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Payments to Investors in a Securitization Structure Protected from Avoidance

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In what appears to be a matter of first impression, the Bankruptcy Court for the Northern District of Illinois recently held that payments made to investors in the two-tiered securitization structures commonly employed in commercial mortgage-backed securitization (CMBS) transactions are largely protected from fraudulent or preferential transfer claims by the securities contract safe harbor set forth in Bankruptcy Code section 546(e). Specifically, in *Krol v. Key Bank National Ass'n* (*In re MCK Millennium Centre Parking, LLC*), 2015 WL 1951036 (Bankr. C.D. Ill. April 30, 2015), the court held that payments by a debtor to a commercial bank on account of a loan, where the promissory note evidencing the loan was held by a real estate mortgage conduit (REMIC) trust, could be integrated with the trust's distribution of the loan payments to its investors under a pooling and servicing agreement such that the payments constituted transfers in connection with a securities contract and thus, were unavoidable.

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The Bankruptcy Code's Safe Harbor Provisions

The Bankruptcy Code contains a number of provisions that shield certain financial transactions from application of various provisions of the Bankruptcy Code. For example, payments and other transfers made in connection with these transactions may not be avoided as constructively fraudulent or preferential transfers (but the provisions do not protect payments or transfers made in actual fraud). Actions taken against the debtor pursuant to these transactions are shielded from the application of the automatic stay, and the provisions provide for the enforceability of so-called *ipso facto* clauses (which allow termination or modification of these contracts due to the debtor's financial condition or bankruptcy filing).

These protections, commonly referred to as the safe harbor provisions, were widely supported at the time of passage, including by the Federal Reserve Board, the Securities Industry Association, the New York Clearinghouse Association and the International Swap Dealers Association, and have been viewed as essential to protecting the markets from collapse due to the bankruptcy of a large financial institution. *See generally* Shmuel Vasser, Derivatives in Bankruptcy, 60 *Bus. Law.* 1507, 1510 (2005). The nature of many complex financial transactions is such, it has been argued, that counterparties must be able to move swiftly to liquidate or offset their positions and could not await a court determination as to the permissibility of doing so, lest they suffer irreparable economic damage from quickly moving financial markets. The inability of a counterparty to liquidate its position could have ripple effects on other market participants that could cause a systemic risk to the financial markets.

Bankruptcy Code section 546(e), the statute at issue in *Krol*, discussed below, is one of the safe harbor provisions providing that "[t]he trustee may not avoid a payment that is a … settlement payment … or that is a transfer made by or to (or for the benefit of) a … financial institution… *in connection with a securities contract*, as defined in section 741 (7) … (emphasis added)." Thus, section 546(e) shields from the application of the constructive fraud and preference avoidance sections prepetition payments or transfers made by or to certain financial market participants in connection with a securities contract. The legislative history of section 546(e) demonstrates Congressional concern that if prepetition transactions with financial institutions, stockbrokers, and similar entities were subject to attack as avoidable transfers, the result could chill activity with any institution that was rumored to be in trouble, resulting in a loss of confidence in the markets. *See* Collier on Bankruptcy, ¶ 546.LH[5] (Alan N. Resnick & Henry J. Sommer eds., 16th ed.). The legislative history is clear that by enacting the safe harbor provisions, Congress intended to ensure the stability of the financial markets notwithstanding the collapse of a participating firm. On the same basis, section 546 also provides safe harbors for commodities contracts, swaps, forward contracts, repurchase agreements and master netting agreements. Notwithstanding strong Congressional and industry support for the safe harbor provisions, some commentators have questioned whether their language is overly broad in pursuit of protecting the markets at the expense of important bankruptcy policies such as equality for creditors and the preservation of going concern value. Many courts have been called on to decide on the proper interpretation and application of these provisions facing litigants' arguments that the application of the statutes as written would improperly protect private transactions whose protection is contrary to Congress' policy goals to protect public markets.

For example, an early circuit-level decision on this issue applied a narrow reading of section 546(e) in holding that payments to shareholders pursuant to a leveraged buyout transaction (LBO) were not protected as settlement payments by or to a financial institution in connection with a securities contract. In that decision, *Munford, Inc. v. Valuation Research Corp.*, 98 F.3d 604 (6th Cir. 1996), the payment to the selling shareholders in a privately held company was made to a bank, which in turn distributed the payment per share to the shareholders. When the bankruptcy trustee sought to avoid the payments as constructively fraudulent, the shareholders raised the 546(e) defense. Notwithstanding that section 546(e) protects any transfer "by or to" a financial institution (which includes a bank), the Eleventh Circuit held that the payments to the shareholders were not protected because the bank had acted as a "mere conduit" for the payments, was not intended to be the ultimate transferee, and had no economic interest in the securities.

In the Courts

The majority of courts, however, decline to follow *Munford*, and adhere to the plain language of section 546(e). In *Plassein Int'l Corp. v. B.A. Capital Co. LP*, 590 F.3d 353 (3d Cir. 2009), the U.S. Court of Appeals for the Third Circuit affirmed its prior holding that payments to shareholders in a privately held company pursuant to an LBO transaction are protected from avoidance under section 546(e). In *Plassein*, as in *Munford*, the Chapter 7 trustee for the debtor sought to avoid payments from the debtor to its shareholders as constructively fraudulent transfers. The payments were part of an LBO transaction and were accomplished by wire transfer from the debtor's bank to the shareholders' accounts. The Third Circuit held that the transfers to the shareholders were settlement payments and therefore protected from avoidance under section 546(e). The U.S. Court of Appeals for the Sixth Circuit reached a similar conclusion in *QSI Holdings, Inc.*, 571 F.3d 545, 549 (6th Cir. 2009).

Both courts relied on the broad definition of settlement payment under Bankruptcy Code section 741(8), which includes a laundry list of settlement payments (preliminary, partial, interim, etc.), as well as "any other similar payment commonly used in the securities trade," and reasoned that this language should include payments made for shares in an LBO transaction, even if the LBO involved a private company. The courts refused to distinguish between settlement payments for publicly versus privately traded shares, because that distinction has no basis in the statute. The U.S. Court of Appeals for the Second Circuit reached the same conclusions in *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329 (2d Cir. 2011) and in *Official Committee of Unsecured Creditors of Quebecor World (USA) v. American United Life Insurance Co.*, 719 F.3d 94 (2d Cir. 2013).

The *Krol* Decision

The court's decision in *Krol* arose in the context of an adversary proceeding instituted by the Chapter 7 trustee for debtor MCK Millennium Centre Parking, LLC (Debtor). The trustee sought to recover payments made by Debtor to defendant Key Bank National Association (Key), alleging that the payments were made for no consideration, as they were applied to repay a loan made to MCK Millennium Centre Retail (Retail), a subsidiary and insider of the Debtor. Over a period of four years prior to the bankruptcy filing, the Debtor transferred over $5 million to Key on account of an $11.2 million loan made by Key to Retail. The payments to Key, however, were only held by it temporarily. Soon after making the loan to Retail, Key had transferred the promissory note for the loan to a REMIC trust managed by Wells Fargo, N.A. (the Trust). Although Key continued to receive payments on account of the loan, it no longer had an economic interest in the loan and transferred the payments to the Trust. The latter held the note evidencing the loan to Retail as part of a pool of mortgages.

Key's transfer of the promissory note to the Trust was the first step in a two-step CMBS transaction: mortgages and promissory notes in respect of the commercial mortgages were sold to the Trust, which then pooled the mortgages together and issued certificates representing ownership in the Trust to investors. As is standard for CMBS transactions, this was governed by a pooling and services agreement (the PSA) among Key, the Trust and other financial institutions. The PSA designated Key as master servicer, and in that capacity, it continued to handle administration of the loans by receiving the payments on the loans, including the payments from the Debtor to be applied to Retail's outstanding loan balance. In response to the trustee's complaint, Key argued that the payments were shielded from avoidance under Bankruptcy Code section 546(e) as payments made to a financial institution in connection with a securities contract.

It was not disputed by any party that Key, as a commercial bank, fell within the Bankruptcy Code's definition of "financial institution." Although the trustee initially argued that the transfers to Key should not be protected because Key neither used nor benefited from the payments by Debtor, urging the court to adopt the mere conduit theory applied in *Munford*, the court, following the majority view, dismissed that argument based on the plain language of section 546(e) requiring only that the payment be made to "by or to" a financial institution and imposing no conditions as to how the payment is used.

The chief issue for the court to consider was whether the payments from Retail to Key were made "in connection with a securities contract." First, therefore, the court had to identify the relevant securities contract. Bankruptcy Code section 741(7) broadly defines "securities contract" to include, among others, "a contract for the purchase, sale, or loan of a security … a mortgage loan, any interest in a mortgage loan, [or] a group or index of securities … or mortgage loans or interests therein (including an interest therein or based on the value thereof)[.]" Furthermore, section 741(7) contains a catch-all provision providing that a securities contract includes "any other agreement or transaction that is similar to an agreement or transaction" referred to in section 741(7). The PSA provided that the depositor in the securitization intended to sell "mortgage pass-through certificates, to be issued hereunder in multiple classes, which in the aggregate will evidence the entire beneficial ownership interest in a trust fund to be created hereunder, the primary assets of which will be the Mortgage Loans." Based on this, the court had no difficulty concluding that the PSA qualified as a securities contract.

Upon indentifying the applicable securities contract, the court had to resolve the final disputed issue — whether the Debtor's payments on the loan were "in connection with" the PSA. The bankruptcy trustee argued that the payments were applied to the loan made by Key to Retail, which was plainly not a securities contract. Key argued that the loan had to be integrated with the PSA due to the subsequent transfer of the note to the Trust and its pooling with the other notes in the securitization.

The court sided with Key, and recommended dismissal of the trustee's claims. In its opinion, the court emphasized that the promissory note evidencing the loan was owned by the Trust and therefore was governed by the PSA; for example, the PSA dictated how payments made on the loan to Retail would be distributed to certificate holders, *i.e.*, investors in the Trust. The court believed that it made sense to "properly consider two separate transactions as a single transaction when doing so would align with the economic realities" and held that the payments by Debtor bore a significant enough relationship to the PSA to constitute a securities contract. In further support of its decision, the court focused on the language of sections 546(e) and 741(7).

It reasoned that the phrase, "in connection with" has historically been interpreted very broadly to mean "related to." The court believed that the statutory language, coupled with the expansive definition of securities contract in section 741, reflected Congressional desire to afford broad protection to securities contracts. Therefore, the payments made on the loan were at a minimum related to the PSA, a securities contract, and thus the payments could not be avoided. The trustee has since appealed the decision and the district court remanded the proceedings to the bankruptcy court for reconsideration in light of allegations that some of the payments were made to a Key affiliate which may not qualify as a financial institution.

Implications

Even though CMBS transactions are common, *Krol* appears to be the first reported decision addressing whether payments made in respect of pooled mortgages held by a securitization vehicle are entitled to protection under section 546(e). Following the trend of recent circuit court decisions applying section 546(e) as written, the court did not consider the policy goals of section 546(e). The court's decision, if upheld and followed by other courts, would ensure that the bankruptcy of an individual mortgagor would not affect the stability of securitization vehicles by shielding them from potential liability for clawback actions (which they have no resources to satisfy after the payments are distributed to investors) as well as protect investors from liability on account of distributions made to them by securitization vehicles.