AKIN GUMP STRAUSS HAUER & FELD LLP
Attorneys at Law

March 2008

BANKRUPTCY UPDATE

X-CLAUSE MUST BE STRICTLY CONSTRUED

IN RE DURA AUTOMOTIVE SYSTEMS, INC.

Every rule has an exception, and subordination agreements are no exception to that rule. Intercreditor agreements often contain subordination provisions that address circumstances under which holders of subordinated notes can receive a distribution if the issuer files for chapter 11 relief, even if holders of the senior notes are not paid in full. That's what so-called "X-Clauses" are all about – contractually agreed "x-ceptions" to the general rule of subordination.

X-Clauses can entitle subordinated noteholders, for example, to a pro rata distribution of stock under a plan of reorganization on par with senior unsecured creditors. But because they are exceptions to the rule, courts will apply them strictly, and only within the broader context of the indenture in which they are found. That was the holding of the Bankruptcy Court for the District of Delaware in *In re Dura Automotive Systems, Inc.*[1]

Dura Operating Corp. (the "Debtor") issued a series of subordinated notes (the "Subordinated Notes") pursuant to a certain indenture (the "Subordinated Indenture"). Thereafter, the Debtor issued a series of senior notes (the "Senior Notes") which were to be senior in priority to the Subordinated Notes pursuant to another indenture (the "Senior Indenture"). By agreement between the note holders, the Senior Notes were entitled to full payment prior to payment to holders of the Subordinated Notes. The Subordinated Indenture, however, contained an X-Clause which provided that in the event of a bankruptcy filing by the Debtor, the holders of the Subordinated Notes could receive "Permitted Junior Securities" prior to a full distribution to the holders of the Senior Notes. "Permitted Junior Securities" were defined by the Subordinated Indenture as: "(i) equity interests; or (ii) debt securities that were subordinated to senior debt."

The Debtor's plan of reorganization contemplated a rights offering of approximately $150 million in new cash investments in exchange for approximately 41 percent of the common stock of the reorganized company, with the balance of the new common stock being distributed to holders of the Senior Notes and certain large trade

[1] 379 B.R. 257 (Bankr. D. Del. 2007).

creditors. Under the plan, holders of Subordinated Notes: (i) were to neither receive nor retain any property, (ii) were not allowed to vote on the Plan and (iii) were not permitted to participate in the rights offering, as any new common stock was to be distributed to holders of Senior Notes.

Certain holders of the Subordinated Notes filed an adversary proceeding against the Debtor, seeking a declaratory judgment that the Plan violated applicable law by: (i) failing to provide for a distribution of new common stock to Subordinated Note holders and (ii) failing to allow the Subordinated Note holders to participate in the rights offering.

The plaintiffs argued that the holders of the Subordinated Notes were entitled to receive new common stock under the X-Clause, which excepted Permitted Junior Securities from subordination. In reading the definition of Permitted Junior Securities, the holders of the Subordinated Notes, noting the presence of a semi-colon and the word "or," argued that only "debt securities" had to be subordinated while the term "equity interests" was placed within the definition without such qualification.

In granting summary judgment to the defendants, the court noted that an X-Clause must be read in context and, when read as a whole, the Subordinated Note Indenture clearly manifested the intent to assure payment in full of the Senior Notes before permitting payment to the holders of the Subordinated Notes and, accordingly:

> To interpret the X-Clause to include the New Common Stock and the Rights Offering in the definition of 'Permitted Junior Securities' would eviscerate the purpose of the subordination provisions in the Subordinated Notes Indenture and expand the limited carve out beyond its intended scope.[2]

In so holding, the court relied heavily on the 2nd Circuit's ruling in *In re Metromedia Fiber Network*,[3] in which that court noted that:

> When subordinated and senior noteholders are given securities under a plan of reorganization, an X-Clause allows the subordinated noteholder to retain its securities only if the securities given to the senior noteholder have priority to future distributions and dividends (up to the full amount of the senior notes). This approach assures that the junior creditor remains fully subordinated without requiring it to yield assets that are not required for full payment of the senior creditor and that would therefore make a round-trip to the senior creditor and back with the attendant delay.[4]

By holding that an X-Clause must not be considered based upon its grammatical structure alone, but should rather be read in the broader context of the subordinated note indenture, it appears as though the court intended that, "x-cept" in extremely limited circumstances, no payment should be made to Subordinated Note holders under such a clause.

To view the *In re Dura Automotive Systems, Inc.* memorandum, please visit http://www.akingump.com/files/upload/1095.pdf

---

[2] *Id.* at 270.
[3] 416 F.3d 136 (2d Cir. 2005).
[4] *Id.* at 140.

For further information, please contact:

Philip C. Dublin
212.872.8083
pdublin@akingump.com
Financial Restructuring Group

James R. Savin
202.887.4417
jsavin@akingump.com
Financial Restructuring Group

POSTPETITION SURVIVAL AND REVIVAL OF PREPETITION CLAIMS: PREFERENCE RECOVERY REINSTATES GUARANTY / POSTPETITION ATTORNEY FEES ALLOWED FOR UNSECURED CREDITORS

CENTRE INS. CO. VS. SNTL CORP. (IN RE SNTL CORP.) [5]

The Bankruptcy Appellate Panel (B.A.P.) for the 9th Circuit recently held that despite the prepetition settlement and release of a guarantor in exchange for a payment from the principal obligor, the guaranty may be reinstated and allowed as a claim against the guarantor in its subsequent bankruptcy case if the prepetition payment is avoided and repaid to the principal obligor as a preference, even though the repayment of the preference occurs postpetition. The court further determined that unsecured creditors may claim attorneys' fees incurred postpetition but arising under a prepetition contract. *Centre Ins. Co. v. SNTL Corp.* (*In re SNTL Corp.*).[6]

SNTL Corp. and its affiliates filed chapter 11 petitions for bankruptcy relief. Centre Insurance Co. (Centre) filed a proof of claim for over $232 million, excluding contingent and unliquidated claims but including attorneys' fees incurred postpetition. The Trustee objected to Centre's proof of claim on the basis that Centre had released its claims against the Debtor prior to the filing of the bankruptcy and therefore could not assert these claims postpetition. The Trustee further objected to Centre's claim for postpetition attorneys' fees on the grounds that Centre was an unsecured creditor.

Prior to filing for bankruptcy, Debtor Superior National Insurance Group Inc. (SNIG) guaranteed certain of its affiliates obligations to Centre. Upon default on these obligations, the affiliates paid Centre $163.4 million in satisfaction of a $180 million debt in exchange for Centre's release of the principal obligor and of SNIG, as guarantor. The affiliates, insurance companies, were placed into a state court supervised liquidation and SNIG then filed a chapter 11 case. The liquidator of the affiliates subsequently filed a state court preference action to recover the payment made by the affiliates to Centre. In settlement of the preference claim, Centre returned $110 million of the $163.4 million payment to the liquidator. Centre then filed a claim in SNIG's bankruptcy case to

[5] Akin Gump represents Centre Insurance Company in *Centre Insurance Company v. SNTL Trust et al*.
[6] No. 06-1350, slip op., 2007 WL 4625246 (B.A.P. 9th Cir. Dec. 19, 2007).

Back To TOC

recover the $110 million from SNIG, as guarantor. The Trustee objected, arguing that Centre could not assert the guaranty claim postpetition since it had been released prepetition. Centre also filed a claim for attorneys' fees incurred postpetition, asserting that its prepetition contracts permitted it to recover such costs. The Trustee filed a motion for summary adjudication claiming that Centre had released SNIG's liability as guarantor prepetition and that, as unsecured creditor, Centre could not assert a claim for attorneys' fees incurred postpetition. The bankruptcy court granted the Trustee's motion for summary adjudication as to both issues.

The B.A.P. reversed the bankruptcy court's decision on both points. In determining that the avoidance and repayment of the $110 million as a preference reinstated SNIG's liability as guarantor, the B.A.P. conducted the following analysis. The agreement governing the release of SNIG as guarantor provided that the Centre's remedies against SNIG could be revived if a court determined that the settlement payments to Centre were avoidable preference payments. At the time Centre returned $110 million of the $163.4 million payment in settlement of the liquidator's state court preference claim, the state court entered an order approving the settlement. The B.A.P. found that this state court order triggered the provision restoring Centre's remedies against SNIG. The B.A.P. also reasoned that under guaranty law when a creditor returns a preference payment to its principal obligor, a guarantor's liability is restored. The Trustee asserted that even if the court found that SNIG's liability was reinstated under the release and guaranty law, section 502(b) of the Bankruptcy Code would preclude Centre from recovering the $110 million repayment. Section 502(b) requires a court to assess the amount of a prepetition claim "as of the petition date." The Trustee maintained that as of the petition date, Centre had released its claim against SNIG. The B.A.P. recognized, however, that section 502(b) does not disallow a claim on the basis that it is contingent. Centre's claim existed as a contingent claim as of the petition date. Because Centre's claim against SNIG was restored by the recovery of the preference payment, the B.A.P. reversed the bankruptcy court's holding regarding guarantor liability.

Next, the B.A.P. evaluated Centre's claim as a general unsecured creditor for postpetition attorneys' fees. In *Travelers Casualty & Surety Co. v. Pacific Gas & Electric Co. (Travelers)*, the United States Supreme Court recently declined to decide whether a bankruptcy court may allow an unsecured creditor's claim for postpetition attorneys' fees and instead remanded the issue to the Court of Appeals for the 9th Circuit.[7] The *Travelers* decision reversed former 9th Circuit case law denying creditors' claims for attorneys' fees for bankruptcy litigation and held that such attorneys' fees may be allowed if provided for in a prepetition contract with the debtor.[8] Since the Supreme Court issued the decision, courts have been split on whether an unsecured creditor's claim for postpetition attorneys' fees may be allowed.[9] In analyzing this issue, the B.A.P. noted that courts, both before and after the *Travelers* holding, have focused on four main arguments. First, courts have considered whether section 506(b) of the Bankruptcy Code disallows an unsecured creditor's claim for postpetition attorneys' fees. The B.A.P. rejected the contention that section 506(b), which circumscribes only secured claims, restricts unsecured claims. Second, courts have looked to section 502(b)'s requirement that a claim be measured as of the petition date. Although the amount of postpetition attorneys' fees is not certain as of the petition date,

[7] 127 S. Ct. 1199 (2007).
[8] *See In re SNTL Corp.*, No. 06-1350, slip op., 2007 WL 4625246 at *9; Collier on Bankruptcy § 502.03[2][b][iv] (citing *Fobian v. W. Farm Credit Bank* (*In re Fobian*), 951 F.2d 1149 (9th Cir. 1991).
[9] *In re SNTL Corp.*, No. 06-1350, slip op., 2007 WL 4625246 at *10 (citing *Qmect, Inc. v. Burlingame Capital Partners II, LP* (*In re Qmect, Inc.*), 368 (Bankr. N.D. Cal. 2007); *In re Elec. Mach. Enter., Inc.*, 371 B.R. 549 (Bankr. M.D. Fla. 2007)).

the B.A.P. found that because the right to payment existed as of the petition date section 502(b) did not preclude an unsecured creditor's claim to postpetition attorneys' fees. Third, courts have considered whether the Supreme Court's decision in *United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd.* (*Timbers*) prevents an unsecured creditor from recovering postpetition attorneys' fees.[10] *Timbers* held that an undersecured creditor was not entitled to interest on its unsecured debt.[11] The B.A.P. held that *Timbers* was not applicable because section 502(b) disallows interest on unsecured debt but does not prevent a claim for attorneys' fees. Fourth, courts have evaluated public policy. The B.A.P., however, deemed a public policy analysis unnecessary because the Bankruptcy Code controls the issue. Ultimately, the B.A.P. concluded that postpetition attorneys' fees should not be disallowed because the claimant is a general unsecured creditor.

In issuing its opinion, the court became the first Bankruptcy Appellate Panel to decide whether to award postpetition attorneys' fees to an unsecured creditor since the United States Supreme Court's ruling in *Travelers*.[12] Since the Supreme Court issued the *Travelers* decision, courts have struggled with whether to allow unsecured creditors postpetition attorneys' fees and have come down on both sides of the issue.[13] The *SNTL Corp.* opinion demonstrates that at least in some instances a claim for postpetition attorneys' fees is available to unsecured creditors. In addition, the *SNTL Corp.* case demonstrates that notwithstanding a prepetition settlement and release of a guarantor, a guaranty may be revived if the prepetition settlement payment is returned to the principal obligor as a preference, whether the repayment occurs after avoidance by court order or in a court approved settlement of the preference claim.[14]

To view the *In re SNTL Corp.* opinion, please visit http://www.akingump.com/files/upload/1093.pdf

For further information, please contact:

Peter J. Gurfein
310.552.6696
pgurfein@akingump.com
Financial Restructuring Group

BANKRUPTCY COURT PROFESSIONALS' FEES – AT RISK?

IN RE GADZOOKS[15]

The Bankruptcy Code limits compensation for bankruptcy court employed professionals. Although bankruptcy professionals may, in limited situations, obtain pre-approval of a compensation arrangement pursuant to section 328, generally court-appointed bankruptcy professionals must submit periodic fee applications that are typically

[10] *United Saving Association of Texas v. Timbers of Inwood Forest Associates., Ltd.*, 484 U.S. 365 (1988).
[11] *In re SNTL Corp.*, No. 06-1350, slip op., 2007 WL 4625246 at *13 (citing *Timbers*, 484 U.S. at 380).
[12] 127 S. Ct. 1199.
[13] *Compare In re SNTL Corp.*, No. 06-1350, slip op., 2007 WL 4625246 *with In re WCS Enters., Inc.*, No. 07-10054, slip op., 2007 Bankr. LEXIS 3914 (Bankr. E.D. Va. Nov. 20, 2007).
[14] On January 17, 2008, the SNTL Trust filed a Notice of Appeal to the U.S. Court of Appeals for the 9th Circuit.
[15] Akin Gump represented the Debtor in *In re Gadzooks*.

Back To TOC

reviewed under the reasonableness standard set forth in section 330 and accorded first priority distribution pursuant to section 507.

Section 330 of the Bankruptcy Code provides that professionals are entitled to "reasonable compensation for actual, necessary services."[16] It further provides that in determining reasonable compensation, a court should consider the nature, extent and value of such services, taking into account all relevant factors, including time spent, rates charges and whether services were necessary or beneficial to estate administration when rendered.[17] The plain language of section 330(a)(3) indicates that these factors are not exclusive. To that end, in the 5th Circuit, bankruptcy courts utilize the lodestar method set forth in *Johnson v. Georgia Highway Express, Inc.*[18] to calculate "reasonable fees" (*In re First Colonial Corp. of Am.)*.[19]

Andrews & Kurth L.L.P. v. Family Snacks, Inc. (In re ProSnax Distributions, Inc.)[20] is a 5th Circuit decision that continues to provide potential pitfalls for bankruptcy court employed professionals. In *ProSnax* the 5th Circuit denied debtor's counsel compensation for services provided subsequent to the appointment of a chapter 11 trustee.[21] Furthermore, and more troubling to court-employed professionals, the court stated that services provided by court-appointed professionals must, in hindsight, have provided an "identifiable, tangible and material benefit to the bankruptcy court."[22]

The scope and applicability of *ProSnax* was recently examined by the United States District Court for the Northern District of Texas in *In re Gadzooks*. In the chapter 11 proceeding of this Dallas-based retailer, an official committee of equity security holders assisted in the development of a plan of reorganization premised on a rights offering backed by certain of its members (*In re Gadzooks)*.[23] After the rights offering failed, the company's assets were sold for an amount that yielded nothing to equity holders. Shortly thereafter, the equity committee was disbanded and its counsel applied for compensation.[24] The liquidating trustee objected, asserting that counsel to the equity committee failed to provide "identifiable, tangible and material benefit" to the Gadzooks estate.

In allowing the bulk of the equity committee's fee application, the bankruptcy court held that at the time the equity committee's counsel provided services, the surrounding facts and circumstances suggested that equity security holders would receive a return. The bankruptcy court determined that it was free to apply the reasonableness test rejected by the 5th Circuit in *ProSnax*, because it determined the 5th Circuit's discussion of the so-called "hindsight test" to be mere dictum.[25] Applying the reasonableness test enunciated by the 5th Circuit earlier in *Georgia Highway Express* and *First Colonial*, the bankruptcy court noted that the services

[16] 11 U.S.C. § 330(a)(1)(A).
[17] 11 U.S.C.§ 330(a)(3).
[18] 488 F.2d 714 (5th Cir. 1974).
[19] 544 F.2d 1291, 1298 (5th Cir. 1977).
[20] 157 F.3d 414 (5th Cir. 1998).
[21] *Id.* at 416.
[22] *Id*. at 426.
[23] 352 B.R. 796, 799-803 (Bankr. N.D.Tex. 2006).
[24] *Id.* at 803.
[25] *Id*. at 809.

provided by the equity committee's counsel were reasonable at the time they were rendered.[26] The bankruptcy court further noted that if the "hindsight test" in *ProSnax* is controlling, it is limited only to debtor's professionals, as making committee counsel responsible to constituencies outside the committee itself – i.e., requiring services to benefit a debtor, not the committee's constituents – would lead to confusion and potentially absurd results in bankruptcy cases.[27]

The liquidating trustee appealed, asserting that since the services provided by the equity committee's counsel allegedly did not provide a material benefit for the Gadzooks estate, the bankruptcy court should have denied the fee application *(Kaye v. Hughes & Luce, LLP)*.[28] In reversing and remanding for further findings consistent with its opinion, the district court stated that "the court is doubtful of whether the 5th Circuit's adoption of the material benefit or hindsight test was dictum at all."[29] The district court determined that "given the clarity of the language used in *ProSnax*, this court believes that it is constrained by its pronouncements."[30]

Equity committee counsel has appealed the district court's decision to the 5th Circuit. The 5th Circuit's decision may render future compensation for bankruptcy professionals' services in engagements in this district to be essentially contingent in nature – i.e., dependent on the "tangible and material benefit" provided. This is a different and more onerous standard than that applied in other circuits.[31]

To view the *Kaye v. Hughes & Luce, LLP* memorandum order, please visit http://www.akingump.com/files/upload/1094.pdf

For further information, please contact:

Charles R. Gibbs
214.969.4710
cgibbs@akingump.com
Financial Restructuring Group

Sarah Link Schultz
214.969.4367
sschultz@akingump.com
Financial Restructuring Group

[26] *Id.* at 811.
[27] *Id.* at 812.
[28] 2007 WL 2059724 (N.D.Tex. 2007).
[29] *Id.* at *7.
[30] *Id.*
[31] This article originally was published in the January 1, 2008, issue of *Headnotes*, a publication of the Dallas Bar Association.

Back To TOC

CAPPING LANDLORD'S CLAIMS JUST GOT MORE DIFFICULT

SADDLEBACK VALLEY COMMUNITY CHURCH V. EL TORO MATERIALS CO. (IN RE EL TORO MATERIALS CO.)

Bankruptcy Code section 502(b)(6) caps landlords' damages "resulting for the termination of a lease of real property." But does that cap limit damage claims other than for "rent"? Until recently collateral damage claims, including the cost to repair rental property, were more often than not included in the definition of "rent," and therefore were limited to the cap.[32] But not any more, according to the U.S. Court of Appeals for the 9th Circuit in *Saddleback Valley Community Church v. El Toro Materials Co.* (*In re El Toro Materials Co.*).[33] Such damage claims now fall outside of the term "rent" and are not capped by Code section 506(b).

The court of appeals grounded its holding in the legislative history and intent behind Bankruptcy Code section 502(b)(6). Until 1934, bankruptcy courts deemed future rents contingent and disallowed landlords' claims for lost rental income upon a debtor's rejection of a lease. The Bankruptcy Act of 1934 balanced (1) the injury to landlords resulting from broken leases against (2) the concern that large damages claims for future rents under long-term leases would consume bankruptcy estates and deprive other creditors of recovery by capping landlords' rental damages. The damages cap was tied to the remaining duration of the lease. Today, this damages cap is codified in Section 502(b)(6).

Damages "resulting from the termination of a lease of real property" may not exceed –

A. the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of –

   i. the date of the filing of the petition, and

   ii. the date on which such lessor repossessed, or the lessee surrendered, the leased property, plus

B. any unpaid rent due under such lease, without acceleration, on the earlier of such dates.

11 U.S.C. § 502(b)(6).

With this statutory framework in mind, the court of appeals considered whether the damages cap limits a landlord's recovery for the cost of repairing the leased premises. El Toro Materials, a bankrupt mining company, rejected its lease of Saddleback Valley Community Church's property. El Toro Materials left behind "one million tons of its wet clay 'goo,' mining equipment, and other materials." Saddleback filed an adversary proceeding seeking $23 million in repair damages. The bankruptcy court rejected El Toro Materials' argument that section 502(b)(6) limited Saddleback's recovery. The Bankruptcy Appellate Panel reversed the bankruptcy court's holding, and the court of appeals reversed the B.A.P.'s decision.

---

[32] *See, e.g., Kuske v. McSheridan* (*In re McSheridan*), 184 B.R. 91 (B.A.P. 9th Cir. 1995).
[33] 504 F.3d 978 (9th Cir. 2007).

The court of appeals considered that the section 502(b)(6) damages cap is calculated based upon the time period remaining under the lease. The court reasoned that damages for lost rental income are necessarily tied to the amount of anticipated future rent, but collateral damages are not. Further, the court determined that limiting landlords' collateral damages based on the value of anticipated rent would unfairly reduce their recovery in comparison to other types of creditors. Landlords, just as other creditors, should recover collateral damages in proportion to the amount of their claim. The plain language of section 502(b)(6) also indicates that the damages cap applies only to landlords' claims for lost rental income and not to collateral damages. The cap limits damages "resulting from" the rejection of a lease. Saddleback's claim resulted from the debtor's physical damage to its rental property and would have existed even if El Toro Materials had assumed the lease. The court noted that capping collateral damages would encourage some debtors to reject leases solely to benefit from reduced collateral damages awards. Capping collateral damages would also give debtors free reign to violate leases and cause damage beyond the cap without penalty.

Based on all of these reasons, the court of appeals held that section 502(b)(6) limits landlords' claims for lost rental income and not landlords' collateral damages.[34] In so holding, the court expressly overruled in part *Kuske v. McSheridan* (*In re McSheridan*).[35]

To view the *In Re El Toro Materials Co.* opinion, please visit http://www.akingump.com/files/upload/1092.pdf

For further information, please contact:

S. Margie Venus
713.220.5818
svenus@akingump.com
Financial Restructuring Group

BROAD IS NOT AMBIGUOUS – THE APPLICATION OF SECTION 546(e) TO A PRIVATE COMPANY LBO

QSI HOLDINGS, INC. V. ALFORD

Section 546(e) of the Bankruptcy Code exempts from avoidance, among other things, constructively fraudulent transfers that were "settlement payments"[36] made by or to a stockbroker or financial institution. That exemption is not limited to publicly traded securities, but is equally applicable in a leveraged buy-out (LBO) of privately held stock, according to the U.S. District Court for the Western District of Michigan in *QSI Holdings, Inc. v. Alford (In re QSI Holdings, Inc.)*.[37]

[34] On January 30, 2008, the Debtors filed a Petition for Writ of Certiorari to the Supreme Court.
[35] 184 B.R. 91 (B.A.P. 9th Cir. 1995).
[36] A "settlement payment" is defined under the relevant definitional statute 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." 11 U.S.C. §§ 546(e), 741(8).
[37] 2007 WL 4557855 (Dec. 21, 2007).

Back To TOC

In *QSI Holdings*, shareholders received payment for their equity interests in privately held companies (through a clearing agent bank) as part of an LBO that occurred several years before the bankruptcy filings. The debtors alleged that the shareholders gave less than reasonably equivalent value when they tendered their stock for cash and that the LBO left the company with unreasonably small capital and caused the company to incur debts beyond its ability to pay. On that basis, the debtors sought to avoid the transfers as fraudulent conveyances. The defendants argued that Bankruptcy Code section 546(e) exempted the transfers from avoidance. The bankruptcy court disagreed, but on appeal the district court applied the Code section 546(e) exemption to the transaction.

The *QSI* Court, *citing Kaiser Steel Corp. v. Charles Schwab & Co., Inc*.[38] noted that the purpose of this exemption is "to minimize the displacement caused in the… securities markets in the event of a major bankruptcy affecting those industries" by preventing the avoidance of settled securities transactions, including in the context of leveraged buy-outs (LBOs) *(QSI Holdings, Inc. v. Alford).*[39]

The debtors argued that settlement payments, within the context of the Code section 546(e) exemption, should be limited to publicly traded securities. In ruling for the defendants, the district court rejected the debtors' argument because there was no evidence that Congress intended to exclude transactions such as an LBO of privately held stock from the exemption. The district court refused to base its ruling on "discerned" congressional intent.[40] Under the district court's analysis, interpretation of the exemption necessarily begins with the plain meaning of the statute. If the statutory language is not "inescapably ambiguous" and application of the plain meaning does not lead to absurd results, then the plain meaning must be followed. A "settlement payment" is defined 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*" (emphasis added).[41] In this case, the mere fact that the statutory definition of "settlement payment" is broad, including "any payment commonly used in the securities industry," does not render it ambiguous. Further, applying the term "settlement payment" broadly in the case produced no absurdity. Given the multitude of shareholders, many of whom likely reinvested the proceeds of the LBO, the district court questioned whether the undoing of hundreds of transactions would not cause disruption in the securities markets. Further, at least one of the debtors' major creditors who would benefit from recovery of the LBO transfers provided financing for the LBO and, therefore, would have been fully aware of the financial context of the LBO.

Under these circumstances, the district court opted to follow a broad interpretation of "settlement payment" as advocated by courts in the 3rd, 9th and 10th Circuits and refused to look past the language of the statute to attempt to limit application of section 546(e) to transactions involving public securities.[42] Because the LBO payments were settlement payments made by the exchange agent bank (a "financial institution"), such payments fell squarely within section 546(e) and were exempt from avoidance.

---

[38] 913 F.2d 846, 848-49 (10th Cir. 1990).
[39] 2007 WL 4557855 at *5.
[40] Although the bankruptcy court judge did state in his opinion that "[a]s a voice from the rivers and forests of Michigan, this judge hopes that Congress will reassess section 546(e)." 355 B.R. 629, 635 n. 5 (Bankr. W.D. Mich. 2006).
[41] 11 U.S.C. §§ 546(e), 741(8).
[42] *See id*. at *6 (citing cases); *but see In re Norstan Apparel Shops, Inc.*, 367 B.R. 68, 75-76 (Bankr. E.D.N.Y. 2007) (examining section 546(e) and holding that the transfer sought to be avoided was not a "settlement payment" because it did not involve publicly traded securities or otherwise implicate the public securities markets).

To view the *In re Quality Stores, Inc.* opinion, please visit http://www.akingump.com/files/upload/1096.pdf

For further information, please contact:

David P. Simonds
310.552.6692
dsimonds@akingump.com
Financial Restructuring Group

CONTACT INFORMATION

If you have questions about these topics, please contact any of the lawyers listed below:

Editor in Chief

Peter J. Gurfein.....310.552.6696..... pgurfein@akingump.com.....Los Angeles

Managing Editor

Philip C. Dublin.....212.872.8083..... pdublin@akingump.com ..... New York

Contributing Editors

Maggie D. Conner .....713.250.2151..... mconner@akingump.com.....Houston
J. Meritt Crosby Jr. .....214.969.4255..... mcrosby@akingump.com..... Dallas
Ryan C. Jacobs .....212.872.7434..... rjacobs@akingump.com ..... New York
Christina M. Moore .....310.229.1082 ..... cmoore@akingump.com .....Los Angeles
Joanna F. Newdeck.....202.887.4549..... jnewdeck@akingump.com ..... Washington, D.C.
Tracy Southwell, *Paralegal*.....310.728.3029..... tsouthwell@akingump.com.....Los Angeles

Austin Beijing Dallas Houston London Los Angeles Moscow
New York Philadelphia San Antonio San Francisco Silicon Valley Taipei Washington, D.C.

Back To TOC