Clients&FriendsMemo

S.D.N.Y. Bankruptcy Court Continues to Construe Bankruptcy Code's Safe Harbor Provisions Narrowly

June 7, 2011

In two recent decisions, the United States Bankruptcy Court for the Southern District of New York has interpreted narrowly certain of the Bankruptcy Code's safe harbor provisions.

Last month, Judge James M. Peck ruled that a payment subordination provision in a swap agreement triggered by a bankruptcy constituted an unenforceable *ipso facto* clause and was not protected by the safe harbors. This resolved uncertainty related to a similar 2010 decision. *See Lehman Brothers Special Financing Inc. v. Ballyrock ABS CDO 2007-1 Ltd. (In re Lehman Brothers Holdings Inc.)*, Adv. Pro. No. 09-01032, 2011 WL 1831779 (Bankr. S.D.N.Y. May 12, 2011).

Several weeks earlier, Judge Robert D. Drain ruled that the safe harbor provided by section 546(e) of the Bankruptcy Code, which insulates certain "settlement payments" from avoidance actions, does not apply to transfers made or obligations incurred in the context of a leveraged buyout of a privately-held company. The Court, in applying its holding, voided both the payments made to the company's former shareholders in exchange for their equity interests and the obligations incurred by the company on account of the loan that financed the LBO. *See Geltzer v. Mooney (In re MacMenamin's Grill Ltd.)*, 2011 WL 1549056 (Bankr. S.D.N.Y. April 21, 2011).

Ballyrock: A Second Look at Payment Subordination Provisions

Background

In July 2007, Lehman Brothers Special Financing Inc. ("LBSF") entered into an ISDA master agreement with Ballyrock ABS CDO 2007-1 Ltd. Lehman Brothers Holdings Inc. ("LBHI") issued a guarantee in connection with the master agreement and served as "Credit Support Provider" to LBSF under a credit support annex. Ballyrock entered into an indenture pursuant to which it issued several classes of notes to investors. The indenture established a waterfall distribution system under which the holders of senior notes must be paid in full before holders of more junior notes could receive any distributions. Under the terms of the ISDA Master Agreement and the Ballyrock

Indenture, LBSF purchased and Ballyrock sold loss protection with respect to certain CDOs and mortgage-backed securities.

The Ballyrock Master Agreement identified a number of Events of Default, including a bankruptcy filing by either of the parties (LBSF or Ballyrock) or by the credit support provider (LBHI). Upon an Event of Default, the non-defaulting party could "designate a day not earlier than the day such notice is effective as an Early Termination Date in respect of all outstanding transactions" under the swap.[1] On the Early Termination Date, the swap required the out-of-the-money party to make a termination payment to the in-the-money party. The parties agreed that "any termination payment would be calculated using a recognized industry methodology referred to as the 'Second Method', which calls for payment to the in-the-money counterparty regardless of whether it was the defaulting party.[2]

Generally, a termination payment is given higher priority under a waterfall distribution scheme and would receive payment before senior noteholders. However, the Indenture "singled out for particularly harsh treatment" under the waterfall, a payment due upon an Event of Default triggered by LBSF or LBHI. The Indenture subordinated this payment – a so-called Defaulted Synthetic Termination Payment – further down the waterfall distribution scheme. Therefore, if either LBSF or LBHI triggered an event of default while LBSF was in-the-money, the Defaulted Synthetic Termination Payment would be subordinated to distributions owing to senior noteholders and, additionally, capped at $30,000.

LBHI filed for bankruptcy on September 15, 2008. Ballyrock then gave notice to LBSF that LBHI's bankruptcy filing constituted an Event of Default, and designated September 16, 2008, as the Early Termination Date. Wells Fargo Bank, N.A., the trustee under the Ballyrock indenture, then gave notice that LBSF was in-the-money on the underlying transactions – to the tune of approximately $404 million. Ballyrock liquidated its assets, generating a total of approximately $326 million for distribution. The trustee made the first distribution of $189 million to the senior noteholders in accordance with the waterfall distribution scheme. The trustee also stated, however, that the remaining $137 million, which the trustee would have paid LBSF pursuant to the waterfall distribution scheme, constituted a Defaulted Synthetic Termination Payment and would be distributed to the senior noteholders rather than LBSF.

In response, LBSF commenced an adversary proceeding in the bankruptcy court seeking (i) a declaratory judgment that the proposed distribution of the remaining $137 million violated applicable law; (ii) a declaratory judgment that the relevant credit default swap agreement was

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1 Ballyrock Master Agreement, § 5(a).

2 Opinion at *3.

improperly terminated and (iii) a temporary restraining order and permanent injunction preventing the trustee from distributing the remaining funds to the senior noteholders. Ballyrock, with the support of the senior noteholders, moved to dismiss the complaint.

The Perpetual Decision

The Court addressed a similar provision in a 2010 decision issued in another Lehman adversary proceeding. *See Lehman Bros. Special Fin. Inc. v. BNY Corporate Trust Servs. Ltd. (In re Lehman Brothers Holdings Inc.)*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010) ("*Perpetual*"). In *Perpetual*, the Court addressed the enforceability of a priority "flip" provision, which reversed the payment priorities in a terminated swap transaction if either the swap counterparty or its credit support provider (again, LBSF and LBHI, respectively) triggered the relevant event of default. Judge Peck held that the flip provision in *Perpetual* was an unenforceable *ipso facto* clause, and that the bankruptcy of LBHI (as credit support provider, a non-party to the swap) triggered the flip provision.

As detailed in sections 365(e)(1) and 541(c)(1)(b) of the Bankruptcy Code, contract provisions that prohibit the modification of a debtor's right solely because of a provision in an agreement conditioned on "the commencement of a case under this title" are unenforceable. In *Perpetual*, Judge Peck held that the Bankruptcy Code's *ipso facto* provisions applied to contract terms that modified a debtor's rights based on the filing of "presumably any case that is related in some appropriate manner to the contracting parties,"[3] and not solely upon the commencement of the debtor's case. Applying this logic to the facts before it, the Court concluded that the flip provision was unenforceable because it was triggered by the commencement of LBHI's chapter 11 case.

Analysis

Here, the Court applied similar reasoning and held that "the analysis from the *Perpetual* decision would render ineffective the changes in the Waterfall that would result from activation of the Defaulted Synthetic Termination Payment Clause."[4] The Court therefore found that "the Complaint brought by LBSF is sufficient to state claims against Ballyrock based on the allegations that the clause in question constitutes an unenforceable *ipso facto* provision."[5]

The Court next considered whether the Defaulted Synthetic Termination Payment clause was protected by the safe harbor provisions of the Bankruptcy Code – an issue arguably not addressed in *Perpetual* (where the Court held that the safe harbor did not apply because the "flip" provision

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[3] *Perpetual,* 422 B.R. at 419.

[4] *Ballyrock* at *5.

[5] *Id.*

was not contained within the four corners of the swap agreement itself). Section 560 of the Bankruptcy Code protects a non-defaulting swap participant's contractual right to liquidate, terminate or accelerate "one or more swap agreements because of a condition of the kind specified in section 365(e)(1)" of the Bankruptcy Code (the insolvency of the debtor, or commencement of a bankruptcy case) or (ii) "offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation or acceleration of one or more swap agreements."[6] The Court found that the Defaulted Synthetic Termination Payment clause "would change the flow of funds in a manner that would deprive LBSF of pre-existing distribution rights" and that such a deprivation of payment rights "should not be entitled to any protection under safe harbor provisions that, by their express terms are limited exclusively to preserving the right to liquidate, terminate and accelerate a qualifying financial contract."[7]

Finally, the Court considered whether Ballyrock improperly terminated the credit default swap, and that, as a result, the underlying transactions remained in effect. LBSF argued that, pursuant to the Indenture, Ballyrock could only have terminated the swap if no transactions remained outstanding under the Master Agreement or if Ballyrock had entered into a replacement Master Agreement. The Court held that this argument "confuses and obscures the distinction between the Ballyrock Master Agreement and the Transactions that may be entered into pursuant to that agreement."[8] Concluding that Ballyrock "did all that was necessary to designate an Early Termination Date, terminate all outstanding transactions and establish the obligation of the out-of-the-money party to pay the termination payment,"[9] the Court dismissed Count II of the Complaint.

In *Ballyrock*, Judge Peck again interpreted the Bankruptcy Code's safe harbor provisions in a light favorable to debtors. Following the *Perpetual* decision, which was limited to the particular facts of that case, there was uncertainty as to whether the Court would find similar priority-altering provisions that were expressly incorporated in the safe-harbored agreement protected by the Bankruptcy Code's safe harbors. *Ballyrock* does away with that uncertainty.

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6 11 U.S.C. § 560.

7 *Ballyrock* at *6.

8 *Id.* at *7.

9 *Id.* at *8.

MacMenamin's Grill: Limiting Section 546(e)'s "Settlement Payment" Exception

Background

Each of three defendants owned 31 percent of the outstanding common stock of MacMenamin's Grill Ltd., a bar and grill. In July of 2007, the shareholders agreed to sell their ownership interests back to MacMenamin's in a typical, though relatively small, LBO transaction. Pursuant to a Loan and Security Agreement, Commerce Bank, N.A., extended a $1,150,000 loan to MacMenamin's to finance the transaction. As security for the loan, MacMenamin's granted the lender a security interest in substantially all of its assets. MacMenamin's directed the lender to pay the loan proceeds directly to the three shareholders as consideration for their stock. The transaction closed on August 31, 2007. MacMenamin's filed for bankruptcy on November 18, 2008.

During the pendency of the bankruptcy case, a chapter 11 trustee was appointed. The trustee subsequently filed a complaint seeking to avoid the transfers made and obligations incurred in connection with the LBO as constructively fraudulent transfers pursuant to sections 544 and 548 of the Bankruptcy Code, and to recover for the benefit of the estate, the value of the proceeds paid out to the shareholders under section 550 of the Bankruptcy Code.

Analysis

The dispute in this case did not revolve around whether the transfers themselves were avoidable under sections 544 and 548 of the Bankruptcy Code. Rather, the shareholders conceded that the transfers were constructively fraudulent and subject to avoidance by the trustee. The shareholders and the lender contended that the transfers at issue were exempt from the trustee's avoidance powers by nature of section 546(e) of the Bankruptcy Code – a so-called "safe harbor" provision that insulates certain transactions from the avoidance provisions of chapter 5 of the Bankruptcy Code – and sought summary judgment in their favor.

Section 546(e) provides, in relevant part:

> 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, or. . . that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in section 741(7). . . .

Section 741(8) of the Bankruptcy Code defines "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 shareholders argued that the transfers in question – the payment of the loan proceeds to them in exchange for their shares in MacMenamin's – constituted "settlement payments" for purposes of section 546(e), or, in the alternative, were transfers made by and to financial institutions in connection with a securities contract. Thus, they argued, the transfers fit squarely within the safe harbor of section 546(e) pursuant to the plain language of the statute.

Having considered the text of section 546(e), along with its various cross-references and definitions, the Court found the section to be ambiguous. Thus, the Court turned to the relevant legislative history in an attempt to uncover the purpose and scope that Congress had intended for section 546(e). The Court held:

> That legislative history . . . makes it clear that Congress intended section 546(e) to address risks that the movants have failed to show conclusively are implicated by the avoidance of the transaction at issue here. The Court should not, therefore, impose a result contrary to Congressional intent.[10]

The Court challenged the prevailing view of the circuit courts that the safe harbor provided by section 546(e) of the Bankruptcy Code applies to transfers made in connection with private securities transactions, as well as those involving publicly traded stock.

The Court also ruled that the obligations incurred by MacMenamin's in connection with the lender's financing of the transaction were outside of the scope of section 546(e) and therefore subject to avoidance. The Court's reasoning was twofold. First, the Court's analysis of section 546(e)'s legislative history did not differentiate between transfers made and obligations incurred, and thus the same reasoning applied. And second, while sections 544 and 548 of the Bankruptcy Code provide a trustee with the power to avoid transfers made and obligations incurred by the debtor, section 546(e) only provides that "the trustee may not avoid *a transfer*," but imposes no express limitation on the avoidance of obligations incurred. Therefore, the Court held that section 546(e)'s

[10] *MacMenamin's* at *10.

exemption is inapplicable to actions seeking to avoid obligations incurred by a debtor, regardless of whether the relevant transaction involves private or publicly traded securities.[11]

While a number of circuit courts have held that LBO-related transfers are protected by the safe harbors of section 546(e) of the Bankruptcy Code,[12] in the last year, courts in both the Southern District of New York and the District of Delaware have narrowed the scope of the safe harbor and generally read them in a manner most favorable to debtors and their estates.[13] Participants in private LBOs should be aware that the transfers made and obligations incurred in connection with an LBO may be susceptible to avoidance as fraudulent transfers. And all non-debtor parties should be aware that courts in recent years have given debtor-friendly views of various safe harbor provisions.

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[11] *Id.* at * 15.

[12] *See, e.g., QSI Holdings 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 Int'l Corp.)*, 590 F.3d 252 (3d Cir. 2010), *cert. denied* 130 S.Ct. 2389 (2010); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009).

[13] *See, e.g.*, *Chevron Products Co. v. SemCrude, L.P. (In re SemCrude, L.P.)*, 428 B.R. 590 (D. Del. 2010) (affirming bankruptcy court decision holding that contractual provision allowing for triangular setoff violates mutuality requirement of section 553); *In re Lehman Bros. Holdings Inc.*, 2011 WL 350280 (S.D.N.Y. Jan. 27, 2011) (affirming bankruptcy court decision holding that safe harbor provisions allow for exercise of contractual right to setoff notwithstanding automatic stay, but that other prerequisites for setoff, such as mutuality, must be satisfied); *Bank of America, N.A. v. Lehman Brothers Holdings Inc.,* 439 B.R. 811 (Bankr. S.D.N.Y. 2010) (holding that lender's seizure of debtor's account funds, which were unrelated to any safe harbored transaction, absent court approval was impermissible setoff in violation of automatic stay).