The settlement payment exception was clearly meant to protect financial

\textsuperscript{155} 11 U.S.C. § 101(51A) defines “settlement payments” for purposes of forward contracts.

\textsuperscript{156} 11 U.S.C. § 741(8).

\textsuperscript{157} 5–546 COLLIER ON BANKRUPTCY P. 546.LH; H.R. REP. 97-420, at 1 (1982).

\textsuperscript{158} \textit{See} discussion infra Part III.

\textsuperscript{159} 5–546 COLLIER ON BANKRUPTCY P 546.06. This is not a significant curtailment of the settlement payment exception because actual fraud is very difficult to prove. \textit{See} discussion supra Part II.1.a.

\textsuperscript{160} Contemporary Indus. Corp. v. Frost, 564 F.3d 981 (8th Cir. 2009); QSI Holdings, Inc. v. Alford (\textit{In re QSI Holdings, Inc.}), 571 F.3d 545 (6th Cir. 2009), \textit{cert. denied}, 130 S.Ct. 1141 (2010); Brandt v. B.A. Capital Co. LP (\textit{In re Plassein Intern. Corp.}), 590 F.3d 252 (3d Cir. 2009), \textit{cert. denied}, 130 S.Ct. 2389 (2010) (all concluding that sections 546(e) and 741(8) shield from avoidance closely held company LBOs). \textit{See also} discussion infra Part III (providing examples of cases reaching different outcomes).
intermediaries.\textsuperscript{161} Intermediaries such as clearing and brokerage houses are mere conduits for the payments, but they also must guarantee that the transaction will ultimately close.\textsuperscript{162} Hence, it is essential to prevent the trustee from going after such intermediaries. Commentators have argued that the settlement payment exception was designed only for the protection of financial intermediaries and does not shield payments to shareholders at all.\textsuperscript{163} Others are willing to extend protection to all publicly traded stock.\textsuperscript{164} Yet, the three recent appellate decisions expand the settlement payment exception to shield all LBO payments from avoidance.\textsuperscript{165} Although the end results reached by courts may be different, courts generally agree on the basic elements of the analysis.

**PART III. APPLICATION OF SECTION 546(E) TO LBO PAYMENTS**

When applying the settlement payment exception, courts single out two separate elements that the party claiming the exception must prove.\textsuperscript{166} First, the payment has to qualify as a statutorily defined “settlement payment.”\textsuperscript{167} Second, the payment has to be made by or to (or for the benefit of) a party, specifically enumerated in the statute.\textsuperscript{168}

The application of the first element by a court depends on the court’s interpretation of “settlement payment.” Section 546(e) refers to section 741(8), which contains a notoriously

\textsuperscript{161} H.R. REP. 97-420, at 1 (1982); Kaiser Steel Corp. v Charles Schwab & Co. (Kaiser Steel I), 913 F.2d 846 (10th Cir. 1990).
\textsuperscript{162} See discussion supra Part II.2.a.
\textsuperscript{163} See, e.g., Munford v. Valuation Research Corp. (In re Munford, Inc.), 98 F.3d 604 (11th Cir. 1996) (holding that section 546(e) does not shield payments to shareholders); Garfinkel, supra note 6, at 67–68 (arguing that payments by brokers to shareholders are not protected from avoidance).
\textsuperscript{165} Contemporary Indus. Corp., 564 F.3d 981; In re QSI Holdings, Inc., 571 F.3d 545; In re Plassein Intern. Corp., 590 F.3d 252.
\textsuperscript{166} See, e.g., Contemporary Indus. Corp., 564 F.3d at 984–87.
\textsuperscript{167} 11 USC § 741(8) (2010).
\textsuperscript{168} 11 USC § 546(e)
circular definition of settlement payments. It 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.” The definition that uses \textit{definiendum} as the \textit{definiens} is always problematic because it does not provide substantive guidance.  

Some courts perceive the definition as broad, with the last clause “or any other similar payment commonly used in the securities trade” being a catch-all. Another line of jurisprudence views the same phrase as being a limiting modifier, which restricts the scope of the provision to publicly traded companies. Some decisions view the language of section 741(8) as clear and unambiguous, not requiring review of the section’s legislative history. Such courts are likely to find that any sale of stock qualifies as a settlement payment. Other decisions find that the section “cryptically defines” the term, using “circuitous verbiage.” These decisions then go on to review the history of the provision to find that it only applies to sale of securities that are publicly traded in the markets.

\footnotesize

169 11 USC §741(8).
The second element under section 546(e) is that the settlement payment must be made “by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency.” Most of the terminology is unambiguous because common sense definitions are provided, with the main issues being the meaning of the prepositions “by or to (or for the benefit of)” and the scope of what constitutes a “financial institution.”

Courts that read the language of the settlement payment exception as clear and unambiguous also interpret the second requirement of a specific market participant very broadly. These courts will consider any LBO (whether or not public stock is involved) to constitute a settlement payment. Further, such courts do not require that the transaction participants be involved in the clearing and settlement system: they interpret “financial institution” literally, concluding that a simple bank wire satisfies the second element. Conversely, other courts that review the legislative history of the provision are likely to limit the protection from avoidance to a narrow class of parties. Such courts require that the transfer involve the clearing and settlement system in the context of trade in public securities. This difference in interpretation has resulted in a circuit split.

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180 See, e.g., In re Plassein Intern. Corp., 590 F.3d at 257–58 (considering money wired through a bank as a settlement payment by a financial institution).
The approach taken by a court on interpreting sections 546(e) and 741(8) will determine which parties a trustee can recover from. In a typical failed LBO, the trustee will attempt to avoid as constructively fraudulent payments transferred to and by brokers and payments retained by the shareholders. Courts disagree on what parties enjoy protections from avoidance, with some decisions limiting such protections to the financial intermediaries only, other courts exempting payments to shareholders of publicly held companies, and yet others extending settlement payment exception to all involved parties.  

1. Settlement Payment Exception As Applied to Brokers and Other Intermediaries in the Clearance and Settlement System

The pioneer court to analyze the scope of the settlement payment exception was the Tenth Circuit with its series of decisions which arose out of the bankruptcy of Kaiser Steel. In February 1984, Kaiser Steel, which at the time was a publicly traded corporation, was acquired in an LBO by a group of outside investors. The acquisition was endorsed by the board of Kaiser Steel’s directors and approved by the shareholders. Each share of common stock was to be exchanged for twenty-two dollars in cash and two shares of preferred stock of the surviving corporation. The total amount required to buy out the shareholders’ equity interest was $162 million. The acquiring entity borrowed $100 million from Citibank, with the assets of Kaiser Steel securing the loan repayment obligation. Kaiser Steel stockholders tendered their shares

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183 Kaiser Steel Corp. v Charles Schwab & Co. (Kaiser Steel I), 913 F.2d 846 (10th Cir. 1990); Kaiser Steel Corp. v. Pearl Brewing Co. (Kaiser Steel II), 952 F.2d 1230 (10th Cir. 1991).
184 Id.
185 Id.
186 Id.
187 Id.
188 Id.
to Kaiser’s disbursing agent, Bank of America, which exchanged the common stock shares for cash and preferred stock of the new entity.\textsuperscript{189}

Some three years later, in 1987, Kaiser Steel filed for bankruptcy.\textsuperscript{190} In connection with the bankruptcy, the debtor-in-possession filed several fraudulent conveyance actions in an attempt to recover $162 million paid out in connection with the 1984 LBO.\textsuperscript{191} The Tenth Circuit did not address the elements of avoidance actions in the context of an LBO because it found that the transfer of consideration was a settlement payment protected from avoidance under section 546(e).\textsuperscript{192}

The defendant in the first lawsuit was Charles Schwab & Company, Inc. (“Schwab”)—a broker for some of the holders of Kaiser Steel common stock.\textsuperscript{193} The majority of the common stock certificates were held by a securities clearinghouse the Depository Trust Company (“DTC”).\textsuperscript{194} After the merger, Bank of America transferred to DTC cash and the preferred stock in the surviving corporation in exchange for common stock of Kaiser Steel.\textsuperscript{195} Subsequently, Schwab credited its customers’ accounts with consideration it received (total of about $450,000) either from DTC or directly from Bank of America.\textsuperscript{196}

Schwab filed a motion for summary judgment, asserting that it was not a transferee but merely a conduit\textsuperscript{197} and that LBO payments that it forwarded on to the shareholders were

\textsuperscript{189} Id.
\textsuperscript{190} Id. at 848.
\textsuperscript{191} Id.
\textsuperscript{192} Id. at 850; Kaiser Steel Corp. v. Pearl Brewing Co. (\textit{Kaiser Steel II}), 952 F.2d 1230, 1235 (10th Cir. 1991).
\textsuperscript{193} \textit{Kaiser Steel I}, 913 F.2d at 847–48.
\textsuperscript{194} Id. at 847.
\textsuperscript{195} Id. at 847.
\textsuperscript{196} Id. at 848.
\textsuperscript{197} 11 USC § 550(a) (2010).
settlement payments protected from avoidance under section 546(e). The tenth circuit affirmed the decision of the district court, agreeing with Schwab that section 546(e) exempted Schwab from having to repay the transferred funds.

The court’s reasoning was based on the language of section 741(8), which defines “settlement payment” broadly, so as to include “anything which may be considered a settlement payment.” In court’s view, such a broad reading of the provision was consistent with Congressional intent to use section 546(e) “to protect the nation’s financial markets from instability caused by the reversal of settled securities transactions.” Thus, shielding payments made in this LBO was necessary to prevent the ripple effect on the markets that Kaiser Steel bankruptcy would otherwise cause. The court also cited a variety of financial references to support its proposition that transfers in an LBO are consistent with how “settlement payments” are defined in the securities industry. The Securities and Exchange Commission also filed a brief in this case claiming that LBO payments are exempt from avoidance as settlement payments under section 546(e). The court concluded that because LBO payments to and by Schwab were securities transactions they were exempt from avoidance powers.

After the first Kaiser Steel decision, it was well-settled that sections 546(e) and 741(8) exempt from avoidance payments made to brokers and other financial intermediaries. The issue left open was whether payments retained by former shareholders of a publicly traded company acquired in an LBO are also eligible for section 546(e) protection.

198 Kaiser Steel I, 913 F.2d at 848.
199 Id.
200 Id.
201 Id.
202 Id.
203 Id. at 849 (citing A. PLESSIN & J. ROSS, WORDS OF WALL STREET: 2000 INVESTMENT TERMS DEFINED 227 (1983); other citations omitted).
204 Id. at 849–50 & n.7.
205 Id. at 850.
2. Settlement Payment Exception As Applied to Shareholders of Public Companies

One year later, the Tenth Circuit faced another fraudulent conveyance action in the Kaiser Steel bankruptcy, but this time against the former Kaiser Steel public shareholders. Before the LBO, Kaiser Steel was owned by many unaffiliated shareholders: indeed, the list of defendants in the opinion goes on for four pages. The Tenth Circuit once again affirmed the district court’s grant of summary judgment in favor of the defendants based on the theory that consideration paid to shareholders in a leveraged buyout is a settlement payment exempt from trustee’s avoidance powers under section 546(e).

The court reiterated that the definition of settlement payment contained in section 741(8) is extremely broad and its aim is “to encompass all ‘settlement payments’ commonly used in the securities trade.” The court then reviewed the usage of the term “settlement” in the context of purchase and sale of securities. It rejected the plaintiff Kaiser Steel’s argument that Congress limited the definition of settlement payment so as to exclude extraordinary transactions like LBOs and to protect only routine trades in securities. The Tenth Circuit noted that the plain language of the statute does not exclude any particular form of securities trade on its face. Although an LBO may be considered an extraordinary transaction, the substance of what happened in the Kaiser Steel merger was that the shareholders tendered their shares and received

206 Kaiser Steel Corp. v. Pearl Brewing Co. (Kaiser Steel II), 952 F.2d 1230, 1241 (10th Cir. 1991).
207 Id. at 1230–34.
208 Id. at 1235.
209 Id. at 1237.
210 Id. at 1237–38.
211 Id. at 1238–39.
212 Id. at 1239.
payment in settlement of a securities transaction.\textsuperscript{213} Thus, the court concluded that shareholders’ tender of shares and receipt of consideration should be protected from avoidance.\textsuperscript{214}

The Tenth Circuit also disagreed with Kaiser Steel’s averment that section 546(e) only exempted payments by a broker or some other clearing agency to another member of the clearing system and payments to equity holders were not exempt.\textsuperscript{215} The court noted that the language of the statute clearly exempted “payments made ‘by or to’ a stockbroker, financial institution, or clearing agency.”\textsuperscript{216} Since there was nothing in the statute that would specifically exclude from section 546(e) protection payments to equity holders, and the application of the statute did not lead to absurd results, the court thought it was unnecessary to resort to the obscure legislative history behind the provisions.

Thus, the Tenth Circuit in \textit{Kaiser Steel} concluded that the settlement payment exception in section 546(e) of the Bankruptcy Code protected from avoidance not only the payments transferred by brokers, but also consideration retained by the shareholders of a company acquired in an LBO. The court’s reasoning in both cases was based on the breadth of the statutory language. Indeed, at the end of the second Kaiser Steel settlement payment decision, the court noted that it realized the broad implications of their holding but that it was “not convinced it leaves the trustee remediless by way of a suit for damages, or some similar device, against specific individuals or institutions for unlawful acts.”\textsuperscript{217}

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\textsuperscript{213} \textit{Id.} at 1240. \\
\textsuperscript{214} \textit{Id.} \\
\textsuperscript{215} \textit{Id.} \\
\textsuperscript{216} \textit{Id.} \\
\textsuperscript{217} \textit{Id.} at 1241. \textit{But see} Contemporary Indus. Corp. v. Frost, 564 F.3d 981, 984 (8th Cir. 2009) (discussed \textit{infra}) (noting that all alternative state law remedies such as unjust enrichment and illegal and excessive distributions were preempted because the relief they provide is the substantially the same as avoidance in bankruptcy). \\
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Kaiser Steel’s reasoning was followed by the Third Circuit in *Lowenschuss v. Resorts International, Inc.*218 The bankrupt debtor—former public corporation Resorts—sued one of its former shareholder Lowenschuss to recover more than three million dollars that he received when the company was sold in an LBO.219 This particular shareholder attempted to use his appraisal rights, dissenting from the merger vote.220 After filing an appraisal action in court, the shareholder apparently changed his mind, and, without notifying the company, tendered his shares to his broker, who transferred them to Resorts’ transfer agent for the merger.221 The transfer agent sent the list of tendering shareholders to Resorts, which wired funds to the agent.222 The funds were then disbursed to the shareholders, with Lowenschuss receiving more than three million dollars.223 When Resorts realized that a dissenting shareholder was paid full merger price for his shares, they sued to recover the amount received by Lowenschuss, using several theories, one of which was based on fraudulent transfer law.224 Shortly after, Resorts filed for bankruptcy and the suits were consolidated.225

Just as the tenth circuit in *Kaiser Steel*, the *Resorts* court did not address the avoidance action factors because it found section 546(e) controlling.226 Analyzing the language of the definition of “settlement payment,” the court noted that the settlement payment exception was “at the intersection of ‘two important national legislative policies . . . on a collision course’”—the

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219 *Id.* at 508–09.
220 *Id.* at 508.
221 *Id.*
222 *Id.*
223 *Id.* at 508–09.
224 *Id.* at 509.
225 *Id.* at 509.
226 *Id.* at 514 n.7.
policies of bankruptcy and securities law.” Consistent with legislative intent, the settlement payment exception should be interpreted broadly. The court then turned to Kaiser Steel and its analysis of securities industry texts for what constitutes a settlement payment. Because a settlement payment was commonly understood as “the transfer of cash or securities made to complete a securities transaction,” the exchange between Lowenschuss, his broker, Resorts, and its transfer agent fell under the literal definition of “settlement payment.” Although no clearing house was involved in the transaction, the brokerage firm and transfer agent were both financial institutions, explicitly mentioned in the statute. Because the payment for stock in an LBO was a common securities transaction, the court found that the LBO payment in this case was a settlement payment exempt from avoidance.

This approach of applying settlement payment exception has been the majority interpretation of sections 546(e) and 741(8). However, not all other courts are willing to use section 546(e) to shield LBO payments to shareholders from avoidance. Shortly after the first Kaiser Steel decision, Northern District of Illinois addressed a trustee avoidance action as part of the Wieboldt Stores, Inc. (Wieboldt) bankruptcy. Nine months after WSI acquired Wieboldt in a leveraged buyout, Wieboldt filed for bankruptcy and its Chapter 11 trustee sued several

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227 Id. at 515 (citing Bevill, Bresler & Schulman Asset Management Corp. v. Spencer Savings & Loan Ass’n., 878 F.2d 742, 751 (3d Cir. 1989)).
228 Id.
229 Id.
230 Id.
231 Id.
232 Id. at 516.
233 With the exception of the Eleventh Circuit, no other federal appellate circuit has yet held that the settlement payment exception does not shield public stock transactions from avoidance.
defendants to recover payments they received in connection with the LBO.\textsuperscript{235} As part of the LBO transaction, the acquirer engaged the depository and disbursing services of Harris Bank, which collected all of the issued and outstanding shares of the target company.\textsuperscript{236} The shareholders were to tender their stock certificates to Harris Bank and upon such tender were entitled to receive a cash payment.\textsuperscript{237} Other shareholders got paid upon confirmation of the book entry transfer of their shares from their accounts to the account of Harris Bank with one of the depository trust companies.\textsuperscript{238} The defendants in this case followed the procedure by turning over their shares to Harris Bank and received payment from the Bank.\textsuperscript{239} The defendant shareholders moved to dismiss trustee’s avoidance action on several grounds, one of which was their claim that section 546(e) shielded the consideration they received as settlement payment.\textsuperscript{240}

On these facts, the court disagreed with the defendants concluding that section 546(e) would not protect the LBO payments from avoidance.\textsuperscript{241} Just as did the court in \textit{Kaiser Steel}, this court started with the language of the statute.\textsuperscript{242} The court found that the key language in section 546(e)—“settlement payment”—is not clearly defined by the Code in section 741(8). Because the “circular definition” lacked clarity, the court found it necessary to resort to the legislative history of the provision.\textsuperscript{243} The purpose of the provision was to protect the clearance and settlement system by preventing bankruptcy of one firm from causing the collapse of the affected market.\textsuperscript{244} Interestingly, the court cited the first \textit{Kaiser Steel} decision when reviewing the

\begin{itemize}
\item \textsuperscript{235} \textit{Wieboldt Stores, Inc.}, 131 B.R. at 658.
\item \textit{Id.} at 663.
\item \textit{Id.}
\item \textit{Id.}
\item \textit{Id.}
\item \textit{Id.} at 662–63.
\item \textit{Id.} at 663.
\item \textit{Id.}
\item \textit{Id.}
\item \textit{Id.} at 664.
\end{itemize}
legislative history of the statute.\textsuperscript{245} The holding of the case was that section 546(e) did not protect payments the shareholders received in the LBO because the clearance and settlement chain was not affected by this avoidance action.\textsuperscript{246} The court did not engage in a substantive discussion of \textit{Kaiser Steel} but merely noted that none of the participants of the clearance and settlement system would be affected by the recovery of the funds from Wieboldt shareholders.\textsuperscript{247} Just like \textit{Kaiser Steel}, the court based its conclusion on the legislative history of the statute but came to an opposite result due to the absence of practical implications for the clearance and settlement system.\textsuperscript{248}

The only federal appellate court to agree that settlement payment exception does not protect shareholders at all is the Eleventh Circuit, which reached a result similar to that of the \textit{Wieboldt} court but for a different reason. The case arose out of the bankruptcy of Munford, Inc. ("Munford").\textsuperscript{249} In 1988, Munford—at the time a publicly held corporation—was acquired by the Panfida Group in a leveraged buyout.\textsuperscript{250} Only thirteen months later, the surviving company filed for bankruptcy.\textsuperscript{251} The debtor sued two of its largest former shareholders to recover payments they received in connection with the LBO, and the defendant shareholders moved for summary judgment.\textsuperscript{252} The debtor alleged that LBOs do not fall under section 546(e) because they constitute “private transactions between the merging companies and their existing shareholders and therefore do not sufficiently involve the securities settlement and clearance

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\textsuperscript{245} \textit{Id.} at 663–64.
\textsuperscript{246} \textit{Id.} at 664.
\textsuperscript{247} \textit{Id.} at 664–65.
\textsuperscript{248} \textit{Id.} at 665.
\textsuperscript{249} Munford v. Valuation Research Corp. (\textit{In re Munford, Inc.}, 98 F.3d 604 (11th Cir. 1996).
\textsuperscript{250} \textit{Id.} at 607.
\textsuperscript{251} \textit{Id.}
\textsuperscript{252} \textit{Id.} at 608–09.
\end{flushleft}
To qualify for the exception, it was necessary to use the clearance and settlement system not merely to transfer payments to the shareholders, as was the case with Munford, but rather to match sales and purchases of securities, to account for or to guarantee transactions. The debtor seeking avoidance also cited *Wieboldt* for the premise that protecting LBO payments would not be consistent with the goal of the provision because such protection would not safeguard the clearance and settlement system. Moreover, Munford argued that section 546(e) as applied to LBO payments would produce unfair results for the unsecured creditors by frustrating the goals of fraudulent conveyance laws. The shareholders averred that failure to shield LBO payments from avoidance would undermine investor confidence in the markets and destabilize all mergers and acquisitions of public companies.

The *Munford* court ultimately reached the same result as the *Wieboldt* decision, however, the Eleventh Circuit expressly rejected the reasoning of *Wieboldt*, noting that trustee’s avoidance of LBO payments “has the potential to lessen confidence in the commodity market as a whole.” Instead of focusing on whether LBO consideration can qualify as settlement payments, the court underscored that not all settlement payments are eligible for the 546(e) exception. In fact, presuming that the payments in this case were settlement payments, the court dwelled on whether the transfer was “‘made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, or securities clearing agency.’” Although all the payments from Munford’s acquirer to the shareholders were channeled through a bank, the court was convinced that even if the bank is literally a “financial institution” it was only used as a

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253 *Id.* at 609.
254 *Id.*
255 *Id.* at 609–10.
256 *Id.* at 610.
257 *Id.*
258 *Id.* at 610, n.4.
259 *Id.* at 610 (citing 11 USC §546(e)).
conduit, never acquiring a beneficial interest in the funds or stock.\textsuperscript{260} Under section 550 of the Bankruptcy Code, a trustee may only get back payments from transferees.\textsuperscript{261} The conduit bank was not a transferee, only the shareholders were.\textsuperscript{262} Then, somewhat confusingly and without further explanation, the court stated that “of course, section 546(e) offers no protection from the trustees [sic] avoiding powers to shareholders.”\textsuperscript{263} The protection of section 546(e) was reserved for the participants of the clearance and settlement system: i.e. “commodity brokers, forward contract merchants, stockbrokers, financial institutions, or securities clearing agencies.”\textsuperscript{264} The bankrupt entity was entitled to avoid LBO payments to its former shareholders because “the LBO transaction did not involve a transfer to one of the listed protected entities.”\textsuperscript{265} The \textit{Munford} approach does not have many followers, with most courts noting that nothing in the statute mandates that the party obtain beneficial interest to be exempt from avoidance.\textsuperscript{266}

The foregoing decisions demonstrate the various interpretations of the settlement payment exception as applied to LBOs of formerly-public companies. Granted that section 546(e) was enacted to protect securities markets from ripple effects of bankruptcy of one of its participants, it makes sense that a trustee cannot recover from former shareholders of public companies.\textsuperscript{267} The \textit{Kaiser Steel} court was correct in disallowing the trustee to unwind the deal in which publicly traded stock was bought out.

\begin{footnotesize}
\begin{itemize}
\item 260 Id. at 610.
\item 261 Id. at 610.
\item 262 Id. at 610.
\item 263 Id. at 610.
\item 264 Id. at 610.
\item 265 Id. at 610.
\item 267 H.R. REP. 97-420, at 1 (1982).
\end{itemize}
\end{footnotesize}
Although it has been argued that the original intent of sections 546(e) and 741(8) was to protect merely the clearing and settlement system intermediaries, there are many reasons why all publicly traded transactions deserve protection.268 Publicly traded securities are subject to a comprehensive scheme of regulation by governmental agencies and self-regulation by the securities industry.269 Moreover, the sale of public companies involves a complex process, with governmental oversight at various stages.270 Bankruptcy law would interfere with the efficient operation of the stock market and undermine the investor confidence in the markets.

As mandated by the SEC, public companies are bound by periodic disclosure requirements under the Securities Exchange Act.271 Public companies’ audited financials are easily accessible on the internet.272 The major events in the company’s life have to be reported to the SEC as well.273 Such stringent reporting requirements make the operations of public companies more transparent. The unsecured creditors, such as debenture holders, are able to make informed decisions.

The wellbeing of the US economy depends on the healthy operation of the stock market.274 Undoing settled market transactions would undermine confidence in the markets, which can have a significant impact on the entire economy. Moreover, disintegration of one

268 See, e.g., In re Munford, Inc., 98 F.3d 604 (11th Cir. 1996) (holding that section 546(e) does not shield payments to shareholders); Garfinkel, supra note 6, at 67–68 (arguing that payments by brokers to shareholders are not protected from avoidance).

269 See generally Cox, supra note 17, 2–18 (reviewing the legal framework of securities regulation, discussing the federal securities laws, state blue sky laws, and self-regulatory organizations).


271 See Cox, supra note 17, 548–51 (discussing periodic reporting obligations of public companies).

272 The SEC online database contains filings for all public companies. See http://www.sec.gov/edgar.shtml.

273 Cox, supra note 17, at 549 (outlining Form 8-K requirements for filings “triggered by certain significant, if not extraordinary, events”).

significant player may be detrimental to the rest of the system. We don’t have to look too far back for an example: the recent collapse of Lehman brothers triggered the worst financial crisis since the Great Depression.\textsuperscript{275}

Furthermore, it may be practically impossible to unwind a public transaction: shareholders of publicly traded companies are numerous and widely-dispersed making it hard to recover money that they received in an LBO. Few individuals now manage their own accounts; instead the brokers maintain them. Very frequently, the shareholders will never see the cash, as it immediately gets reinvested. Unwinding a failed LBO of a public company would negatively affect other companies’ stock, because it will cause a chain reaction in the markets.

Therefore, a market for publicly traded stock to a large extent depends on the guarantees inherent in the clearing and settlement system. Realizing the significance of stock markets and perceiving the threat to the markets from unwinding LBOs of public companies, Congress attempted to protect the clearing and settlement system by enacting section 546(e).\textsuperscript{276} A trustee in bankruptcy should be barred from recovering from any market participants by filing a fraudulent conveyance action in connection with a failed LBO.

3. Settlement Payment Exception As Applied to Shareholders of Closely held Companies

The equities are entirely different in relation to closely held companies. First, the market for closely held company stock does not exist, so there is nothing to protect. In fact, many such


\textsuperscript{276} H.R. REP. 97-420, at 1 (1982).
companies have various restrictions on resale of stock: some contractual, others legal. During the sale of private stock, the parties may engage services of an intermediary. But such intermediary would clearly be protected either because it is conduit, and not a transferee, or through an extension of *Kaiser Steel I*. Neither the stock nor the day-to-day operations of closely held companies are monitored by the SEC, or, to a large extent, by any other government agency. Most of the time, the shareholders are the same people who run the company. If it is apparent to them that the company’s future looks bleak, they may want to sell, and leave the unsecured creditors behind.

Realizing congressional intent behind section 546(e), courts recognize that payments to shareholders of private companies are not protected from avoidance powers. For example, the bankruptcy court in the previously discussed Norstan bankruptcy found that payments to the Lattman family could be avoidable fraudulent conveyances. The court recognized that the definition of “settlement payment” in section 741(8) is broad and reviewed several decisions that found it circular, essentially providing that “a settlement payment is a settlement payment.” However, the *Norstan* court underscored that the definition was “saved from complete circularity by the concluding phrase, ‘or any other similar payment commonly used in the securities trade.’” Unlike other decisions that interpreted the last phrase as a catch-all, this court found that it contained a limiting principle, concluding that a transaction had to involve the public securities markets. To ignore the last phrase would render it meaningless, which violates one

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279 *Id.* See discussion *supra* Part II.1.b (discussing the facts of *Norstan*).
280 *In re Norstan Apparel Shops, Inc.*, 367 B.R. at 76.
281 *Id.* (citing 11 U.S.C. §741(8)).
282 *Id.*
of the basic canons of statutory interpretation.\textsuperscript{283} Applying section 546(e) to shield payments for non-public securities would also immunize all leveraged buyouts from avoidance, which, in court’s view, was inconsistent with “the extensive body of jurisprudence under which leveraged buyouts challenged under §544 and §548 have been analyzed for fairness and adequacy of consideration.”\textsuperscript{284} The court held that since the transfer to the Lattman family did not involve sale of public securities or otherwise implicate the stock market, it was not a settlement payment and was not shielded from avoidance.\textsuperscript{285} Other decisions also recognize the distinction in the statute and correctly refuse to apply the settlement payment exception to payments in connection with LBOs of closely held companies.\textsuperscript{286}

Unfortunately, the prevailing trend recently is to interpret the language of sections 546(e) and 741(8) broadly and apply them to all LBOs indiscriminately. In 2009, three circuit courts were faced with the question whether section 546(e) exempts from avoidance payments to shareholders in an LBO of a closely held company.\textsuperscript{287} The circuits faced a very similar fact pattern and came to the same conclusion using virtually the same analysis.

In \textit{Contemporary Industries Corp. v. Frost}, the Eighth Circuit case, a privately-held Nebraska corporation Contemporary Industries was sold to an outside investor group.\textsuperscript{288} The purchasers borrowed a significant amount of money to fund the transaction and pledged the assets of Contemporary Industries as collateral.\textsuperscript{289} The borrowed funds were deposited with First

\textsuperscript{283} \textit{Id.} at 76–77.
\textsuperscript{284} \textit{Id.} at 77.
\textsuperscript{285} \textit{Id.}
\textsuperscript{288} 564 F.3d 981, 983 (8th Cir. 2009).
\textsuperscript{289} \textit{Id.}
National Bank of Omaha. The five individual shareholders of the corporation and their family trusts then tendered their stock certificates to the Bank and received cash in exchange. A little over two years after the LBO, Contemporary Industries filed for bankruptcy. The debtor sued the former shareholders to avoid the LBO payments under section 544 and Nebraska Fraudulent Transfer Act, alleging that the bankruptcy resulted from the debt burden incurred in connection with the LBO.

The defendant shareholders asserted that the settlement payment exception in section 546(e) barred the avoidance action. The plaintiffs alleged that avoiding payments to shareholders in a buyout of a privately owned company would not disrupt the markets and thus applying the settlement payment exception would be inconsistent with the statutory purpose. Additionally, following the Munford analysis, the debtors argued that the intermediary bank in the buyout did not fall within the statutory definition of a “financial institution” because the intermediary never obtained a beneficial interest in the transferred funds.

The court found that the question raised an issue of statutory interpretation and that plain language of the law governs unless it leads to absurd results. The first part of the analysis concentrated on whether the payments received by the shareholders were settlement payments as defined in section 741(8). Reviewing previous decisions on the matter, the court concluded that this definition is “extremely broad” and covers what is ordinarily considered to be a

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290 Id.
291 Id.
292 Id.
293 Id. at 983–84.
294 Id. at 984.
295 Id.
296 Id.
297 Id. at 984–85.
298 Id. at 985.
settlement payment. The court did not find it necessary to resort to legislative history in order to determine whether payment to shareholders of a privately-held company would be covered by the definition; instead the eighth circuit stressed that the clear and unambiguous language of section 741(8) did not distinguish between treatment of public versus private companies. Further, the court found support for the broad reading of the definition in the last phrase “or any other similar payment commonly used in the securities trade.”

The second part of the analysis focused on the list of participants of the clearing and settlement system that is contained in section 546(e). The only possibility was involvement of a “financial institution.” The court rejected the additional requirement that the financial institution obtain a beneficial interest in the transferred stock or funds imposed by the Eleventh Circuit in Munford, noting that this requirement could not be “squared with §546(e)’s plain language.” Thus, the Eighth Circuit found that the payments at issue were protected from avoidance because they were settlement payments under section 741(8) made by a financial institution under 546(e). The court also concluded that applying settlement payment exception to LBO transactions involving privately-held companies does not lead to absurd results because where significant amounts of money are involved, “Congress might have believed undoing similar transactions could impact [financial] markets.” Moreover, the court did not agree with the plaintiff’s argument that such broad interpretation of the exception would lead to abuse “by encouraging savvy investors and counsel to funnel any and all payments for stock through banks

299 Id.
300 Id. at 986.
301 Id.
302 Id.
303 Id. at 986–87 (citing Lowenschuss v. Resorts Int'l, Inc. (In re Resorts Int'l, Inc.), 181 F.3d 505, 515 (3d Cir.), cert. denied sub nom. Sun Int'l North America, Inc. v. Lowenschuss, 528 U.S. 1021 (1999)).
304 Id. at 987.
305 Id.
and to thereby immunize the payments from later avoidance in bankruptcy.\textsuperscript{306} It seemed unlikely to the court that a transaction abusing the exception would fall under the definition of settlement payments which must be commonly used in the securities trade.\textsuperscript{307}

The facts of \textit{QSI Holdings, Inc. v. Alford}, the Sixth Circuit decision, are similar in that the debtor Quality Stores, Inc. ("Quality") was also a privately-held company.\textsuperscript{308} However, unlike Contemporary Industries, which was owned by a family,\textsuperscript{309} Quality’s shareholders were more numerous and diverse.\textsuperscript{310} Before it was acquired by another company, Quality had 170 shareholders, some of whom were unaffiliated with Quality, while others owned their stock through participation in Employee Stock Ownership Trust ("ESOT").\textsuperscript{311} In order to fund the purchase, the acquiring corporation pledged its own assets, as well as the assets of Quality as collateral.\textsuperscript{312} The purchaser deposited the cash and its own stock to be exchanged with HSBC Bank USA, which transferred the cash and stock to Quality shareholders upon tender of their shares to HSBC.\textsuperscript{313} Additionally, the ESOT shares were ordinarily held by the ESOT trustee LaSalle Bank, which transferred the certificates to HSBC.\textsuperscript{314} The bankrupt estate sought to avoid the LBO payments received by the former shareholders and filed a fraudulent transfer action under section 544(b) and the Michigan Uniform Transfer Act.\textsuperscript{315}

\textsuperscript{306} \textit{Id.} at 987 n.5.
\textsuperscript{307} \textit{Id.}
\textsuperscript{308} \textit{QSI Holdings, Inc. v. Alford} (\textit{In re QSI Holdings, Inc.}), 571 F.3d 545 (6th Cir. 2009), \textit{cert. denied}, 130 S.Ct. 1141 (2010).
\textsuperscript{309} \textit{Contemporary Industries Corp.}, 564 F.3d at 983.
\textsuperscript{310} \textit{In re QSI holdings, Inc.}, 571 F.3d at 547.
\textsuperscript{311} \textit{Id.} at 547–48.
\textsuperscript{312} \textit{Id.} at 548.
\textsuperscript{313} \textit{Id.}
\textsuperscript{314} \textit{Id.}
\textsuperscript{315} \textit{Id.}
As was the case with Contemporary Industries, the shareholder of Quality asserted that section 546(e) protected the LBO payments from avoidance. The plaintiff argued that shielding payments for non-public stock does not serve the statutory purpose of protecting the financial markets from the negative consequences of bankruptcy. The Sixth Circuit first looked at the language of the settlement payment exception, noting that the definition of this term although circular, has been interpreted as “extremely broad.” The court reviewed the Kaiser Steel decision which concluded that LBO payments fall within the definition as payments “commonly used in the securities trade.” Citing the Eighth Circuit’s opinion in Contemporary Industries, the Sixth Circuit emphasized that there is nothing in the statute that would provide for a different treatment of privately-held stock payments. The court distinguished the Norstan decision where the defendants were the only two shareholders of a closely held subchapter S corporation. While the transaction in Norstan did not implicate financial markets in general, the buyout in this case, if unwound, would clearly have an effect on the markets because it involved many shareholders and substantial amounts of money.

Just as did the plaintiffs in Contemporary Industries, the debtor in QSI Holdings cited Munford, stating that there was no transfer to a financial institution in this case because the intermediary HSBC Bank never had beneficial interest of the funds. The Sixth Circuit rejected this analysis noting that the statute does not impose any such requirement and concluded that the

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316 Id. at 549.
317 Id.
318 Id.
319 Id.
320 Id. at 550 (citing Contemporary Indus. Corp. v. Frost, 564 F.3d 981, 986 (8th Cir. 2009)).
321 Id. at 550. A subchapter S corporation is entitled to a pass-through status for purposes of federal taxation and must be a domestic corporation with not more that 100 eligible shareholders. See generally S Corporations, INTERNAL REVENUE SERVICE, available at http://www.irs.gov/businesses/small/article/0,,id=98263,00.html.
322 In re QSI holdings, Inc., 571 F.3d at 550.
323 Id. at 550–51 (citing Munford v. Valuation Research Corp. (In re Munford, Inc.), 98 F.3d 604, 610 (11th Cir. 1996)).
role that HSBC Bank played in the transaction was “sufficient to satisfy the requirement that the transfer was made to a financial institution.”324

Finally, the Third Circuit reviewed a fraudulent conveyance action in connection with the bankruptcy of Plassein International Corporation (“Plassein”).325 In 1999, Plassein was formed to purchase several closely held corporations in a leveraged buyout, with the assets of the target companies pledged as collateral to secure the loan that funded the transaction.326 Most of the acquired companies were owned only by a few people who were required to tender their shares directly to Plassein.327 After the receipt of the shares, at Plassein’s direction, its bank wired funds to the shareholders’ accounts at their respective banks.328 Thus, the parties did not resort to the traditional clearance and settlement system.329 Soon after the LBO, Plassein filed for bankruptcy under Chapter 11, which was eventually converted to Chapter 7.330 The appointed trustee tried to recover payments from the target companies’ shareholders under Delaware fraudulent transfer law and section 544 of the bankruptcy code.331 The shareholders alleged that the LBO payments were settlement payments exempt from avoidance under section 546(e).332

The court relied on its own decision in Resorts but recognized that Resorts dealt with publicly traded stock.333 Nonetheless, Resorts did not require that settlement payments go through a settlement system intermediary, focusing instead on how the securities trade

324 Id. at 551.
325 Brandt v. B.A. Capital Co. LP (In re Plassein Intern. Corp.), 590 F.3d 252 (3d Cir. 2009), cert. denied, 130 S.Ct. 2389 (2010). Significantly, the state of Delaware is part of the Third Circuit so the implications of this decision are very important to the world business community.
326 Id. at 254.
327 Id. at 255.
328 Id.
329 Id.
330 Id.
331 Id.
332 Id.
333 Id. at 258.
understood the term “settlement payment.” The Resorts court found that payments in completion of a leveraged buyout were considered to be settlement payments by people who work in the securities trade. Thus, the Plassein court concluded that it was not dispositive whether the bought-out company was publicly or closely held. Rather, the court was bound by the plain language of the statute and by its precedent in Resorts. Thus, the payments to former Plassein shareholders were exempt from avoidance, despite the fact that the securities market was not implicated, nor was the clearing and settlement system involved.

The recent appellate opinions seem to imply that not all LBOs are exempt from avoidance. The opinions indicate that to determine whether the settlement payment exception applies, a court may consider the size of the transaction and the number of former shareholders. However, even if the courts did propose a multi-factor test for section 546(e), they certainly did not provide clear guidelines for its application. Without precise guidelines on the matter, how is a bankruptcy court to determine how much money has to be involved for

334 Id.
335 Id.
336 Id. at 259.
337 Id.
338 Id.

Contemporary Indus. Corp. v. Frost, 564 F.3d 981, 987 (8th Cir. 2009) (noting that Congress “might have thought it prudent to extend protection to payments” such as the ones at stake in this case—i.e. $26.5 million); QSI Holdings, Inc. v. Alford (In re QSI Holdings, Inc.), 571 F.3d 545 (6th Cir. 2009), cert. denied, 130 S.Ct. 1141 (2010) (“The value of the privately held securities at issue is substantial and there is no reason to think that unwinding that settlement would have any less of an impact on financial markets than publicly traded securities”).

339 Id. at 550.

340 Some courts previously suggested a multi-factor test in evaluating whether a transaction is a settlement payment within the meaning of section 546(e). See, e.g., Jackson v. Mishkin (In re Adler, Coleman Clearing Corp.), 263 B.R. 406, 479-480 (S.D.N.Y. 2001) (citations omitted) (suggesting the following factors: “whether (1) the transactions have long settled by means of actual transfers of consideration, so that subsequent reversal of the trade may result in disruption of the securities industry, creating a potential chain reaction that could threaten collapse of the affected market; (2) consideration was paid out in exchange for the securities or property interest as part of settlement of the transaction; (3) the transfer of cash or securities effected contemplates consummation of a securities transaction; (4) the transfers were made to financial intermediaries involved in the national clearance and settlement system; (5) the transaction implicated participants in the system of intermediaries and guarantees which characterize the clearing and settlement process of public markets and therefore would create the potential for adverse impacts on the functioning of the securities market if any of those guarantees in the chain were invoked”).

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the settlement exception to apply? Or how many shareholders must have been bought out: two shareholders were not enough in *Norstan*,³⁴² but 170 shareholders was a number larger enough to warrant protection under 546(e) in the QSI bankruptcy.³⁴³ Or are courts to measure the effect of unwinding the LBO on the markets³⁴⁴? If the right approach is to evaluate the impact on the markets, what methodology are courts to use? And what impact is significant enough to warrant protection from avoidance? In the absence of specific guidance from the three appellate decisions, it is likely that lower courts will shield all LBOs from avoidance indiscriminately. In the Third, Sixth, and Eighth Circuits, LBO payments are now exempt from avoidance, unless actual fraud can be shown by the trustee.³⁴⁵

PART IV. LEGISLATIVE AMENDMENT LIMITING THE APPLICATION OF THE SETTLEMENT PAYMENT EXCEPTION TO PUBLICLY TRADED STOCK

The current provisions of the Bankruptcy Code covering the settlement payment exception need to be revised so as to clarify the scope of this exception, solving the circuit split. The foregoing discussion demonstrates that there is no consensus on the meaning and scope of the settlement payment exception. Some decisions interpret it as applicable only to the clearing and settlement intermediaries.³⁴⁶ Others are willing to extend it to payments made to

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³⁴³ In re *QSI Holdings, Inc.*, 571 F.3d at 550.
³⁴⁴ *Contemporary Indus. Corp.*, 564 F.3d at 987; In re *QSI Holdings, Inc.*, 571 F.3d at 550.
³⁴⁵ *Contemporary Indus. Corp.*, 564 F.3d 981; In re *QSI Holdings, Inc.*, 571 F.3d 545; Brandt v. B.A. Capital Co. LP (*In re Plassein Intern. Corp.*), 590 F.3d 252 (3d Cir. 2009), cert. denied, 130 S.Ct. 2389 (2010). *See* 11 U.S.C §546(e) (2010) (where the last paragraph clarifies that actually fraudulent payments are not exempt from avoidance). *See generally* Gilsinger, *supra* note 182 (providing a compilation of jurisprudence which interprets the meaning of “settlement payments”).
shareholders of publicly traded stock, only if such payments used the clearing and settlement system. Finally, the broadest interpretation is to shield all LBO payments.

For the past twenty years courts have struggled with the same issues regarding interpretation of sections 546(e) and 741(8). The definition of “settlement payment” is problematic for two reasons: it is circular because definiens contains definiendum and because the last part could be interpreted either as a catch-all or as a limiting factor. It seems clear to this author as it does to some courts that, in light of the provision’s legislative history, the last phrase “any other similar payment commonly used in the securities trade” qualifies the definition, limiting it to publicly traded stock. However, as is demonstrated in the foregoing discussion of jurisprudence, not all courts interpret the law this way. The three appellate decisions in 2009 significantly expand the scope of the settlement payment exception, which will curtail trustee’s ability to avoid fraudulent transfers. Although more arguments can be made that the three decisions misapplied the law, the only practically meaningful solution would be to revise the definition of “settlement payment” because the divergence of thought reveals the provision’s inherent ambiguity.

Because the dispute about the meaning of section 741(8) is rather narrow, the revision will be minor and will merely reflect its limited application to the public securities market. The current text of section 741(8) should be amended as follows:

347 See, e.g., In re Norstan Apparel Shops, Inc., 367 B.R. at 76.
348 Contemporary Indus. Corp., 564 F.3d 981; In re QSI Holdings, Inc., 571 F.3d 545 (6th Cir. 2009); In re Plassein Intern. Corp., 590 F.3d 252.
“Settlement payment” means any transfer of cash or securities made to complete a publicly traded securities transaction, to include 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 trade for public securities.

This revision will clarify that the settlement payment exception is limited to trade in public securities and does not shield transactions dealing with privately-held stock. The clarification that section 741(8) is restricted to public securities will harmonize the overall application of section 546(e). Another exception to avoidance powers listed in 546(e) applies to margin payments, which do not exist outside of trade for public stock.\footnote{Section 546(e) is the only provision in the Bankruptcy Code that refers to section 741(8) for definition. Although section 741(8) applies to settlement payments outside of LBOs, its amendment will only clarify what Congress had originally intended.} Section 546(e) is the only provision in the Bankruptcy Code that refers to section 741(8) for definition. Although section 741(8) applies to settlement payments outside of LBOs, its amendment will only clarify what Congress had originally intended.\footnote{This revision is necessary because decisions such as the recent opinions by the three circuit courts undermine the goals of avoidance powers: to restore what was fraudulently taken away from the creditors in the vicinity of bankruptcy. Since any exchange of stock for cash is now interpreted to be a settlement payment, the only requirement for an exemption from avoidance is that consideration paid for stock be wired through a bank. After \textit{Plassein}, any bank

\hspace{1cm}\textit{9B A. M. JUR. 2d Bankruptcy} § 2052 (2010) (containing background information on margin payments); Brief for Appellant William Brandt, Trustee, Brandt v. B.A. Capital Co. LP \textit{(In re Plassein Intern. Corp.)}, 590 F.3d 252 (3d Cir. 2009) (No. 08-2616) (providing the definition of “margin payments” and noting that “[t]hese terms have no meaning outside the markets for publicly-traded securities, as is evident from the securities industry’s definitions of several terms relating to margins and margin payments, all of which depend on the notion of a current ‘market value’ for a particular security”). See also Edward R. Morrison & Joerg Riegel, \textit{Financial Contracts and the New Bankruptcy Code: Insulating Markets From Bankrupt Debtors and Bankruptcy Judges}, 13 AM. BANKR. INST. L. REV. 641 (2005) (discussing various mechanisms of market protection in the Bankruptcy Code). Gilsinger, supra note 182 (citing jurisprudence interpreting section 741(8) outside of the leveraged buyout).
transferring funds (even if outside of the clearing and settlement system) qualifies as a “financial institution.” This lenient approach “would serve to sanction the practice of structuring private stock purchases in an effort to circumvent the avoidance section, merely by utilizing a financial institution.” In fact, after the 2009 decisions by the three circuit courts commentators have been advising practitioners about relatively easy ways to circumvent the possibility of avoidance: simple use of “a financial institution, instead of a law firm, to act as escrow agent for an LBO transaction involving the sale of privately-held stock, and otherwise fraudulent transfer of funds to the selling shareholders may be exempted from avoidance.”

On the other hand, this amendment will clarify that payments to shareholders of publicly traded companies are exempt from avoidance. Some courts have held and commentators have urged that section 546(e) is not meant to protect payments to shareholders at all. However, allowing for avoidance of payments to shareholders of public companies would have a significant impact on the market and, depending on the size of the company, may halt the US stock market. Section 546(e) “is at the intersection of ‘two important national legislative policies . . . on a collision course’—the policies of bankruptcy and securities law.” The settlement payment exception was designed to preserve the balance between these fields. Bankruptcy law will reach back to fix the effects of fraudulent transfers in relation to sale of private companies.

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354 Walker & Green, supra note 13, at 72.
355 See, e.g., Munford v. Valuation Research Corp. (In re Munford, Inc.), 98 F.3d 604 (11th Cir. 1996) (holding that section 546(e) does not shield payments to shareholders); Garfinkel, supra note 6, at 67–68 (arguing that payments by brokers to shareholders are not protected from avoidance).

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while securities regulation will impose reporting requirements and disclosure for public corporations.

PART V. CONCLUSION

Indisputably, successful LBOs are an essential part of healthy markets. Allowing a trustee to exercise her avoidance powers with respect to closely held company LBOs does not translate into avoidance of all closely held company LBOs. Section 546(e) is merely an exception to avoidance powers. To avoid an LBO payment, a trustee has to prove that there was actual or constructive fraud involved,\textsuperscript{357} and although it may be easier to show constructive fraud than actual fraud, constructive fraud is still difficult to prove. But if the trustee can prove that all the elements of a fraudulent conveyance are met, payments to former shareholders should be recovered for the benefit of the estate.

A simple revision of one provision in the Bankruptcy Code would once and for all clarify the scope of settlement payment exception. When it adopted section 546(e), Congress had in mind the clearing and settlement system,\textsuperscript{358} which facilitates trade in public securities and provides a series of guarantees that transactions will settle.\textsuperscript{359} The proposed amendment to the Bankruptcy Code would clarify that section 546(e) is limited to public securities, thus aligning the scope of the settlement payment exception with its original legislative purpose of protecting the market from the detrimental effects of bankruptcy of a market participant.\textsuperscript{360}

\textsuperscript{358} H.R. REP. 97-420, at 1 (1982).
\textsuperscript{359} See discussion \textit{supra} Part II.2.a.
\textsuperscript{360} H.R. REP. 97-420, at 1.
In recent years, section 546(e) was expanded well beyond its intended scope. The expanded interpretation poses danger to the fair administration of bankruptcy claims in that it is possible to structure a sale of private stock so as to bar the possibility of avoidance. The unsecured creditors are left with nothing, as the trustee cannot bring a fraudulent conveyance action. In a time when our economy is slowly recovering, the law should not jeopardize that recovery by encouraging reckless lending and irresponsible borrowing by shielding LBOs from avoidance.

361 The epitome of the expansion are the three recent appellate decisions. See Contemporary Indus. Corp. v. Frost, 564 F.3d 981 (8th Cir. 2009); QSI Holdings, Inc. v. Alford (In re QSI Holdings, Inc.), 571 F.3d 545 (6th Cir. 2009), cert. denied, 130 S.Ct. 1141 (2010); Brandt v. B.A. Capital Co. LP (In re Plassein Intern. Corp.), 590 F.3d 252 (3d Cir. 2009), cert. denied, 130 S.Ct. 2389 (2010).

362 See, e.g., Walker & Green, supra note 13, at 72 (providing practical tips for avoidance risk reduction).