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The Intent of Section 546(e)

Will Reversing a Transaction 'Seriously Upset The Securities Market's Ability to Function'?

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On Dec. 1, 2016, Bankruptcy Judge Michael J. Kaplan, in *Christophersen v. Pahel* (*In re TVGA Engineering, Surveying, P.C.*), 14-1104 (K) (Bankr. W.D.N.Y. Dec. 1, 2016), held that when a private company repurchases stock from a shareholder, and the payments were made "by" the company "to" the shareholder, through a bank, those payments are not protected by Bankruptcy Code § 546(e)'s safe harbor defense because its application "cannot be permitted to turn upon the use of a bank." *In re TVGA Engineering, Surveying, P.C.*, 14-1104 (K) p.5 (Bankr. W.D.N.Y. Dec. 1, 2016).

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Judge Kaplan relied on legislative intent to find that a transaction which potentially falls within the safe harbor protections of 546(e) should not be afforded the benefits of the safe harbor defense because it is between *private* parties, is truly "by" the debtor and "to" the transferor, merely uses a financial institution like cash and, perhaps most important, if reversed, would not likely "seriously upset the securities market's ability to function."

The Judge recognized that he was bound by precedent in the U.S. Court of Appeals for the Second Circuit that "a financial institution (such as a bank) need not have taken a 'beneficial interest' in a security (such as a share of stock or a note or a bond) in order to trigger the §546(e) 'safe harbor.'" *In re TVGA Engineering, Surveying, P.C.*, 14-1104 (K) p.5 (Bankr. W.D.N.Y. Dec. 1, 2016) (citing *In re Quebecor World (USA) Inc.*, 719 F.3d 94 (2d Cir. 2013)). Accordingly, Judge Kaplan could not rely solely upon the fact that the bank in *In re TVGA Engineering Surveying, P.C.* did not receive a financial benefit from the transaction. Instead, he distinguished prior precedent, and aligned with decisions looking to the legislative intent of Bankruptcy Code § 546(e).

Background

Bankruptcy Code § 546(e) prevents the avoidance of "a transfer made by or to (or for the benefit of)" a "financial institution" that was made "in connection with a securities contract." 11 U.S.C. § 546(e). In *In re TVGA Engineering, Surveying, P.C.*, years before the debtor filed its bankruptcy case, a privately held company agreed with the defendant shareholder to repurchase his shares. The company made payments to the defendant shareholder over a period of 65 months, aggregating $259,000. After the company's Chapter 11 case was converted to Chapter 7, the trustee commenced an adversary proceeding against the defendant

shareholder to recover the payments he received in the year before the filing. In his Dec. 1, 2016 opinion, Judge Kaplan denied the defendant shareholder's motion to dismiss, which raised the safe harbor under Bankruptcy Code § 546(e) as a defense.

Distinguishing Second Circuit Precedent

Judge Kaplan distinguished the facts in *TVGA Engineering* from three other cases in which the Second Circuit recognized the safe harbor defense, each of which involved significantly larger amounts of money, and would arguably have affected the securities market if they were subject to avoidance. *See In re Tribune Co. Fraudulent Conveyance Litigation*, 818 F.3d 98 (2d Cir. 2016) (involving an $11 million debt); *In re Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329 (2d Cir. 2011) (involving the debtor's retirement or redemption of its own publicly traded debt in the amount of $1.1 billion); *In re Quebecor World (USA) Inc.*, 719 F.3d 94 (2d Cir. 2013) (involving $376 million paid by the debtor to a financial institution serving as trustee).

Looking to Legislative Intent

Judge Kaplan likened this case to decisions by the U.S. Court of Appeals for the Eleventh Circuit in *In re Munford, Inc.*, 98 F.3d 604 (1996) (holding that a bank's instrumental role in a transaction does not change that the payment may have been "by" a debtor "to" a shareholder), and by Bankruptcy Judge Robert D. Drain in *In re MacMenamin's Grill, Ltd.*, 450 B.R. 414 (Bankr. S.D.N.Y. 2011) (denying safe harbor protection to transfers, and relying upon legislative history because language of Bankruptcy Code § 546(e) is ambiguous). Judge Kaplan agreed with Judge Drain that resorting to legislative history is necessary when analyzing a 546(e) defense, and relied upon Judge James Michael Peck's dictum in *Quebecor* concluding that Judge Drain's reliance upon legislative intent was responsible for Judge Drain's conclusion that Congress' intent was to shield from avoidance transfers between entities, which could seriously upset the securities market's ability to function, as opposed to transfers in a "small scale private stock transaction." *In re TVGA Engineering, Surveying, P.C.*, 14-1104 (K) p.6 (Bankr. W.D.N.Y. Dec. 1, 2016) (quoting *Quebecor*, 453 B.R. 201 (Bankr. S.D.N.Y. 2011) (citing I*n re MacMenamin's Grill, Ltd.*, 98 F.3d 604 (1996))).

Lessons from the Decision

Although Bankruptcy Code Section 546(e) does not contain a dollar threshold, the lesson of *TVGA Engineering* appears to be that even if the transfers at issue were "settlement payments" made "in connection with a securities contract," the fact that those transfers were also made through a "financial institution" will not be sufficient to invoke the safe harbor unless the reversal of those transfers will "seriously upset the securities market's ability to function." In other words, practitioners should consider whether the scope and nature of the transfers at issue were of the type contemplated by Congress when it created the safe harbor defense.

Notwithstanding the foregoing, Judge Kaplan made clear in his decision that the shareholder defendant's motion to dismiss was not a motion for summary judgment, and that his decision did not "foreclose a future motion to dismiss or summary judgment motion" based upon future discovery.

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