# Clients&FriendsMemo

## Delaware's Not So Safe Harbors: Third Circuit Bankruptcy Court Declines to Rule that a Payment on a Letter of Credit is an Avoidance-Proof "Settlement Payment"

**April 17, 2012**

On March 26, 2012, Judge Mary F. Walrath of the United States Bankruptcy Court for the District of Delaware refused to rule that, as a matter of law, payments made to satisfy a debtor's obligations under a letter of credit constitute "settlement payments" protected from avoidance under section 546(e) of the Bankruptcy Code. *EPLG I, LLC v. Citibank, National Association et al. (In re Qimonda Richmond, LLC, et al.)*, No. 09-10589, 2012 Bankr. LEXIS 1264 (Bankr. Del. March 26, 2012). Although the decision helps to clarify the scope of one of the Bankruptcy Code's most important safe harbor provisions, it has also left some important questions unanswered regarding the scope of section 546(e).

In *Qimonda*, a series of industrial revenue bonds were issued on the Debtors' behalf by a municipal development authority. To enhance the credit rating on these bonds, the Debtors arranged for one of the defendants, Citibank, National Association ("Citibank"), to issue a letter of credit, or "LC," in favor of the indenture trustee. The LC had an initial expiration date of January 27, 2001, but was to be automatically extended on an annual basis until such time as Citibank notified the indenture trustee that it did not intend to renew the letter. If Citibank chose not to renew, then the indenture trustee was entitled to draw on the letter, and the Debtors agreed to reimburse Citibank in this event. The Debtors secured this reimbursement obligation by granting Citibank a security interest in all of their Citibank deposit accounts.

In October 2008, in the midst of the 2008 economic crisis, Citibank notified the indenture trustee that it would allow the LC to expire in January of 2009. This notification triggered the trustee's right to draw on the letter, but the balance of the Debtors' Citibank account stood at $0. To cover their security/reimbursement obligations to Citibank, the Debtors deposited funds into the account. The trustee then drew on the LC and used the proceeds to redeem the bonds. Pursuant to its security agreement with the Debtors, Citibank subsequently debited the amount it had paid out under the LC from the Debtors' now flush cash collateral account.

Less than two months later, the Debtors filed for chapter 11 bankruptcy and proposed a liquidating chapter 11 plan that created a liquidating trust. The trustee appointed to manage this trust filed an adversary complaint seeking to avoid as preferential transfers (1) the Debtors' deposit of funds into their account at Citibank, and (2) Citibank's debit of these funds as reimbursement for the payment it had made pursuant to the letter of credit.

Citibank filed a motion to dismiss the trustee's adversary complaint, arguing that both the deposit and the debit were "settlement payments" for purposes of section 546(e) of the Bankruptcy Code, which shields certain "settlement payments" from a trustee's avoidance powers. In the Third Circuit, a "settlement payment" includes any transfer of cash to a financial institution in connection with a securities transaction. *See In re Plassein Int'l Corp.*, 590 F.3d 252, 258 (3d Cir. 2009). In *Qimonda*, however, the Delaware bankruptcy court concluded that a payment made pursuant to a letter of credit did not, as such, constitute a "settlement payment," because a letter of credit is specifically excluded from the definition of a "security" contained in section 101(49)(B)(i) of the Bankruptcy Code.

Accordingly, for the deposit and debit to nonetheless constitute "settlement payments," they would have to be viewed as steps in the completion of a larger securities transaction, namely the Debtors' redemption of their bonds. Viewed as part of this larger securities transaction, the payments on the LC might fall under the protections of section 546(e).

Citibank attempted to make precisely this argument by analogizing *Qimonda* to *In re Quebecor World (USA) Inc.)*, 453 B.R. 201 (Bankr. S.D.N.Y. 2011), a case in which the debtor first transferred money into its bank account at Bank of America; Bank of America then wired this money to the trustee of the debtor's notes; the trustee wired to each noteholder its portion of the funds; and the noteholders then surrendered their notes to the debtor. In *Quebecor*, the Bankruptcy Court for the Southern District of New York ruled that this entire series of transactions was safe harbored under section 546(e).

Applying the foregoing rationale to its case, Citibank argued that the same ruling was appropriate in *Qimonda*. However, Judge Walrath saw an important distinction between *Qimonda* and *Quebecor*. In *Quebecor*, the only purpose of the transfer was to complete a securities transaction, and there was no other independent obligation between the debtor and the financial institution (Bank of America). By contrast, in *Qimonda*, the Debtors made the payments to Citibank in order to collateralize Citibank's exposure under the letter of credit, and thus to fulfill an obligation independent from any securities transaction. Thus, Judge Walrath held that Citibank had failed to meet its burden of establishing that the deposit and debit were "settlement payments" for purposes of 546(e).

Alternatively, Citibank argued that the deposit and the debit constituted "transfer[s] made . . . to a financial institution . . . in connection with a securities contract," another category of transfers protected from avoidance under section 546(e). Citibank maintained that the letter of credit at issue in this particular case was in fact a "securities contract" (even if not a "security"), because its function was to enhance the credit rating on the Debtors' bond issue, and the definition of "securities contract" contained in 11 U.S.C. § 741(7)(xi) includes "other credit enhancement[s] related to [a securities contract]." Judge Walrath pointed out, however, that this argument assumed that the bonds and/or indenture themselves were also "securities contracts." While the court acknowledged that, under settled law, the bonds and the indenture were most certainly *contracts*, it remained unpersuaded that they were *securities* contracts, and declined to decide this issue in the context of the pending motion to dismiss.

At this stage in the proceedings, the case seems to primarily illustrate the dangers of structuring a transaction in a manner that unnecessarily involves payments made pursuant to a letter of credit.

Specifically, it appears likely that Citibank could have protected itself against the trustee's preferential transfer allegations if it had instructed the Debtors to pay off their bonds directly rather than by funding their Citibank account. Nonetheless, the possibility remains that Citibank could prevail on its argument that the letter of credit constituted a "securities contract," and that section 546(e) should apply on this basis, at some later stage in the proceedings. If this occurs, then *Qimonda* will provide even further valuable guidance on the scope of Bankruptcy Code section 546(e), particularly with regard to the question of whether bonds and/or indentures constitute "securities contracts" for purposes of that provision.

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