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Safe Harbor Unavailable for Payments to Collateralize Letter of Credit in Bond Redemption

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Section 546(e) of the Bankruptcy Code has engendered more than its fair share of litigation. Section 546(e) provides a safe harbor to exempt certain types of financial contracts from the reach of the automatic stay and the avoidance powers of the code.

Congress enacted Section 546(e) "to minimize displacement caused in the commodities and securities market in the event of a major bankruptcy affecting those industries." The section provides that a trustee in bankruptcy may not avoid a transfer that is a "settlement payment" by a financial institution, financial participant or securities-clearing agency. On its face, the code's definition of "settlement payment" is not very helpful: A settlement payment is "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 U.S. Court of Appeals for the Third Circuit has defined "settlement payments" broadly to include "the transfer of cash or securities made to complete a transfer payment."

Courts have held that Section 546(e) protects payments made to redeem public or private stock in the course of a leveraged buyout, although some courts have held that the section is only meant to protect the public securities market and therefore does not apply to transfers for the purchase of private company stock through an LBO. In *In re Qimonda Richmond,* 2012 WL 1021789 (Del. Bankr. Mar. 26, 2012), the court considered whether the pre-petition collateralization of a letter of credit by the debtors in connection with the redemption of bonds issued for their benefit constituted a settlement payment within the meaning of the safe harbor provision. The court held that it did not.

Qimonda involved a fairly typical transaction structure for industrial revenue bonds. According to the opinion, the debtors' predecessor had borrowed $33 million through the issuance of industrial revenue bonds by the Economic Development Authority of Henrico County, Va., pursuant to an indenture. In order to collateralize the debtors' obligation to pay the bondholders, Citibank issued a letter of credit in favor of the indenture trustee. Under the letter of credit, Citibank assumed the obligation to pay the indenture trustee upon a valid draw notice. In exchange for that undertaking, the debtors agreed to reimburse Citibank if the letter of credit was drawn down and gave Citibank liens on their assets to secure that obligation.

As the financial crisis worsened throughout 2008, Citibank sought additional collateral for the debtors' obligation under the letter of credit agreement. In September 2008, the debtors granted Citibank a security interest in additional collateral, including funds in a collateral account held at the bank, according to the opinion. In October 2008, Citibank notified the debtors and the indenture trustee that it would not renew the letter of credit when it expired in January 2009, triggering the indenture trustee's right to draw on the letter of credit. The debtors agreed to reimburse Citibank before or immediately after the indenture trustee drew on the letter of credit or to repay the bonds in full prior to a draw on the letter of credit.

In December 2008, the debtors directed the indenture trustee to redeem the bonds and the indenture trustee sent a redemption notice to the bondholders, according to the opinion. The debtors then deposited funds into their Citibank account, in part to satisfy their obligation to reimburse Citibank under the letter of credit. In January 2009, Citibank debited the debtors' account for $33 million and paid the money to the indenture trustee, which used it to retire the bonds.

In February 2009, the debtors filed voluntary petitions for relief under Chapter 11, according to the opinion. After the case was converted to Chapter 7, the trustee in bankruptcy filed a complaint against Citibank seeking to avoid and recover the debtors' deposit of $33 million into the Citibank account and the transfer of those funds from the debtors' account to Citibank as fraudulent and preferential transfers. Citibank sought to dismiss the preference claims, arguing that the deposit and debit fell within the safe harbor provisions of Section 546(e) as a "settlement payment" made "in connection with a securities contract."

Citibank argued that the series of events - the debtors' transfer of money into an account at the bank, the disbursement of those funds to the indenture trustee on account of the debtors' notes, and the retirement of those notes when the holders received payment - constituted a "settlement payment." Citibank relied on *In re Quebecor,* 453 B.R. 201 (Bankr. S.D.N.Y. 2011), which held that such payments qualify for safe harbor treatment under Section 546(e) because they involve a transfer of cash to complete a securities transaction. Citibank contended that treating the payment as a settlement payment served the purpose of the safe harbor provision, which was to protect securities transactions from avoidance and preserve the finality of those transactions. Citibank argued that the debtors were seeking to avoid transfers made to secure and satisfy their obligations under the bonds, and the only way to protect the bondholders was to protect the financial institutions that facilitated the transactions involving the bonds.

The trustee disputed that the payments were settlement payments. First, the trustee argued that the payments to Citibank were made to secure Citibank's exposure under the letter of credit, not to pay off the bonds. Because a letter of credit is specifically exempted from the definition of a security under the code, the payments related to the letter of credit were not settlement payments. Second, the trustee argued that Citibank failed to show that collateralization of a letter of credit would commonly be called a "settlement payment" by those who work in the securities market. Finally, the trustee argued that even if a series of transactions ultimately include a purchase or sale of a security, that does not make each step in the chain of events a settlement payment.

The court held that the payments were not "settlement payments" within the meaning of Section 546(e). First, the court found that the debtors made the payments to Citibank to fulfill an independent obligation they had under the letter of credit and not as part of any securities transaction. The court distinguished from *Quebecor* on the grounds that the only purpose of the transfer in that case was to complete a securities transaction and there was no other independent obligation between the debtor and the financial institution as there was here. Second, the court agreed with the trustee that Citibank had not shown that a payment on a letter of credit is considered a settlement payment in the securities industry or is a commonly used payment structure in a securities transaction. Finally, the court concluded that the payments were not made "in connection with a securities contract" because the bonds and indentures were not securities contracts within the definition in the Bankruptcy Code. While the payments were made in connection with the letter of credit, even if the letter of credit was a credit enhancement to the bonds, the payments were not "in connection with a securities contract."

The battle over Section 546(e) has frequently been waged over leveraged buyouts and whether a statute designed to protect the public securities market should be extended to cover leveraged buyouts of private companies. *Qimonda* suggests that the trend to sanction the expansive interpretation of Section 546(e) by courts in the Third Circuit and elsewhere is not without its limits, and at least one bankruptcy court is not willing to give safe harbor protection to any payment that can arguably be characterized as a link in the chain to a securities transaction.

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