In Re Kaiser Steel Corporation: Does Section 546(e) of the Bankruptcy Code Apply to a Fraudulent Conveyance Made in the Form of an LBO Payment?

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IN RE KAISER STEEL CORPORATION: DOES SECTION 546(e) OF THE BANKRUPTCY CODE APPLY TO A FRAUDULENT CONVEYANCE MADE IN THE FORM OF AN LBO PAYMENT?

I. Introduction

In the 1980’s, easy credit and the availability of junk bond financing created a frenzy of leveraged buyouts (“LBOs”). These LBOs transformed many companies into debt-laden institutions destined to go bankrupt. When these companies inevitably file for bankruptcy, the first question is whether creditors should be permitted to sue an original stockholder under fraudulent conveyance law to recover the LBO acquisition payments ("LBO payments") that were made to the original stockholder to purchase his stock. Assuming creditors can sue

1. A "leveraged buyout" occurs when a group of investors acquires the stock of a company with borrowed money that is secured by the assets of the company to be purchased. Ultimately the debt is paid with money generated by the acquired company's operations or the sale of its assets. The new debt increases the fixed interest cost and limits the ability of the company to increase debt to survive an economic slowdown. The risk is that a small decline in operating cash flow will force the company into bankruptcy. See THE BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 1990, Table 883 at 534 (1990). See also Benjamin J. Stein, End of an Era? Why the Great Takeover Frenzy of the Eighties May Have Peaked, BARRON'S, Aug. 28, 1989, at 14.

2. A fraudulent conveyance exists where a debtor makes a transfer before bankruptcy for which he receives less than reasonable equivalent value. The classic example is the bankrupt farmer who sells his cow to his neighbor for a mere shilling. The remedy for this injustice is to avoid the transaction and return the cow to the farmer's estate. A fraudulent conveyance occurs in an LBO if the purchaser uses new debt, secured by the assets of the company, to purchase the stock of the company and such purchase leaves the company insolvent or with an unreasonably small capital base. Courts have held that the purchased stock does not represent adequate consideration because the stock does not increase the assets available to the creditors. Thus, the proceeds of the new debt have been squandered and the creditors have been left with a less than adequate asset base. Therefore, when the company inevitably files for bankruptcy or becomes insolvent, the creditors desire to have these assets returned to the estate. The debtor can sue to recover the squandered assets under section 548 of the Bankruptcy Code or alternatively if the debtor is not a debtor under the Bankruptcy Code, he can sue under state fraudulent conveyance law. State fraudulent conveyance law is also incorporated in the Bankruptcy Code under 11 U.S.C. § 544 (1991). See also Kevin J. Liss, Fraudulent Conveyance Law and Leveraged Buyouts, 87 COLUM. L. REV. 1491 (1987); Douglas G. Baird & Thomas H. Jackson, Fraudulent Conveyance Law and Its Proper Domain, 38 VAND. L. REV. 829 (1985); Emily L. Sherwin, Creditors' Rights Against Participants in a Leveraged Buyout, 72 MINN L. REV. 449 (1988); David G. Carlson, Leveraged Buyouts in Bankruptcy, 20 GA. L. REV. 73 (1985); David A. Murdoch, Linda D. Sartin, & Robert A. Zadek, Fraudulent Conveyances and Leveraged Buyouts, 43 BUS. LAW. 1 (1987); Alan Russo, Fraudulent Conveyance Claims in Leveraged Buyout Bankruptcies, N.Y.L.J., Aug.
an original stockholder, the second question is: who is the original stockholder, the recipient of the LBO payments, the stockholder or the stockbroker who received the LBO payment on behalf of the stockholder? More specifically, may the stockbroker be treated as a mere conduit of the funds, immune from liability?

Although case law has established that the Bankruptcy Code permits a debtor to recover LBO payments that constitute fraudulent conveyances, the Tenth Circuit in Kaiser Steel Corp. v. Charles Schwab & Co., Inc. recently denied a corporate debtor such a recovery from Charles Schwab & Co. The court held that section 546(e)


Fraudulent transfers and obligations

(a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily—

(1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

(2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(B)(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

(ii) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or

(iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.


6. 11 U.S.C. 546(e) (1989) states:

Notwithstanding sections 544, 545, 547, 548(a)(2), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 101(34), 741(5), or 761(15) of this title, or settlement payment, as defined in section 101(35) or 741(8) of this title, made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, or security clearing
of the Bankruptcy Code protected transfers to stockbrokers made pursuant to an LBO because such transfers represented "settlement payments," and were thus exempt from the avoidance power of the bankruptcy trustee. Congress enacted section 546(e) to protect the securities markets from the disruptive effects of bankruptcy. However, neither the express language of the Bankruptcy Code nor its legislative history make clear whether an LBO payment is a "settlement payment" within the meaning of section 546(e). The Kaiser Steel court broadly interpreted the term "settlement payment" to extend the protection of section 546(e) to LBO transactions, and thereby arguably unfairly denied recovery to the victims of a fraudulent conveyance.

This Comment considers whether, in spite of the Kaiser Steel decision, a bankruptcy trustee should be able to recover a fraudulent conveyance made to a stockholder's brokerage account in the form of an LBO payment. Part I summarizes the Kaiser Steel opinion and questions the court's interpretation of earlier case law. Part II explains why an LBO payment to a stockholder's brokerage account should not qualify as an exempt "settlement payment" under section 546(e) and thus should be recoverable as a fraudulent conveyance under section 548; Part III assumes that such payment is recoverable as a fraudulent conveyance from the initial transferee of such payment and considers whether the initial transferee is the stockholder or the stockbroker who accepted the payment into the stockholder's account. The question is whether the stockbroker should be liable as an initial transferee or whether the stockbroker should be protected as an innocent conduit of the payment. This Comment concludes that section 546(e) should be construed to allow the recovery from a stock-

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7. According to 11 U.S.C. § 550 (1989), if the bankruptcy trustee avoids a payment made before bankruptcy, the transaction must be reversed and the payment returned to be distributed according to the priority of creditors. See infra note 115.
8. Kaiser Steel, 913 F.2d at 848-49.
9. Congress first amended the Bankruptcy Code in 1982; it enacted section 546(e) to extend the commodities market protections to the securities markets. Section 546(e) limited the ability of a bankruptcy trustee to avoid transfers that were margin or settlement payments to stockbrokers or financial institutions. Congress next amended the Code in 1984 and enacted section 546(f) to specifically extend these protections to the market for the repurchase of government securities ("the repo market"). See H.R. REP. No. 420, 97th Cong., 2d Sess. (1982). Recently in 1990, Congress added 546(g) to give specific protection to the interest rate swaps market. See H.R. REP. No. 484, 101st Cong., 2d Sess. (1990) and S. REP. No. 285, 101st Cong., 2d Sess. (1990).
holder of a fraudulent conveyance made in the form of an LBO payment. It also asserts that a bankruptcy trustee, or a debtor in possession, should be permitted to recover an LBO payment from a stockholder but not from a stockbroker who merely functions as an innocent conduit in the LBO payment process.

II. Summary of Kaiser Opinion

In 1984, Kaiser Steel Corporation ("Kaiser") entered into a leveraged buyout transaction (the "Kaiser LBO"). The Kaiser LBO commenced with a proxy statement and prospectus that advised shareholders of the upcoming annual shareholders meeting and the proposed LBO transaction. At the meeting, the majority of shareholders of Kaiser common stock approved the proposed LBO. As a result, all shareholders were required to tender their shares to Kaiser in exchange for the right to receive for each share $22 in cash and two shares of preferred stock in the acquiring corporation.

Kaiser subsequently filed for bankruptcy and sued Charles Schwab, Inc. ("Schwab"), a discount brokerage firm that had accepted LBO payments in exchange for Kaiser shares owned by its clients. Kaiser, the debtor, argued that the LBO payments to Schwab should be avoided as fraudulent conveyances and returned to the creditors. Kaiser asserted that Schwab was the initial transferee of the LBO payments.

In response to the avoidance suit, Schwab sought summary judgment on two grounds. Schwab claimed that it was not liable because it was merely a "conduit" through which the LBO payments flowed and because the LBO payments were "settlement payments" that, by virtue of section 546(e) of the Bankruptcy Code, were not subject to the trustee's avoidance power. The bankruptcy court denied Schwab's motion on both grounds, and the district court reversed on both grounds. The circuit court affirmed the district court and held

13. Id.
14. Id.
15. 11 U.S.C. § 550(a) permits recovery from:
   (1) the initial transferee of such transfer or the entity or the entity for whose benefit such transfer was made; or
   (2) any immediate or mediate transferee of such initial transferee.
17. Id. at 650-53.
that the LBO payments were "settlement payments" under section 546(e). The circuit court, however, failed to address the conduit issue.19

The bankruptcy court held that the LBO payments were not exempt as settlement payments to a stockbroker because the payments were not made in the ordinary course of the stockbroker's business, i.e. the settlement of ordinary purchases and sales of stock.20 From the legislative history, the court determined that Congress intended to restrict the meaning of "settlement payments" to include only those payments made in the ordinary course of business.21 The ordinary course of business of a stockbroker is to settle buy or sell orders for shares of stock in the open market. The court further held that, according to agency law, the stockbroker was liable as the initial transferee of the payment.22 According to agency law, an agent is immune from contract liability only if the contracting party had knowledge of the agency status and the identity of the principal.23 Because the stock was held by Schwab in a street name, the purchaser had no knowledge of the principals who were the actual owners of the stock.

The district court, reversing the decision of the bankruptcy court, held that the LBO payments should be considered settlement payments because the Bankruptcy Code's definition included "any similar payment commonly used in the securities trade."24 The court interpreted this phrase to give the term "settlement payment" "a reasonably flexible meaning with reference to industry practice."25 The court cited Bevill, Bresler & Schulman Asset Mgt. Corp. v. Spencer Sav. & Loan Ass'n.26 and Blanton v. Prudential-Bache Securities, Inc.27 to support its flexible interpretation. The district court rejected the bankruptcy court's agency analysis of the transferee issue. Instead it followed the case law exempting mere conduits from transferee liability and held that the stockbroker was such a conduit.28

On appeal to the Tenth Circuit, the Kaiser court addressed whether the LBO payments were "settlement payments" under section 546(e).

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21. Id.
22. Id. at 649-50.
The court held that the LBO payments were settlement payments and thus not recoverable because settlement payments are exempt from avoidance as a fraudulent conveyance under section 548. The court looked to the definitions referenced in section 546(e) of the Bankruptcy Code and concluded that the referenced sections, sections 101(35) and 741(8), did not provide a clear definition of “settlement payment.” Because these Bankruptcy Code definitions are circular and relatively ambiguous, the court turned to the case law and legislative comments to determine the intended meaning of the term “settlement payment.”

Few courts have attempted to interpret section 741(8). In Kaiser, the Tenth Circuit looked to In re Bevill and In re Blanton to support an “extremely broad” definition of “settlement payment” that was not limited to settlements in the ordinary course of business. The court justified its reliance on these cases because it claimed that a broad interpretation was “consistent with the legislative intent behind section 546 to protect the nation’s financial markets from the instability caused by the reversal of settled securities transactions.” The court also noted that its decision to treat LBO payments as settlement payments was consistent with the securities industry’s definition of “settlement payment.”

The Kaiser decision unfairly relied on the persuasive authority of

29. Section 101(35) of the 1990 Bankruptcy Code states:
   “settlement payment” means, for purposes of the forward contract provisions of
   this title, 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 forward contract
   trade.


31. Bevill, 878 F.2d at 751.


33. Id.; Bevill, 878 F.2d at 751.

34. Kaiser Steel Corp. v. Charles Schwab & Co., 913 F.2d 846, 848-49 (10th Cir.
    1990).

35. Id. (citing Kaiser Steel Resources, Inc. v. Jacobs, 110 B.R. 514, 522 (Bankr. D.
    Colo. 1990)).

36. Securities industry defines “settlement” to be “[t]he completion of a transaction,
    wherein securities and corresponding funds are delivered and credited to the appropriate
    accounts,” NEW YORK STOCK EXCHANGE, LANGUAGE OF INVESTING GLOSSARY 30
    (1981). The SEC took the position in Kaiser that the consumation of an LBO is a settle-
    ment payment. Kaiser Steel Corp. v Charles Schwab & Co., 913 F.2d 846, 849-50 (10th
    Cir. 1990).
the *In re Blanton* and *In re Bevill* decisions. These cases involved different markets and different sections of the Bankruptcy Code. The next section will summarize these decisions, distinguish them, and explain why their broad interpretation of "settlement payment" should not apply to LBO payments in the equity securities market.

A. Summary of Blanton

*In re Blanton* involved margin payments of a Prudential-Bache employee, Blanton, used to cover the currency options that he sold. Blanton used leverage to sell put and call options on the Swiss franc. The options created a band of volatility within which he would make money.\(^{37}\) If the franc traded above or below the band, he would liqui-

\(^{37}\) *Blanton*, 105 B.R. at 326-27. An option is a contract that gives its holder the right to buy or sell an asset at some predetermined price within a specified period of time. To understand how options work, suppose an investor owns 100 Swiss francs which on April 11, 1985 sell for 65 dollars. The investor could sell someone else the right to buy his 100 Swiss francs at any time during the next three months for a price of 70 cents per franc. The 70 cent price is called the exercise or striking price. This type of option is referred to as a call option. The seller of the option is defined as an option writer. An investor who sells a call option against Swiss francs in his portfolio is said to be selling a covered option. Options sold without the francs to back them up are called naked options. For example suppose an investor sells 3 month naked call options for 100 francs at 70 cents a franc. If the price of a franc reaches 80 cents per franc and the option is exercised, the writer must cover his position to pay the option holder. The writer is forced to buy 100 francs on the open market for 800 dollars and then sell the 100 francs to the option holder for 70 cents per franc or 700 dollars, resulting in a 100 dollar loss.

A speculator could also sell someone the right to sell Swiss francs at a specified price at any time in the next three months. This type of option is called a put option. Suppose you sell a 3 month put option on 100 Swiss francs at a strike price of 60 cents per franc. If the market price for francs decreases to 50 cents per dollar and the put option is exercised, the writer of the option must buy 100 Swiss francs for 600 dollars and then sell them on the open market for 500 dollars, taking a loss of 100 dollars.

A straddle results when an investor buys put and call currency options to profit on an increase or decrease in price of a currency above or below the two strike prices. If an investor feels that the price of a currency will remain between the band created by the upper and lower strike price, he can sell both put and call options. If at the end of the option period the market price of the currency has not gone above or below the band, he will profit by the amount of the sale price of the options. An investor who has sold put and call options to create a band can limit his losses by rolling over his position. He rolls his position by covering his losing position and selling more put and call options to create a new band below or above the original band depending on the direction of the loss. For example, if he sells a put option to strike at 60 and a call option to strike at 70 and the market value of the currency changes from 65 to 55, he will sell new puts at 50 and calls at 60 to help pay for the loss on his original put options. This system helps to control the negative effects of increased volatility but is disastrous in the face of a long term steady decline or rise of a currency.

date his losing position and cover his losses with the proceeds from the sale of more options above and below the new franc value.\textsuperscript{38} In January of 1987, a continuous fall in the value of the U.S. dollar against the Swiss franc created margin calls that Blanton could not cover. In response to the uncovered margin calls, Prudential-Bache liquidated Blanton’s option positions at a substantial margin account deficit.\textsuperscript{39} Blanton could not cover this deficit and consequently filed for bankruptcy.\textsuperscript{40}

Blanton sued Prudential-Bache to recover his margin payments as preferences.\textsuperscript{41} Prudential-Bache argued that the margin payments were protected under section 546(e).\textsuperscript{42} The court held that all of the payments were essentially margin payments, except for one payment that was a “settlement payment.” This payment was intended to compensate Prudential-Bache for its expenditures associated with closing out Blanton’s positions.\textsuperscript{43} To close out Blanton’s positions, Prudential-Bache had used its own funds to purchase options voiding those sold by Blanton. Because Blanton’s payment was not used to cover funds borrowed on margin, the margin payment was atypical. To avoid explaining why the payment should be considered a margin payment, the court stated that the terms “margin” and “settlement payment” were “very broadly defined by the Bankruptcy Code.”\textsuperscript{44} Thus, the court held that the payment should be treated as a settlement payment under section 546(e).\textsuperscript{45} The court focused its discussion on the definition of “margin payment”\textsuperscript{46} and neglected to consider the legislative history associated with the term “settlement payment.”

### B. Summary of Bevill

The second case upon which the \textit{Kaiser} court relied, \textit{In re Bevill}, involved the transfer of federal government securities pursuant to a repo agreement.\textsuperscript{47} In \textit{Bevill}, the purchaser entered into a “hold-in-
custody" repo agreement whereby the seller retained possession of the securities. Several weeks after entering into the repo agreement, the seller transferred the securities to the purchaser. Within 90 days of this agreement, the seller filed for Chapter 11 reorganization, and the purchasers liquidated the securities. The Chapter 11 bankruptcy trustee sought to avoid the prepetition deliveries of securities to the purchasers as preferences and fraudulent conveyances.\(^{48}\)

The Third Circuit in *Bevill* held that section 546(f) of the Bankruptcy Code bars a Chapter 11 trustee from utilizing sections 547 and 548 to recover securities or their proceeds from a repo participant.\(^{49}\) Section 546(f) resembles section 546(e); however, section 546(f) was enacted in 1984, two years after section 546(e), and applies to settlement payments made to repo participants.\(^{50}\) The circuit court interpreted section 546(f) to define broadly the term "settlement payment."\(^{51}\) The court held that the transfer of the securities was included in the wide array of accepted settlement procedures for repos and, therefore, should be exempt from avoidance in accordance with the policies behind section 546(f).

The circuit court recognized the flexible and varied settlement practices in the repo market for government securities.\(^{52}\) The court described three traditional repo methods of delivery: a "deliver-out" repo, a "tripartite" repo, and a "hold-in-custody" repo. A "deliver-out repo" provides for the securities to be delivered to the purchaser...
or his designated custodial bank. A “tripartite” repo requires delivery to a third party, usually a custodial bank, which holds the securities for the benefit of both parties. A “hold-in-custody” repo allows the dealer to retain control of the securities as long as the dealer identifies them on his own books as securities subject to specific repo transactions. Some broker-dealers will pay a higher repo rate if the buyer does not require that the securities be physically delivered or transferred over the wire.53

In Bevill, the circuit court held that the transfer of the securities from the seller to the purchaser was the conversion from a “hold-in-custody” repo to a more traditional “deliver-out” repo and that, therefore, because the transfer of securities was designed to effect this conversion, it was an accepted method of “settlement payment.”54 The court stated that section 741(8) of the 1982 amendments to the Code broadly defined “settlement payment” and, consequently, “the district court did not interpret ‘settlement payment’ in accordance [with] the realities of the repo market or in accordance with congressional intent.”55 The court held that the “settlement payment” encompassed all transfers that were traditionally part of the settlement process, regardless of the date on which the transfers occurred.56

The court justified its broad interpretation of “settlement payment” by citing the public policy behind section 546(f). The court first examined the policy behind section 546(e), the 1982 amendment which served as the model for 546(f). The public purpose of section 546(e) was to prevent “the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market.”57 In enacting the section, Congress desired to protect the market from the devastating ramifications of a “ripple effect.”58

53. Id. (citing Br. for Appellant Niagra County Savings Bank, citing The Use of Repurchase Agreements by Broker-Dealers, SEC DIRECTORATE OF ECONOMIC AND POLICY ANALYSIS 18 (Dec. 1987)).
54. Bevill, 878 F.2d at 744.
55. Id. at 751. The Bevill district court focused on the definition of “settlement payment” in the context of corporate securities transactions between a stockholder and a customer. Because securities trades customarily settle within five business days of execution, the court concluded that “settlement payment” refers to a transaction that is consummated within five days of the agreement to purchase. The Bevill district court held that the payment was not a settlement payment because the delivery occurred outside the traditional five day settlement period. Id. at 750.
56. Id. at 752.
57. Id. at 747 (citing H.R. REP. No. 420, 97th Cong., 2d Sess. 1 (1982)).
58. Id.
After the 1982 amendments were in effect, *In re Lombard-Wall* asserted that the amendments did not "adequately protect liquidations of repos in the event of the insolvency of a dealer or other participant in the repo market." In response, Congress passed the 1984 amendments, including the addition of sections 362(b)(7), 546(f), and 559, authorizing repo participants to liquidate their securities and keep the proceeds to the extent of their contract price. The 1984 amendments manifested Congress' increased concern for maintaining the efficiency and stability of the repo market. The *Bevill* court acknowledged Congress' intent to give specific protection to the repo market and therefore interpreted the term "settlement payment" broadly to reflect this intent.

III. The Term "Settlement Payment" Should Have Been Interpreted Narrowly In Connection With The Equity Securities Market

The Tenth Circuit in *Kaiser* relied on both *In re Blanton* and *In re Bevill* to extend a broad definition of "settlement payment" to the equity securities markets. The *Kaiser* court should not have applied such a broad definition of the term "settlement payment" to the equity securities market. First, the broad definitions of "settlement payment" used in *Blanton* and *Bevill* do not apply to the equity securities market because *Blanton* focuses on transactions that are margin payments, and *Bevill* formulates a definition reflecting Congress' specific intent to protect the repo market. Second, Congress intended that the term "settlement payment" would encompass only payments made in the ordinary course of business. LBO payments, however, are not ordinary payments. Third, justice and public policy mandate a more

60. *Bevill*, 878 F.2d at 747 (citing the 1983 Senate report at 47). In the *Lombard-Wall* case, the Bankruptcy Court for the Southern District of New York held that the holder of securities subject to a repurchase agreement was subject to the automatic stay provision of the Bankruptcy Code and could not close out its position with the debtor without the court's approval. The case manifested the risks to the repo market created by the Code's automatic stay and avoidance provisions and the inability of the 1982 amendments to fully protect the repo market from the bankruptcy of market participants. Hearings conducted by the House of Representatives demonstrated that under the *Lombard-Wall* holding the repo participant would be subjected "both to the unexpected inability to liquidate securities it holds and to the risk of capital loss should unfavorable interest rate changes occur; these risks impair the qualities that are the essence of the appeal of repo agreements." *Id.*
61. 11 U.S.C. §§ 546(f), 559.
narrow interpretation of "settlement payment," an interpretation that does not permit stockholders to retain windfall profits at the expense of innocent creditors.

A. The Blanton and Bevill Definitions Do Not Apply to the Equity Securities Market

In analyzing a statute, a court should not be guided by a single sentence or phrase of a sentence, but should look to the provisions, objectives, and policy of the law. According to Justice Holmes, "A word is not a crystal, transparent and unchanged, it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used." As Justice Traynor said, we need "literate, not literal" judges. Thus, the definition of "settlement payment" in section 546(e) should reflect the congressional intent to protect the stability of the equity securities market. The repo market is a completely different securities market; its purpose and importance are separate and apart from that of the equity securities market.

The broad definitions of "settlement payment" employed by the courts in Blanton and Bevill are inappropriate for the equity securities market. The Blanton court molded the term to avoid classifying a payment as a margin payment. The case essentially involved a margin payment and the market for currency options. Moreover, the case focused on the term "margin payment" in section 546(e) and failed to mention the legislative history of the term "settlement payment." The specific interpretation of "settlement payment" in the context of margin payments on currency options should not be applied to LBO payments in the equity securities market.

The Bevill court's definition of "settlement payment" also is similarly inappropriate for the equity securities market. The Bevill court interpreted the term "settlement payment" in the context of section 546(f), a section specifically designed to protect the repo market. Thus, the Bevill interpretation reflected a market whose size and interdependent nature requires a higher degree of protection. The repo market in government securities is a huge market that serves several vital roles in the nation's economy. The repo market facilitates

63. Bevill, 878 F.2d at 750.
66. See supra note 57.
68. See supra note 36.
the auction of government securities, helps the federal reserve to control the money supply, and enhances the liquidity of mortgage-backed securities.69

The United States Treasury relies heavily on the repo market to finance the national debt at the lowest possible cost.70 New issues of Treasury debt securities initially are offered to approximately thirty-six primary dealers at auction.71 The primary dealers themselves lack the funds required for the outright purchase of these securities. Consequently, the dealers need financing and traditionally have relied on repo transactions with secondary dealers to provide the lowest cost of financing.72 Secondary dealers, in turn, finance their purchases by selling the securities under repos to institutional customers.73 Banks may be able to provide the necessary financing, but the cost of bank debt would be greater and would result in lower bids at auction. An inefficient repo market would translate into higher interest rates for government securities.74

Furthermore, the Federal Reserve has used the repo market as an effective short-term mechanism for the implementation of monetary policy.75 The Federal Reserve makes extensive use of repos in regulating the level of bank reserves.76 To smooth unexpected fluctuations of the monetary supply, the Federal Reserve engages in repo transactions as a seller, to decrease bank reserves, and as a buyer, to increase bank reserves.77 Constant monetary supply is important to prevent fluctuations in short-term interest rates and the rate of inflation.78 During 1985, the Federal Reserve entered the repo market over 150 times, and Federal Reserve operations in the market on a single day often reached three to four billion dollars and as high as seven billion dollars.79

Finally, the repo market contributes to a strong housing market by enhancing the liquidity of mortgage-backed securities that are insured

70. Id. at 567 (citing Sternlight, the Executive Vice President of the Federal Reserve Bank of New York, Aff. ¶ 7, at 4).
72. Id.
73. Blanton, 67 B.R. at 567; Bevill, 878 F.2d at 746.
75. Id. See HARRISON, supra note 71.
77. Id. at 567-68.
78. HARRISON, supra note 71.
79. Bevill, 67 B.R. at 568 (citing Sternlight, the Executive Vice President of the Federal Reserve Bank of New York, Aff. ¶ 4, at 3).
by government sponsored agencies such as GNMA and FNMA. Thus, disruption of the repo market would result in higher repo rates and, hence, higher home mortgage rates.

Because of the importance of the repo market to the economy, Congress concluded that:

The effective functioning of the repo market can only be assured if repo investors will be protected against open-ended market loss arising from the insolvency of a dealer or other counter-party in the repo market. The repo market is as complex as it is crucial. It is built on transactions that are highly interrelated. A collapse of one institution involved in repo transactions could start a chain reaction, putting at risk hundreds of billions of dollars and threatening the solvency of many additional institutions.

Because the repo market offers short-term liquidity and low risk of capital loss, it operates at rates similar to those of government securities. If the repo market were disrupted by bankruptcy legislation, the rates would be controlled by the credit of the participant and only AAA participants could operate efficiently. Furthermore, the highly interdependent nature of the repo market suggests that a disruption of the market could lead to a financial crisis.

The equity securities market, in contrast, is much smaller and plays a less fundamental role in the national economy. Although the average daily repo volume is several hundred billion dollars, the daily volume of the New York Stock Exchange for 1988 was approximately five billion dollars. Even after the market crash on October 17, 1987, the record volume of the New York Stock Exchange was only 75 billion dollars for the entire week ending October 23. Because the stock market is smaller and not as interdependent as the repo market, the stock market can survive disruptions more easily with

80. Id. The federal government has established three major organizations to purchase mortgage securities from the financial institutions that originally made the loans. The three organizations are the Federal National Mortgage Association (FNMA), the Government National Mortgage Association (GNMA), and the Federal Home Loan Mortgage Corporation (FHLMC). These organizations purchase loans, guarantee them, and then sell them to the secondary markets. The government guarantee permits the mortgages to trade in the secondary markets at yields only slightly higher than U.S. Treasury bonds.
81. Id. (citing Goldman Report at 12).
83. AAA is Standard & Poor's highest credit rating.
84. See supra note 36.
85. Id.
86. FEDERAL RESERVE BULLETIN, Table 1.43, at A32 (June 1990).
88. Id. at 5-6.
fewer negative effects. In contrast to the repo market, the primary role of the stock market is to provide liquidity to market participants.

The equity market thrives on risk. Collateral does not exist, and in the event of bankruptcy, the equity investor usually loses his entire investment. Unlike investors in the repo market, who seek short-term liquidity and low risk of capital loss, investors in the equity markets acknowledge the risks involved and invest primarily for long-term profits.

If courts permitted the avoidance of fraudulent stock buyouts, the equity markets would not be affected significantly. The value of potential takeover stocks would fall to reflect the new risk associated with LBOs. Although equity investors would be forced to pay back fraudulent LBO payments, such payments would represent only a minor portion of investor funds and would not affect demand in the market. Moreover, avoidance would not create a ripple effect because the Securities and Exchange Commission carefully regulates leveraged securities investing and because the liabilities incurred by investors would be minor in comparison to the diversified portfolios of the investors.

Because the equity market is smaller, less interdependent, and not as closely linked to the framework of the national economy as the repo market, the avoidance of stock buyout payments would not significantly disrupt the routine business of the market or undermine the public policy to protect the market.

B. The Intent of Congress Demands a Narrow Interpretation

Congress intended the term “settlement payment” in section 546(e) of the Bankruptcy Code to refer only to payments in the ordinary course of business in the securities market. Congress’ restrictive in-

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91. Brealey & Myers, supra note 89, at 149-50.
93. Brealey & Meyers, supra note 89, at 125-68.
94. See supra note 4.
tent originated from section 764(c).

Congress enacted section 546(e) in 1982 to replace section 764(c), which applied only to commodity brokers. Section 764(c) was enacted in reaction to *Seligson v. New York Produce Exchange*, which held that a trustee could recover a margin payment made to a commodities clearing house. The court's decision in *Seligson* protected margin payments from the avoiding powers of the trustee except in cases of actual fraud under Bankruptcy Code section 548(a)(1).98 Congress intended section 764(c) to protect only transactions made in "the ordinary course of business in the market."99 In 1982, Congress repealed section 764(c) and incorporated it into 546(e) to "clarify and, in some instances broaden the commodities market protections and expressly extend similar protections to the securities markets."100 Congress' intention in doing so was "to minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries."101

Collier's Bankruptcy Treatise maintains that section 546(e) did not expand the underlying provisions of former section 764(c).102 Rather, Collier claims that Congress intended to retain the qualification that a transaction be in the ordinary course of business in the market. Thus, Congress did not intend to protect the special event of the settlement of a tender offer for stock.103

The *Bevill* court recognized Congress' intent to restrict the meaning of "settlement payment" to the ordinary course of business. The *Bevill* court's broad definition of "settlement payment" expanded the meaning to encompass various acceptable settlement methods commonly used in the market. However, the *Bevill* court did not expand the definition to include transactions outside of the ordinary course of business.104

The purpose of section 546(e) is to protect the market from the destabilizing effects of bankruptcy.105 The stability of the market does not depend upon the treatment of unusual settlement payments that

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548(a)(1). This facilitates prepetition transfers and protects the ordinary course of business in the market. See also 4 *COLLIER ON BANKRUPTCY* § 546.05, at 546-24 (1990).
98. *Id.*
101. *Id.* at 1.
102. 4 *COLLIER ON BANKRUPTCY* § 546.05, at 546-24 (1990).
103. *Id.*
104. *Bevill*, 878 F.2d at 752.
105. Kaiser Steel Corp. v. Charles Schwab & Co., Inc., 913 F.2d 846, 848 (10th Cir.)
occur outside of the ordinary course of a stockbroker's business. LBO payments are not routine settlement payments made in the ordinary course of business; they are special and unusual payments different from routine stock trades. In the LBO in Kaiser, all shares were mandatorily tendered according to a merger agreement that had been approved by a majority of the stockholders. After the buyout, the shares were no longer publicly traded. The transactions were not individual trades, but were the result of a corporate dictate that compelled the sale of an entire class of shares. Congress intended to protect trading in the market and did not intend to protect the organized selling of an entire class of stock in accordance with a merger agreement.

Even if, hypothetically, merger transactions were considered routine transactions in the ordinary course of business, certainly a large-scale merger that is so leveraged that it constitutes a fraudulent conveyance would not constitute a routine and ordinary transaction. Congress never envisioned allowing a windfall profit to shareholders that received fraudulent conveyances in the form of LBO payments ("fraudulent LBO payments"). Although large LBOs were open and notorious in the 1980's, Congress failed to mention LBO transactions either at the time of the enactment of section 546(e) in 1982 or at the time of the enactment of the 1984 repo amendments and the 1990 swap amendment. Because Congress acted to extend specific protection to repo participants, Congress demonstrated that it would provide specific legislation to protect transactions not expressly protected by the 1982 amendments. Congress did not create an amendment to protect LBO settlement payments; thus, it did not intend to protect them.

106. See supra note 52. If the payments are unusual, they will not affect the usual routine payments which constitute the day to day transactions of the market.
108. Id. at 643.
109. Id.
110. Id.
111. See supra note 52. Although actual fraud by the selling stockholders prevents the application of section 546(e), stockholders would rarely be in a position to know the fraudulent intent of the purchaser unless they were in a position close to the company such as an officer or board member of the company. The proxy statement will not provide enough information to make the selling stockholders intentionally fraudulent.
C. Justice and Public Policy Warrant a Narrow Interpretation

In the interest of justice and the public policy behind section 546(e), LBO payments should not be exempt from the avoiding powers of the trustee. The avoidance of LBO payments would prevent stockholders from enjoying the illicit rewards of fraudulent transfers and would cause stockholders to consider tender offers more carefully and reject offers likely to invite bankruptcy. The negative effects of permitting avoidance are insignificant. Avoidance would not cause a major disruption or financial collapse of the equity securities market; rather, avoidance would transfer the risk of bankruptcy from the credit markets to the equity market, where participants could control the risk of bankruptcy by voting against highly leveraged tender offers. Avoidance would deter LBOs, the purpose of which is not to operate a leveraged company effectively, but to gamble with creditors' money.\textsuperscript{115} If courts permitted avoidance, public policy would be served because stockholders would vote against such fraudulently structured LBOs.

Although protecting fraudulent LBO payments may increase the stability of equity securities markets, it simultaneously may decrease the stability in debt markets. While the equity seller need not consider the risk that his sale will be avoided in the event of a fraudulent conveyance determination, the debt holder must contemplate the possibility that an LBO involving the fraudulent conveyance will occur and thus cause the value of his debt securities to deteriorate. Thus, the issue presented is who should lose the value of his investment, the shareholder who voted for the fraudulent buyout or the innocent bondholder whose trust was violated. In the interest of justice, the trustee on behalf of the bondholders should be permitted to recover the fraudulent payments made to stockholders.

\textsuperscript{115} To facilitate a fraudulent LBO, a raider borrows against the assets of the target company and uses the proceeds of the new debt to buy the company from the stockholders. The raider then owns 100% of the equity of a highly leveraged company. If the company has a record year and can increase operating earnings above and beyond the increased interest cost, the raider will make a fortune. If, however, the company has a good, but not exceptional, year, the company will go bankrupt and the bondholders will not be paid in full. Because the raider bought the original shareholders' stock with the debt of the company and probably only a small amount of his own capital, he loses almost nothing. The result is that under 546(e), after the company files for bankruptcy, the creditors cannot recover the assets that have been fraudulently conveyed to the previous stockholders simply because the buyout payments were paid through a stockbroker. See supra note 1.
IV. Result: Broker should be Treated as Conduit

If a court disagrees with the reasoning of the Tenth Circuit in Kaiser, it may hold that the LBO payment to the broker is not protected as a settlement payment under section 546(e). If the payment is not protected, the bankruptcy trustee can avoid the LBO payment and seek repayment from the initial transferee of the fraudulent transfer under section 550(a).\textsuperscript{116} The question of whether the initial transferee is the stockbroker or the stockholder arises. Whether the broker should be considered the initial transferee, an agent for the initial transferee, or simply a "mere conduit," immune from liability, must be addressed. The broker should be treated as an innocent conduit, and the shareholders should be held liable as initial transferees.

Many brokers use security clearinghouses to enable them to transfer and pledge securities on behalf of their customers by means of computerized bookkeeping records without physically transferring the securities.\textsuperscript{117} As a participant, brokerage houses register their customers' securities in a nominee name or, "street name," to facilitate transfers. In Kaiser, Schwab used the Depository Trust Company ("DTC") to effect the redemption of its customers' stock and registered its customers' stock in the name of Schwab & Co.\textsuperscript{118} Although the broker was the physical transferee of the payment for the stock, and the stock was registered in the name of the broker, the broker was only an agent for its customers and could not be treated as a pure transferee.\textsuperscript{119} The broker, however, could be classified as either the agent for the owner of the stock or as a conduit of the funds.\textsuperscript{120}

The bankruptcy court in Kaiser held that the broker was an agent

\begin{itemize}
  \item \textsuperscript{116} Section 550(a) of the Bankruptcy Code governs the trustee's recovery of a fraudulent conveyance. This section provides:
    \begin{enumerate}
      \item except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from—
      \begin{enumerate}
        \item the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
        \item any immediate or mediate transferee of such initial transferee.
      \end{enumerate}
    \end{enumerate}
  \item \textsuperscript{118} Id. at 517.
  \item \textsuperscript{119} Id. at 519-21.
  \item \textsuperscript{120} Id. at 521.
\end{itemize}
for the stockholder and, therefore, was liable under agency law. The court asserted that conduit law did not apply where a direct contractual relationship between the debtor and the defendant existed. The court stated that "the strict application of agency law requires knowledge of the identity of the principals and not just the fact of the agency." Thus Schwab's agency status could be a defense only if the purchaser of the stock knew that Schwab was an agent and knew the identities of the principals. The court concluded that, because Kaiser's records showed that the stock was registered in the broker's name, Kaiser had a contract with the broker. The court claimed that the injustice to Schwab could be avoided by Schwab as agent recovering from its principals, the customers. Unfortunately, the transaction costs associated with recovering from a class of buyout recipients are extensive and would impose a significant liability on the broker.

The district court rejected the bankruptcy court's reliance on agency law and reversed the decision. The district court held that the broker was a conduit. It reasoned that the lower court incorrectly assumed that Kaiser's records indicated Schwab as the record owner of the stock when, in fact, the records revealed that the stock was registered in DTC's street name, "Cede & Co." Furthermore, the court stated that the agency analogy assumed a contract between Kaiser and Schwab; however, the court concluded that no contractual relationship existed.

The decision in Kaiser should not have been based on the street name in which the securities were registered because a broker could use a non-identifiable street name to escape liability. Moreover, the contract that existed was the merger agreement between Kaiser Steel Corporation and KAC, the acquiring corporation. The stockholders, including Schwab as agent for its customers, approved this merger agreement and therefore, were parties to that contract. Nevertheless,

121. Kaiser Steel Corp. v. Jacobs, 105 B.R. 639, 649-50 (Bankr. D. Colo. 1989). If a party enters into a contract in his own name and receives the benefit of that contract in his own name, he is liable for any obligations arising out of that contract even if he is not acting for his own account but is acting for the account of some undisclosed principal. Id.
122. Id. at 648.
123. Id. at 650.
124. Id. at 649-50.
125. Id. at 650.
128. Id. at 523.
the term "transferee" should be interpreted in terms of conduit theory to avoid the unjust consequences of agency law. Stockbrokers who merely accept funds on behalf of their customers should be treated as conduits.

Courts have interpreted section 550(a)(1) to qualify certain initial transferees as conduits who are immune from liability. The court in the seminal case, *In re Fabric Buys*,129 found that a law firm was not liable as an "initial transferee" for the funds that it received from the opposing party to settle a dispute with its client.130 The court held that the law firm acted as a mere conduit of funds from Fabric Buys to its client.131 It stated that an "initial transferee" is one who deals directly with the debtor132 and concluded that the lawyer was not a transferee simply because payments were funneled through an escrow account in his charge.133 The court further held that, even if the law firm were deemed to be the initial transferee, its power of equitable discretion could be exercised to prevent the trustee from recovering the payment from the law firm.134

The first district court case to apply conduit theory was *In re Colombian Coffee Co.*135 In *Colombian Coffee*, the trustee of the debtor sought to recover from a bank, funds that were fraudulently transferred to the bank for deposit into a second corporation's account. The court followed the decision in *In re Fabric Buys* and applied the conduit theory.136 The court cited Judge Cardozo's discussion of initial transferee liability: "the person to be charged with liability, if he has parted before the bankruptcy with title and possession, must have been more than a mere custodian, an intermediary or conduit between the bankrupt and the creditor."137

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130. *Id.* at 336-37.
131. *Id.* at 337.
132. *Id.* (citing 4 COLLIER ON BANKRUPTCY § 550.01, at 550-3 (15th ed. 1983)).
133. *Id.*
134. The *Fabric Buys* court cited COLLIER:
   In some circumstances, a literal application of section 550(a) would permit the Trustee to recover from a party who is innocent of wrongdoing and deserves protection. In such circumstances the bankruptcy court should exercise its discretion to use its equitable powers under section 105(a) and 28 U.S.C. § 1481 to prevent an inequitable result.
136. *Id.* at 178.
137. *Id.* (citing Carson v. Federal Reserve Bank, 254 N.Y. 218, 235-36, 172 N.E. 475, 482 (1930)).
The Seventh Circuit addressed the issue in *Bonded Financial Services, Inc. v. European American Bank.* The court introduced the "dominion and control" test to determine transferee status. In *Bonded Financial Services,* a bank received a check payable to the bank's order with a note directing the bank to deposit the money into their client's account. After this transaction the client instructed the bank to debit the account to pay down one of his outstanding loans from the bank. The court defined "dominion and control" as the right to put money to one's own purposes and concluded that the bank was not liable as an initial transferee because the bank did not have dominion and control over the money.

More recently, the Eleventh Circuit extended the "dominion and control" test in *In re Chase & Sanborn Corp.* In this case, a bankruptcy trustee sought to recover funds wired to a bank that were used to pay down a one day overdraft. The bank permitted the overdraft to facilitate the payment out of the account of funds which the bank had confirmed were to be wired into the account the next day. The court held that the overdraft did not create a debtor-creditor relationship and was insufficient to establish the bank's control over the money. The court stated that the control test "requires courts to step back and evaluate a transaction in its entirety to make sure that their conclusions are logical and equitable." It further found that "courts have refused to allow trustees to recover property from defendants who simply held the property as agents or conduits for one of the real parties to the transaction."

If a court objectively evaluates the role of a broker that accepts an LBO payment on behalf of its customer, it should conclude that the broker has no beneficial interest in the payment and is clearly "not more than a mere custodian, intermediary or conduit" between the parties. The broker does not have the right to use the payment for its own purposes and thus, does not have the "dominion or control"

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139. Id. at 893.
140. Id.
142. Id. at 1198. To pay down an overdraft means to deposit money to an account that has a negative balance.
143. Id. at 1200-02.
144. Id. at 1199.
145. Id. at 1199-1200.
See supra note 137 and accompanying text.
necessary to be considered a transferee. A stockbroker who acts as an intermediary for payments to his customers is an innocent conduit that should be immune from liability as a transferee.

V. Conclusion

The Kaiser court misinterpreted section 546(e) of the Bankruptcy Code and unjustly protected stockholders who had received leveraged buyout payments constituting fraudulent conveyances. The court confused the intent of Congress and incorrectly relied on cases inapplicable to the equity securities market. As a result, contrary to public policy, the Kaiser decision permitted stockholders to retain windfall profits at the expense of innocent creditors.

Other circuits should reconsider the Kaiser opinion. Section 546(e) should not protect a fraudulent conveyance in the form of an LBO payment. Instead, courts should permit the bankruptcy trustee to avoid such payments as fraudulent conveyances and recover such payments from the stockholders. Courts should not permit the trustee to recover from a stockbroker who as an innocent conduit does not qualify as a transferee. This interpretation of section 546(e) prevents stockholders from enjoying the proceeds of fraudulent conveyances, protects stockbrokers who are innocent conduits, and permits creditors to recover their rightful assets.

William C. Rand

147. See Nordberg v. Societe Generale, 848 F.2d 1196 (11th Cir. 1988).