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Bankruptcy Court Holds That the Section 546(e) Safe Harbor Does Not Apply to “Settlement Payments” Made in a Small, Private Leveraged Buyout That Poses No Systemic Risk to the Securities Market

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A decision that a small, private LBO did not fall within the scope of the Section 546(e) safe harbor does not appear to address or impact the application of other safe harbors contained in the Bankruptcy Code, such as the application of provisions relating to the automatic stay.

In *Geltzer v. Mooney (In re MacMenamin’s Grill, Ltd.)*,¹ the U.S. Bankruptcy Court for the Southern District of New York held that the safe harbor in Section 546(e) of the Bankruptcy Code does not apply to a small, private leveraged buyout (“LBO”) transaction that posed no systemic risk to the stability of the financial markets. Specifically, the bankruptcy court held that the transaction, which involved the payment of \$1.15 million by a financial institution to three shareholders to fund the acquisition of their stock in an LBO, did not fall within the safe harbor contained in Section 546(e). Importantly, despite finding that a small, private LBO did not fall within the scope of the Section 546(e) safe harbor, the bankruptcy

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court's opinion does not appear to address or impact the application of the other safe harbors contained in the Bankruptcy Code, such as the application of provisions relating to the automatic stay.

BACKGROUND

To fully understand the impact of the bankruptcy court's ruling, it is important to understand the background facts. MacMenamin's Grill, Ltd. (the "Debtor") was a restaurant in New York. In 2007, three shareholders holding a 31 percent interest in the Debtor entered into a Stock Purchase Agreement — an admittedly small LBO — in which the Debtor borrowed \$1.15 million from TD Bank to cash out the shareholders. In exchange for the loan, TD Bank obtained a security interest in and lien on substantially all the Debtor's assets and directly paid the \$1.15 million to the selling shareholders' respective bank accounts. The Debtor filed a Chapter 11 petition in late 2008, and the court ordered the appointment of a Chapter 11 trustee. The trustee then brought an adversary proceeding against the three selling shareholders and TD Bank, alleging that the transfers made to the shareholders and the obligations incurred to TD Bank were constructively fraudulent transfers under Section 548(a)(1)(B) of the Bankruptcy Code. TD Bank and the shareholders filed motions for summary judgment based on the application of Section 546(e)'s safe harbor that, on its face, protects settlement payments from attack as constructively fraudulent transfers. In connection with the bankruptcy court's consideration of the motions for summary judgment, all parties agreed for purposes of the hearing that (i) the Debtor did not receive reasonably equivalent value and (ii) the Debtor was insolvent when it made the transfers.

Despite recognizing considerable case law supporting that private LBO transactions fall within the safe harbor, the bankruptcy court denied the motions for summary judgment, holding that the legislative history establishes that Congress intended Section 546(e) to address market risks that would arise if the transaction at issue were avoided. In so holding, the court cited case law and commentary stating that Congress, in drafting Section 546(e), was more concerned with protecting the market for publicly traded stock and the security industry's clearance and settlement

system, not settlement payments in small, private LBOs, which posed no threat to the securities market.

In short, the court was faced with resolving the conflict between the broad plain wording of the safe harbor and its narrow legislative purpose. To avoid that conflict, the court found that the term “settlement payment” contained in Section 546(e) is ambiguous, which then allowed the court to look past the plain words of the statute to the legislative history and Congress’ intent — “reducing systemic risk to the financial markets.” Accordingly, the court held “that exempting transactions like the sale of the three Shareholders’ stock in their bar and grill from avoidance actions is so far removed from achieving Congress’ professed intent to protect the financial markets that it would be absurd to apply Section 546(e) to the trustee’s well established and important avoidance powers under Sections 544 and 548(a)(1)(B) and (b) of the Bankruptcy Code.”

THE SIZE AND NATURE OF THE TRANSACTION

What standard does that leave for participants in small, private transactions whose “settlement payments” would, at first blush, fall within the plain wording of Section 546(e)? The standard, even by the court’s own admission, is nebulous. The court stated: “[W]hile it is quite easy to find that avoidance of the transaction at issue here would have absolutely no impact on the financial markets, it is somewhat difficult to articulate a clear standard to distinguish this transaction from the facts of *QSP* or any number of hypothetical transactions in between.” As a result, financial institutions may now need to consider the size and nature of a proposed transaction to quantify the impact on the financial markets.

Perhaps recognizing the dilemma of trying to draw lines under Section 546(e), the Third Circuit has held that Section 546(e)’s safe harbor applies to private LBOs.³ In any event, the decision in *MacMenamin’s Grill, Ltd.* may be limited to its facts, given that it was a very small LBO with a purchase price of \$1.15 million that concerned a single restaurant in New York. In other small, private transactions, counsel will want to ensure they do their best to create a nexus between their transaction and the broader financial markets and confirm that the transaction is more akin to tradition-

ally recognized/pursued market transactions. Counsel for the shareholders in *In re MacMenamin's Grill, Ltd.* still has this opportunity at trial, given that the bankruptcy court only denied their motion for summary judgment.

NOTES

¹ Adv. Pro. No. 09-8266 (Bankr. S.D.N.Y. April 21, 2011).

² *In re QSI Holdings, Inc.*, 571 F.3d 545 (6th Cir. 2009) involved a large private LBO with a \$208 million purchase price and hundreds of selling shareholders, in which at least some of the sales went through a financial intermediary. In *QSI*, the Sixth Circuit held that payments made to selling shareholders in the course of a leveraged buyout qualify as “settlement payments” within the plain meaning of 11 U.S.C. § 546(e) and are thus exempt from attempts by unsecured creditors to avoid the payments as fraudulent transfers. Following the holdings of the Third, Eighth and Tenth Circuits, the court rejected the argument that the definition of “settlement payment” does not encompass payments for privately held securities, concluding that “nothing in the statutory language indicates that Congress sought to limit that protection to publicly traded securities.”

³ *In re Plassein Int'l Corp.*, 590 F.3d 252 (3d Cir. 2009).