Great Debates

Jeffrey N. Pomerantz, Moderator
Pachulski Stang Ziehl & Jones LLP; Los Angeles
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Past Presidents' Debate

Resolved: The chapter 11 model is no longer viable for middle-market businesses.

Pro: Robin E. Phelan
Haynes and Boone, LLP; Dallas

Con: James T. Markus
Markus Williams Young & Zimmermann, LLC; Denver

Consumer Debate

Resolved: Section 523(a)(8) should be repealed or amended to allow for the discharge of all student loan debts.

Pro: Susan E. Hauser
North Carolina Central University School of Law; Durham, N.C.

Con: Dr. Daniel A. Austin
Northeastern University School of Law; Boston

Judicial Debate

Resolved: Section 546(e) does not apply to each and every link in a chain of transactions resulting in a "settlement payment" that is protected by the safe harbor provisions.

Pro: Hon. Mary F. Walrath
U.S. Bankruptcy Court (D. Del.); Wilmington

Con: Hon. Elizabeth W. Magner
U.S. Bankruptcy Court (E.D. La.); New Orleans

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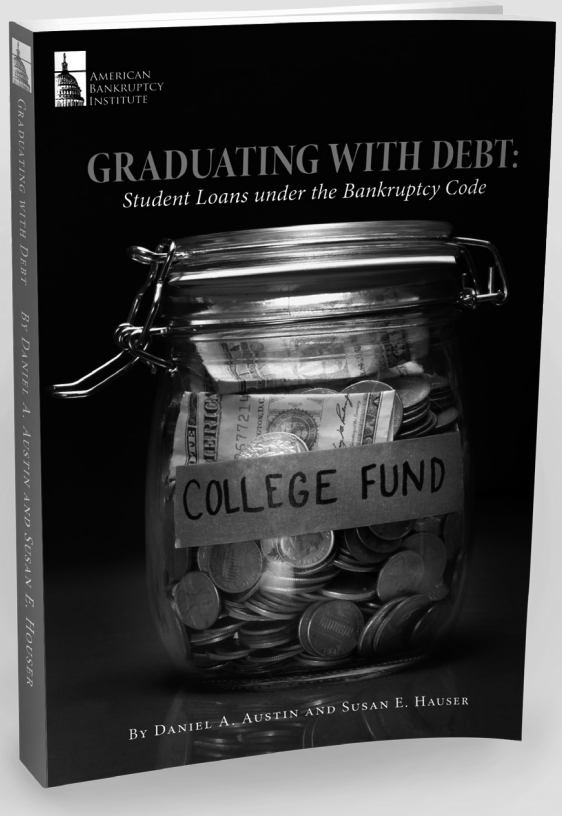

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Feature

By Lawrence J. Kotler

Second Circuit Interprets § 546(e) Broadly — Again!

Lawrence J. Kotler
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In the recent decision of *Official Committee of Unsecured Creditors of Quebecor World (USA) Inc. v. American United Insurance Co., et al. (In re Quebecor World (USA) Inc.)*,[1] the U.S. Court of Appeals for the Second Circuit affirmed decisions by both the bankruptcy court and district court, holding that certain payments received by various noteholders were protected from avoidance by the virtue of § 546(e) of the Bankruptcy Code. In *Quebecor*, the unsecured creditors sought to avoid and recover certain allegedly preferential payments made by the debtor, Quebecor World (USA) Inc. (QWUSA), to certain noteholders in exchange for certain private placement notes that had been issued to these noteholders by one of QWUSA's affiliates.

The committee sought recovery of the transfer pursuant to § 547 of the Bankruptcy Code. After the committee filed suit, the noteholders moved for summary judgment on the basis that the transfer was protected by the safe-harbor provision of § 546(e). The U.S. Bankruptcy Court for the Southern District of New York granted summary judgment in favor of the noteholders on the basis that the payments they received were exempt from avoidance because the payments were both "settlement payments" and "transfers [were] made ... in connection with a securities contract," and therefore, they fell within the safe-harbor provisions of § 546(e).

On appeal, the U.S. District Court for the Southern District of New York affirmed the holding of the bankruptcy court, albeit on slightly different grounds. On a subsequent appeal, the Second Circuit again affirmed portions of both the bankruptcy court and district court decisions.[2]

The facts of this case are relatively simple. QWUSA and another entity, Quebecor World Capital Corp. (QWCC), were both subsidiaries of Quebecor World Inc. (QWI), a Canadian printing company. In 2000, a private placement occurred by which QWCC issued certain notes to various noteholders, and in doing so, raised $371 million. Both QWI and QWUSA guaranteed the notes, and some of the funds, but not all, were transferred from QWCC to QWUSA. The notes were issued pursuant to certain note-purchasing agreements, which provided that QWCC had the option to prepay the notes so long as it paid any outstanding principal, accrued interest and a "make whole amount," which was based on a certain formula provided in the agreements.

In addition, the note-purchasing agreements stated that any affiliate of QWCC could also prepay the notes, provided that the affiliates complied with the same prepayment provisions that QWCC was obligated to comply with pursuant to section 8.2 of the note agreements. The note agreements also provided for the acceleration of the maturity date of the notes if QWI's debt-to-capitalization ratio fell below a certain threshold. To the extent that the notes matured, such an event would have had a deleterious impact on QWI as the maturation of the notes would trigger a default under QWI's outstanding credit facility agreement.

In 2007, QWI began having financial difficulties and initially sought to purchase certain of the notes, but ultimately these negotiations proved to be unsuccessful. Around September of that year, QWI decided to prepay all of the notes and had QWCC issue a notice of its intent to redeem the notes, prior to their respective maturation dates, pursuant to the terms and conditions of the various noteholder purchase agreements. If QWCC had redeemed the notes itself, the redemption would have resulted in significant tax implications under Canadian law. As a result, QWI restructured the deal so that QWUSA would purchase the notes from the various noteholders for cash and then QWCC would in turn redeem the notes from QWUSA in exchange for a forgiveness of certain intercompany indebtedness owed by QWUSA to QWCC.

As a consequence, QWUSA — not QWCC — issued a new notice to the noteholders indicating that it would pay the "redemption price" set out in the note-purchase agreements and that this payment would result in the purchase of the notes by QWUSA. In connection thereto, on Oct. 29, 2007, QWUSA transferred approximately $376 million to the trustee of the noteholders, CIBC Mellon Trust Co. In turn, CIBC Mellon distributed the funds to the various noteholders, which surrendered the notes directly to QWI. On Jan. 21, 2008, less than 90 days after the payment from QWUSA, QWUSA filed for bankruptcy in the U.S. Bankruptcy Court for the Southern District of New York.

Following the commencement of its case, the committee for QWUSA and its related estates commenced an adversary proceeding against the noteholders seek-

1 Docket No. 12-4270, 2013 WL 2460726 (2d Cir. June 10, 2013).

2 While affirming the lower courts' decisions that the "transfers [were] made in ... connection with a securities contract," the Second Circuit specifically did not decide whether the payments fell within the definition of a "settlement payment" as set forth in § 741(8) of the Bankruptcy Code.

ing to avoid the Oct. 29 transfer as a preference. The noteholders eventually moved for summary judgment, arguing that the transfer was exempt from avoidance pursuant to § 546(e).

While the noteholders' motion for summary judgment was pending, the Second Circuit decided the case of *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V. (In re Enron Creditors Recovery Corp.)*,[3] in which the court held that payments made to redeem commercial paper were settlement payments within the safe-harbor provision of § 546(e) because they were "transfers for cash made to complete a securities transaction."

Following the issuance of this decision, the bankruptcy court granted the noteholders' summary-judgment motion and ruled that QWUSA's payment fell within the definition of a "settlement payment" as set forth in the *Enron* case. The court also held that the payment was not only a "settlement payment" but also qualified "as a transfer made in connection with a securities contract," irrespective of whether QWUSA "redeemed" or "purchased" the notes.

On appeal, the district court affirmed the bankruptcy court's decision and ruled that the payment made on Oct. 29 was a "settlement payment." However, the district court did not completely agree with the underlying decision of the bankruptcy court and determined (contrary to the opinion of the bankruptcy court) that a transfer to "redeem securities" could not qualify as a transfer made in connection with a securities contract (as set forth in § 546(e)) because the Bankruptcy Code specifically defined a "securities contract" as a contract for the purchase, sale or loan of a security. Nevertheless, the district court agreed with the bankruptcy court that the Oct. 29 transaction was, in fact, a purchase and not a redemption of a security.

Following the issuance of the district court's decision, the committee appealed to the Second Circuit. On appeal, the Second Circuit reviewed the elements of § 547, as well as the elements set forth in the safe-harbor provision of § 546(e). The court examined the split of authority concerning the role, if any, that a financial institution must play in order for a transaction to fall within the safe-harbor provision of § 546(e). As noted by the Second Circuit, the U.S. Court of Appeals for the Third, Sixth and Eighth Circuits have all determined that the plain language of § 546(e) "includes any transfer to a financial institution, even if it is only serving as a conduit or intermediary."[4] The Second Circuit also noted that only the Eleventh Circuit has found that the "financial institution must acquire a beneficial interest in the transferred funds or securities for the safe harbor to apply."[5]

After noting the split among the circuits, the *Quebecor* court examined its decision in the *Enron* case and noted that in that decision, the Second Circuit had cited the Third, Sixth and Eighth Circuits' decisions "with approval." In addition, the *Quebecor* court noted that the panel in the *Enron* case specifically concluded "that the absence of a financial intermediary that takes title to the transacted securities during the course of the transaction is [not] a proper basis on which to deny safe-harbor protection."[6]

Turning to the facts of the case before it, the *Quebecor* court opined that it need not decide whether the payments at issue were settlement payments within the definition of § 741(8) of the Bankruptcy Code because the payment made on Oct. 29 fit "squarely within the plain wording of the securities contract exemption"[7] as set forth in § 546(e). In particular, the court found that the transfer made on Oct. 29 was a "transfer made by or to (or for the benefit of) a financial institution in connection with a securities contract."

In reaching this decision, the *Quebecor* court first noted that QWUSA specifically transferred funds to CIBC Mellon, which was a financial institution. Second, the court noted that the agreements at issue were clearly securities contracts because they provided for both the original purchase and the "repurchase of the notes." Third, the court found that the transfer that was made by QWUSA was a purchase — as opposed to a redemption — of the notes. Accordingly, the *Quebecor* court had no trouble concluding that the Oct. 29 transfer was made to a financial institution in connection with a securities contract and, thus, was exempt from avoidance.

The court rejected the committee's contention that QWUSA "redeemed" — as opposed to purchased — the securities at issue. In rejecting this contention, the *Quebecor* court noted that QWUSA "was not 'regaining' its own Notes; [rather], it was acquiring for the first time the securities of another corporation QWCC."[8] As such, QWUSA could not, as a matter of law, be considered a "redeemer" of its affiliates' notes, but rather had to be considered a purchaser of such notes. In addition, the court rejected the committee's contention that CIBC Mellon was merely a conduit.

Citing again to its *Enron* decision, the *Quebecor* court expressly held that a "financial intermediary need not have a beneficial interest in the transfer" in order to fall within § 546(e)'s safe harbor.[9] To avoid any possible confusion, the *Quebecor* court specifically held that "we expressly follow the Third, Sixth and Eighth Circuits in holding that a transfer may qualify for the section 546(e) safe harbor even if the financial intermediary is merely a conduit."[10] For these reasons, the *Quebecor* court affirmed the holdings of the lower courts and exempted the Oct. 29 transfer from avoidance pursuant to § 546(a).

Conclusion

In *Quebecor*, the Second Circuit appears to continue the expansive view it took in *Enron* of the type of transactions to which § 546(e) may apply. In both decisions, the court interpreted the safe-harbor provision of § 546(e) broadly to apply to protect the transfers at issue from avoidance. Arguably, in applying a broad scope, the court was seeking to further the statute's goal of reducing potential disruption of the securities market caused by a major bankruptcy. While not necessarily a surprise considering the Second Circuit's prior decision in *Enron*, the *Quebecor* decision represents yet another example of an appellate court taking a very broad view of § 546(e) and will further constrain the ability of a debtor, trustee, committee or plan administrator to pursue avoidance actions for the benefit of unsecured creditors. abi

3 651 F.3d 329 (2d Cir. 2011).
4 *Quebecor*, 2013 WL 2460726, *3 (citing *QSI Holdings Inc. v. Alford (In re QSI Holdings Inc.)*, 571 F.3d 545, 550-51 (6th Cir. 2009); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 987 (8th Cir. 2009); and *Lowenschuss v. Resorts Int'l Inc. (In re Resorts Int'l Inc.)*, 181 F.3d 505-16 (3d Cir. 1999)).
5 2013 WL 2460726, *3 (citing *Munford v. Valuation Research Corp. (In re Munford Inc.)*, 98 F.3d 604, 610 (11th Cir. 1996)).
6 2013 WL 2460726, *3 (quoting *Enron*, 651 F.3d at 338).
7 As defined in § 741(7) of the Bankruptcy Code.
8 2013 WL 2460726, *4.
9 *Id.*
10 *Id.*

To Boldly Go Where No Court Has Gone Before: *Enron* and the Application of § 546(e)

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Editor's Note: *For another article discussing § 546(e), please see the feature on page 40.*

Few and far between are the decisions that have immediate and enormous direct financial impact on bankruptcy cases, and *Enron*[2] is such a decision. The Second Circuit Court of Appeals held that § 546(e) of the Bankruptcy Code should be construed broadly, which is in accordance with rulings by most of the other circuits on this issue. The Second Circuit went further, however, and determined that such application of § 546(e) requires only "an exchange of money or securities that completes a securities transaction."[3] Notably, a purchase or sale of, or transfer of title to, securities[4] is not required. As the first circuit court to address the issue, the Second Circuit stands alone. It remains to be seen whether courts outside of the Second Circuit will follow *Enron*. In the interim, and in only a few months since the decision was rendered, lender recoveries and unsecured creditor distributions will be diminished by literally billions of dollars.

Facts and Procedural History


Oscar N. Pinkas

In late 2001, after the resignation of its CEO, $600 million in third-quarter losses and the commencement of an Securities and Exchange Commission (SEC) investigation, Enron Corporation (together with ECRC, "Enron") and certain of its subsidiaries and affiliates (collectively, the "debtors") filed voluntary petitions for chapter 11 relief. Only weeks before the filings, Enron drew down on revolver loans and paid more than $1 billion to retire unsecured and uncertificated commercial paper it had previously issued, at prices well above the commercial paper's fair-market value.

Three broker-dealers participated in the redemption of the commercial paper, collecting it and paying noteholders the redemption price. As was customary in the industry, the Depository Trust Company (DTC) maintained bookkeeping entries to track the ownership of the commercial paper. The DTC debited the redemption price from the accounts of participating broker-dealers and credited it to the accounts of the noteholders. The broker-dealers then transferred the commercial paper to the DTC account of Enron's issuing and paying agent in exchange for payment from Enron through the DTC. The commercial paper was then extinguished in the DTC's system. Approximately 200 institutional noteholders participated in the redemptions at issue.

In November 2003, Enron Creditors Recovery Corp. (ECRC), successor to Enron Corp., filed adversary complaints against the institutional noteholders seeking to avoid and recover the redemption payments as preferential transfers under § 547 of the Code, or constructively fraudulent transfers under § 548. The defendants moved to dismiss the adversary proceedings, arguing that the redemption payments constituted "settlement payments" that could not be avoided pursuant to § 546(e), which provides that "[n]otwithstanding sections...547 [and] 548(a)(1)(B)...of this title...the trustee may not avoid a transfer that is a...settlement payment, as defined in section...741 of this title, made by or to (or for the benefit of) a...stockbroker, financial institution, financial participant or securities clearing agency...that is made before the commencement of the case."[5] A "settlement payment" was defined in § 741(8) (at the applicable time)[6] 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."[7]


David A. Pisciotta

The bankruptcy court denied the motions to dismiss, holding that the phrase "commonly used in the securities trade" modified all terms in the definition of "settlement payment," thereby limiting the protection of § 546(e) to settlement payments common in the industry and that evidence was necessary to determine whether the redemption payments were "commonly used in the securities trade." Most defendants settled with Enron after that decision was rendered. However, two defendants, who were paid less than $55 million in redemption payments, pressed forward. In denying them summary judgment, the court held that the transfer of ownership of a security is central to the settlement process, and therefore, to constitute a settlement payment, a purchase or sale, as opposed to a redemption, is required.

The two defendants appealed the order denying summary judgment. The district court limited the scope of review to an issue of law, "whether the § 546(e) safe harbor applies to an issuer's redemption of commercial paper prior to maturity, effected through the customary mechanism of transacting in commercial paper through the [DTC], without regard to extrinsic facts, such as the motives and circumstances of the redemption."[8]

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About the Authors

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Lien on Me

1 Nothing in this article constitutes an opinion or view of its authors or SNR Denton.
2 *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V. (In re Enron Creditors Recovery Corp.),* Case No. 09-5122, 09-5142, 2011 U.S. App. LEXIS 13177 (2d Cir. June 28, 2011).
3 *Id.* at *21-22.
4 The term "security" is expansively defined in § 101(49) of the Bankruptcy Code and includes certain debt instruments.
5 *Enron* at *8.
6 The definition of § 741(8) has not changed significantly since.
7 *Enron* at *8.
8 *Id.* at *11.

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Reversing the bankruptcy court, the district court held that (1) settlement payments are not limited to those commonly used in the securities trade, (2) a "settlement payment is any transfer that concludes or consummates a securities transaction," and (3) redemption constitutes a securities transaction because it involved "the delivery and receipt of funds and securities."[9] Enron appealed to the Second Circuit Court of Appeals, which "review[ed] only the issue the district court agreed to hear."[10] The SEC and the Securities Industry and Financial Markets Association filed *amicus* briefs in support of the institutional redeemers' broad interpretation of § 741(8).

Decision

The Second Circuit Court of Appeals' decision is novel in several ways. It is the first decision by the Second Circuit Court of Appeals regarding the application of § 546(e), as well as the scope of § 741(8)'s definition of "settlement payment." Second, it is the first decision to address the application of § 546(e) to the early redemption of commercial paper.

Given the novelty of its decision, the Second Circuit started out by charting the waterways. It noted that other circuit courts of appeals have interpreted § 741(8)'s definition of "settlement payment" extremely broadly. It also took into consideration the genesis of § 546(e) as an effort to minimize displacement in securities and commodities markets caused by major bankruptcy filings. "If a firm is required to repay amounts received in settled securities transactions, it could have insufficient capital or liquidity to meet its current securities trading obligations, placing other market participants and the securities markets themselves at risk. The safe harbor [of § 546(e)] limits this risk by prohibiting the avoidance of 'settlement payments' made by, to or on behalf of a number of participants in the financial markets."[11] The court then addressed each of Enron's three arguments on appeal, that (1) the phrase "commonly used in the securities trade" modifies all the types of settlement payments listed in § 741(8), (2) § 741(8) includes only transactions in which title to securities is transferred and (3) redemption payments are not settlement payments because no financial intermediary took title to the securities and, therefore, the concerns that prompted the enactment of § 546(e) were not implicated. "Because we find nothing in the Bankruptcy Code or the relevant case law that supports Enron's proposed limitations on the definition of settlement payment in § 741(8), we reject them. We hold that Enron's redemption payments fall within the plain language of § 741(8) and are thus protected from avoidance under § 546(e)."[12]

It remains to be seen whether courts outside the Second Circuit will follow Enron*, but one thing is clear: As the Second Circuit is one of the most popular circuits for commercial bankruptcy filings,* Enron *will have—and already has had—a substantial financial impact.*

Applying the last antecedent rule of construction,[13] the court held that "commonly used in the securities trade" modifies only the phrase "any other similar payment" because the modifier was not separated from the antecedents by a comma. Therefore, the phrase is not a limitation, but instead, in accord with Sixth and Eighth Circuit Courts of Appeals' decisions, a catch-all that expands the breadth of § 546(e).[14] The court also noted that Enron's proposed limitation would require a factual determination of the commonness of a transaction, which would create commercial uncertainty and unpredictability regarding the application of § 546(e), at odds with its purpose.

The court next turned to and rejected Enron's argument that a requirement of purchase or sale of securities be read into the definition of "settlement payment." In accord with Eighth and Tenth Circuit Courts of Appeals' decisions, the court "agree[d] that in the context of the securities industry a 'settlement' refers to 'the completion of a securities transaction.'"[15] Therefore, a settlement payment need only be "an exchange of money or securities that completes a securities transaction"; a purchase, sale or transfer of title is not required.[16] Because the interpretation of "settlement payments" must be in the context of the securities industry, the court held that this context is sufficient to exclude "ordinary loans" from the protections of § 546(e).[17] However, it is unclear from the decision what constitutes an "ordinary loan."

Finally, the court rejected the argument that § 546(e)'s application turns on a transaction structured to include a financial intermediary that takes title to the securities. Instead, the DTC's acting as a conduit and recordkeeper, as opposed to a clearing agency, was sufficient. The court relied on Third, Sixth and Eighth Circuit Courts of Appeals' decisions applying the safe harbor to leveraged buyouts of private companies where financial intermediaries acted as mere conduits.[18] The court reasoned that similar to those contexts, avoiding the redemption payments would have a substantial impact on financial markets. Moreover, § 546(e) applies to settlement payments for the benefit of market participants, not just by and to intermediaries. Therefore, the court determined that its interpretation was in accord with the plain meaning of the statute.

Discussion

The impact of *Enron* is twofold. First, the Second Circuit Court of Appeals has now weighed in on the application of §§ 546(e) and 741(8) in the Second Circuit and held that much like in several other circuits,[19] § 546(e) is to be applied broadly. As discussed in

9 *Id.* at *11-12.
10 *Id.* at *12-13.
11 *Id.* at *13-14.
12 *Id.* at *16-17.
13 "Under the rule of the last antecedent...a limiting clause or phrase... should ordinarily be read as modifying only the noun or phrase that it immediately follows." *Id.* at *17.
14 *Id.* at *18-19 (citing *Quality Stores Inc. v. Alford (In re QSI Holdings Inc.)*, 571 F.3d 545, 550 (6th Cir. 2009) (quoting *Official Comm. of Unsecured Creditors of Contemporary Indus. Corp. v. Frost (In re Contemporary Indus. Corp.)*, 564 F.3d 981, 986 (8th Cir. 2009))).
15 *Enron* at *21 (quoting *In re Contemporary Indus. Corp.*, 564 F.3d at 985 (quoting *Kaiser Steel Corp. v. Charles Schwab & Co. Inc.*, 913 F.2d 846, 849 (10th Cir. 1990))).
16 *Enron* at *21-22.
17 *Id.* at *23-25.
18 *Id.* at *26-27 (citing *Brandt v. B.A. Capital Co. LP (In re Plassein Int'l Corp.)*, 590 F.3d 252, 257-59 (3d Cir. 2009); *In re QSI Holdings Inc.*, 571 F.3d at 549-50; *In re Contemporary Indus. Corp.*, 564 F.3d at 986).
19 *See, e.g., Lowenschuss v. Resorts Int'l Inc. (In re Resorts Int'l Inc.)*, 181 F.3d 505, 515 (3d Cir. 1999); *Kaiser Steel Corp. v. Pearl Brewing Co. (In re Kaiser Steel Corp.)*, 952 F.2d 1230, 1239 (10th Cir. 1991); *but see Wieboldt Stores Inc. v. Schottenstein*, 131 B.R. 655, 663-65 (N.D. Ill. 1991).

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a previous *ABI Journal* article, the risk of § 546(e) to lenders and sponsors in leveraged buyouts is "that lenders and their sponsors may be stripped of previously available guaranties, securities or pledges and left with nonpayment or cents on the dollar on large claims," with former "shareholders potentially retaining the benefit of a stock purchase."[20] Outside the context of leveraged buyouts, lenders also face the risk of nonpayment.

In *Enron*, the debtors drew down on revolver loans to make the redemption payments. Application of § 546(e) to preclude avoidance of payments made in any securities transaction incurs the risk of debtors' inability to repay a loan due to the inability to recapture the payment, which is equally a risk of financial instability to debtors. Over and above these is the risk to unsecured creditors of diminished distributions from debtors' estates.

Taking *Enron* as an example, ECRC was unable to maximize unsecured creditor recoveries through the avoidance actions because the appellants' redemption payments, approximately $55 million, benefited from the protections of § 546(e). Those payments instead served to reimburse the two unsecured creditor appellants in the amount of accrued par value plus accrued interest, resulting in diminished recoveries for the remaining unsecured creditors of the debtors.

Second, and more importantly, the Second Circuit Court of Appeals' application of § 546(e) serves to protect redemption payments and any other "exchange of money or securities that completes a securities transaction."[21] A purchase, sale or transfer of title is not required. Given the expansive definition of "security" in the Bankruptcy Code, which includes debt instruments such as notes, bonds and debentures, the protection from avoidance has therefore grown exponentially to cover any exchange of money or such debt instruments that "completes a securities transaction." The magnitude of this change in application is exemplified by the debtors' cases, in which the ECRC could have been precluded from recovering in excess of $1 billion had defendants not settled prior to the Second Circuit Court of Appeals' decision.

The ripple effect of *Enron* is already clear. Lower courts have already begun applying *Enron*'s expansive holding, which, per Hon. John Koeltl's description in his dissent, "seem[s] to bring virtually every transaction involving a debt instrument within the safe harbor of [§ 546(e)], thus allowing the settlement payment exception to swallow up" avoidance powers.[22] In *Quebecor*,[23] the court was faced with the issue of whether to apply § 546(e) to a $376 million repurchase of privately placed notes. Those payments were made by Quebecor "directly to a financial institution that was acting as agent for the Noteholders without passing through the DTC or any other clearing agency while the Notes were delivered later, in certain instances weeks or months later."[24] "[S]ettlement risk relating to the exchange of cash for securities was not part of the transaction because each of the Noteholders received its payments directly and simultaneously without attention to the timing of delivery of the Notes that were being repurchased by [Quebecor]."[25]

Litigation that had been pored over included discovery and expert testimony, and tried over the course of months, now, by virtue of *Enron* and its "easy-to-apply formulation," required a relatively straightforward decision. This is evidenced by the court's one-page application of the formulation.[26] Similar to *Enron*, the legislative history of § 546(e), extrinsic facts and context, atypicality of the delivery process utilized and impact on securities markets were deemed irrelevant.[27] It remains to be seen whether courts outside the Second Circuit will follow *Enron*, but one thing is clear: As the Second Circuit is one of the most popular circuits for commercial bankruptcy filings, *Enron* will have—and already has had—a substantial financial impact. ■

20 Oscar N. Pinkas, "No Collateral and No Cash: Fraudulent Avoidance in Private Equity-Leveraged Buyouts," *Am. Bankr. Inst. J.*, October 2008, at 18, 72.

21 *Enron* at *21-22.
22 *Id.* at *51.
23 *Official Comm. of Unsecured Creditors of Quebecor World (USA) Inc. v. Am. United Life Ins. Co. (In re Quebecor World (USA) Inc.),* Adv. Proc. No. 08-01417, 2011 Bankr. LEXIS 2788 (Bankr. S.D.N.Y. July 27, 2011).
24 *Id.* at *9.
25 *Id.* at *10.
26 *Id.* at *37-38.
27 *Id.* at *37, 39-40 and 45.

Reducing the Life Sentence of Student Loans

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A young hopeful student, discouraged by the economy and dismal job prospects, sees higher education, including graduate school, as an investment in the future; a way to guarantee employment or a higher salary. Unfortunately, that guarantee now seems to fall between unadulterated hope and delusions of grandeur. A recent article quoted a young attorney who admitted that law school was the "worst investment of her life."[1]


Madeleine Patton

Student loan defaults have increased 1.8 percent from last year,[2] and in every other category of debt, Americans are cutting back.[3] Yet the Federal Reserve recently reported that Americans now owe more in educational loans than they do in credit card debt.[4] In a down economy, students are receiving educational loans with increasing frequency. The rise in student loans seems to mimic that of the housing bubble, but unlike the albatross of an underwater mortgage or unmanageable credit card debt, student loans are nearly impossible to discharge in bankruptcy. There are, however, practical remedies that can help to relieve some of the burden of student debts without wreaking the economic havoc that an immediate full discharge of education loans might cause.

A Short History of Nearly Everything

Congress is delegated with the ability to regulate bankruptcies under the Constitution, but it did not address the treatment of student loans in bankruptcy until the 1978 Bankruptcy Code reform.[5]

About the Authors

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An increasing reliance on the government-created student-loan programs prompted the creation of § 523(a)(8)(A), which prohibited the discharge of federal student loans under chapter 7, except for loans that became due five years before the filing of a bankruptcy petition.[6] Congress specified that those loans could be discharged in situations where the loans "impose an under hardship on the debtor." Twelve years later, Congress updated the Code, lengthening the five-year exception period to seven years, and applied the general nondischargeability of student loans to chapter 13 debtors. Convinced that abusive filings could become rampant, Congress amended the Code in 1998 so that debtors had no opportunity to discharge *any* federal student loans outside of the "undue-hardship" provision of § 523(a)(8)(B).[7] In 2005, under pressure from the public, lenders and lobbyists, Congress expanded the umbrella of loans in § 523(a)(8) to include private loans, ushering in an era of true nondischargeability for educational loans and insurmountable hardships for students.

Even with a super-sized § 523(a)(8), Congress left the ostensible availability of the undue-hardship exception intact. The term "undue hardship" lacks any definition in the Code, so courts are left to mete out the requirements and effects of the hardship discharge.[8] Not surprisingly, courts have come to a variety of inconsistent and unpredictable conclusions as to how § 523(a)(8) should be administered.

Under the *Johnson* test, the court considers "the debtor's past resources and future probable resources...good faith...[and] the debtor's motives in filing for bankruptcy" in determining if any discharge should be granted.[9] Eight years later, the same court created the less-complicated, more objective *Bryant* poverty test.[10] Debtors whose net income after taxes fell below the federal poverty lines or those in "unique" and "extraordinary" circumstances were entitled to a discharge. The more frequently applied totality-of-the-circumstances test examines all relevant factors in each case, such as "financial resources [and] necessary expenses."[11] Last, the majority *Brunner*[12] test evaluates whether "the debtor cannot...maintain a 'minimal' standard of living for himself...or his dependents if forced to repay the loans... the debtor's state of affairs is likely to persist for such a significant portion of the repayment period...[and] the debtor has made good faith efforts to repay the student loans."[13]


Brandon Howard

Student Gallery

Critics argue that the application of "unworkable" undue-hardship tests "ha[ve] resulted in more harm than good."[14] Different jurisdictions produce widely varied decisions regarding what constitutes hardship, how long it must persist and what percentage of loans qualify for discharge,[15] and debtors wishing to discharge student loans cannot predict whether an evidence-laden trial is worth their time and money.

Bankruptcy as Avenue for Relief

Why Bankruptcy Is Not Currently an Available Remedy

The cornerstone of the bankruptcy system is that debtors are entitled to a "fresh start." Yet under the current system, the best-case scenario for a debtor struggling with student loans is a "stale" start, given

1 William D. Henderson and Rachel M. Zahorsky, "The Law School Bubble: How Long Will It Last if Law Grads Can't Pay Bills?," *ABA Journal* (Jan. 1, 2012).
2 Tamar Lewin, "Student Loan Default Rates Rise Sharply in Past Year," *New York Times* (Sept. 12, 2011) (citing that in past year, college graduates' default rates rose 3.4 percent for for-profit universities, 1.2 percent for nonprofit universities and 0.6 percent for private universities).
3 Michelle Singletary, "Student Debt Hint: Avoid It," *Washington Post* (Nov. 29, 2011).
4 *Id.*
5 Katheryn E. Hancock, "A Certainty of Hopelessness: Debt, Depression and the Discharge of Student Loans under the Bankruptcy Code," 33 *Law & Psychol. Rev.* 151, 151 (2009).
6 *Id.* at 152.
7 B.J. Huey, "Undue Hardship or Undue Burden: Has the Time Finally Arrived for Congress to Discharge Section 523(a)(8) of the Bankruptcy Code?," 34 *Tex. Tech L. Rev.* 89, 97-8 (2002-03).
8 *Id.* at 101.
9 *Id.* at 102 (citing *Pennsylvania Higher Education Assistance Agency v. Johnson*, 5 Bankr. Ct. Dec. 532 (Bankr. E.D. Pa. 1979)).
10 *Id.* at 104 (citing *Bryant v. Pennsylvania Higher Education Assistance Agency*, 72 B.R. 913, 914 (Bankr. E.D. Pa. 1987)).
11 *Id.* (citing *Andrews v. South Dakota Student Loan Assistance Corp.*, 636 F.2d 233 (Bankr. S.D. 1980)).
12 *Brunner v. New York State Higher Educ. Serv. Corp. (In re Brunner)*, 831 F.2d 395 (2d Cir. 1985).
13 *Id.* at 109-10.
14 *Id.* at 112.
15 Rafael Pardo and Michelle Lacey, "The Real Student-Loan Scandal: Undue Hardship Discharge Litigation," 83 *Am. Bankr. L. J.* 179, 229 (2009) (finding that identity of debtor's attorney and judge were statistically determinant factors in whether debtor's student loan was discharged under undue-hardship standard).

the Code's implicit assumption of fraud and opportunism. The theory is that if bankruptcy were available, students would borrow significant funds, then promptly discharge all debts upon graduation—thus "picking [his or] her debt relief...when [his or] her realizable assets and present income are at their lowest and...debt and future income are at their highest."[16]

The issue lies in the fact that student loans are wholly unsecured; the lender has neither liens nor recourse. Students cannot return the knowledge they gained, and critics argue that "[s]tudents will be able to realize the benefit of education and translate that benefit into [future] financial payoff," long after they have shirked their responsibilities to the lender and to society.[17] Such a precedent, opponents contend, would involve the collapse of the accessibility of higher education to those who require the assistance of student loans, an argument that allows bankruptcy to become "an indirect lever for education policy."[18] Prevailing policy succumbs to the belief that "making bankruptcy harsher for the debtor...makes borrowing more affordable for that debtor in particular and all borrowers generally."[19]

While theories of abuse are prevalent, irrational abuse theories are not realistic: Bankruptcy abuse is not the norm, and there are strong societal stigmas and future financial hardships associated with filing.[20] The Bankruptcy Code has mechanisms in place to catch frivolous filers, such as the trustee system, the chapter 7 means test and provisions designed to catch fraudsters.[21] The National Bankruptcy Review Commission noted that when federal student loans were dischargeable under chapter 7, "a fraction of 1% of all matured student loans were discharged," and under chapter 13, "less than 7/10 of 1% of total debt...was for educational loans."[22] Nonetheless, BAPCPA did not acknowledge the history of low student loan bankruptcy rates. The fact that "[w]hen student loans *were* discharged in bankruptcy...debtors [generally] also had other significant indebtedness," suggested that true financial need permeates the market of student loan holders, since student loan default rates continue to rise—even though bankruptcy relief is unavailable.[23]

Returning Relief as Clear, Viable Option

Bankruptcy has always been an option for student debtors, but the current undue-hardship standard is such an inflexible rule that a debtor must show an almost impossibility of repayment to qualify, restricting the viability of bankruptcy as a relief mechanism.[24] Further, courts are split over whether they maintain an equitable power of the bankruptcy court to fashion remedies despite a determination of undue hardship. Congress should act to clarify or revise the Code to ensure equitable options for student debtors in bankruptcy proceedings.[25]

An overhaul to the treatment of student loans in bankruptcy must achieve three goals: (1) provide more equitable treatment of student borrowers, (2) continue to encourage lending to student borrowers and (3) prevent gaming of the bankruptcy system. First, Congress should explicitly provide that bankruptcy courts may use their § 105(a) equity powers to fashion remedies with respect to student borrowers, which would resolve the conflict among jurisdictions and would allow courts to tailor the bankruptcy proceedings of individual cases rather than a group.[26] Such equitable remedies could include partial discharge or an implementation of a temporary income-based repayment plan for private loans. Various congressional bills currently in circulation provide options such as debt "swaps" of private for public debts, or an outright full discharge.[27] In order to prevent the inequity of current proceedings, Congress must also explicitly state that the undue-hardship standard need not be met to invoke equity; however, the level of hardship must increase depending on the level of equitable remedy sought. Ultimately, full discharge (at least for a time) should be subject to the current undue-hardship standard.

By embracing their equitable powers, courts would also promote the second and third goals. Equity does not reward those with "unclean hands."[28] Thus, bankruptcy courts would be vigilant and scrutinizing when confronted with a request for an equitable remedy from a student borrower. Lenders could allege debtor wrongdoing and have the court consider whether equity is appropriate. Further, the lender is not precluded from arguing that a specific remedy is unfair or unnecessary. Thus, lenders may challenge borrowers in bankruptcy and win, but the lender will not be guaranteed a win. With this system in place, lenders should still feel secure in lending to student borrowers because full discharge is not guaranteed and equitable relief can be challenged.

Last, to prevent gamesmanship and abuse, Congress could limit the availability of a full discharge. In order to attain a complete discharge within a set number of years after graduation, a debtor would have to demonstrate the undue-hardship standard, which would protect the lender from a complete loss for a fixed time, thus keeping an incentive for the lender to lend, and would allow the graduate time to seek other remedies in repaying his or her obligation. However, after a period of seven to 10 years following graduation, it is increasingly unlikely that any request for bankruptcy hinges on student loans alone, but instead on the entirety of accumulated debt. Thus, once that time period has passed, one can eliminate the stringent undue-hardship standard and simply permit full discharge within the court's equitable powers as a part of a complete bankruptcy proceeding.[29]

Conclusion

There are plausible options to loosen the shackles on graduates haunted by their student debts. While initially unpalatable to lenders, affording debtors equitable options to manage their student loans is the only way to avoid the crumbling of our higher education system and an economy that depends on those graduates. We need not jump to harsh conclusions and full discharge, but should realize that the Bankruptcy Code stands as a flexible document that can be altered to suit the needs of student citizens who currently face one of the harshest economic climates in decades, with no "fresh start" in sight. ■

16 *Id.*

17 John A.E. Pottow, "The Nondischargeability of Student Loans in Personal Bankruptcy Proceedings: The Search for a Theory," 44 *Can. Bus. L. J.* 245, 254 (2007).

18 *Id.*

19 *Id.*

20 Sara Murray, "Bankruptcy Comes with Social Stigma," *Wall Street Journal* (Nov. 25, 2010).

21 11 U.S.C. § 707(b)(2)(A). See 11 U.S.C. § 523(a)(2).

22 Nat'l Bankr. Rev. Comm., *Bankruptcy: The Next 20 Years*, 210 (Oct. 20, 1997), http://govinfo.library.unt.edu/nbrc/reportcont.html. *See also* Robert Salvin, "Student Loans, Bankruptcy and the Fresh-Start Policy: Must Debtors Be Impoverished to Discharge Educational Loans?," 71 *Tul. L. Rev.* 139, 145-46 (1996) ("Although student loan bankruptcies were actually small in number and dollar amount...the media tended to portray the abuse as a potentially widespread phenomenon.").

23 Robert M. Lawless and Elizabeth Warren, "Shrinking the Safety Net: The 2005 Changes in U.S. Bankruptcy Law," at 2, U. Illinois Law and Economics Working Paper Series, Research Paper No. LE06-031 (2006), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=949629, Nat'l Bankr. Rev. Comm., *supra*, n. 22, at 210; *supra*, n. 2.

24 Andrew MacArthur, "Pay to Play: The Poor's Problems in the BAPCPA," 25 *Emory Bankr. Dev. J.* 407, 468-69 (2009).

25 *Hemar Ins. Corp. of Am. v. Cox (In re Cox)*, 338 F.3d 1238, 1242 (11th Cir. 2003) (internal citation omitted); *See generally* Brendan Hennessy, "The Partial Discharge of Student Loans: Breaking Apart the All or Nothing Interpretation of 11 U.S.C. 523(a)(8)," 77 *Temp. L. Rev.* 71 (2004); Frank Bayuk, "The Superiority of Partial Discharge for Student Loans under 11 U.S.C. § 523(A)(8): Ensuring a Meaningful Existence for the Undue-Hardship Exception," 31 *Fla. St. U. L. Rev.* 1091 (2004).

26 *Tennessee Student Assistance Corp. v. Hornsby (In re Hornsby)*, 144 F.3d 433, 438-40 (6th Cir. 1998), 144 F.3d at 440, 438-40 (6th Cir. 1998) (stating that courts could use its equity power by "partially discharging loans, whether by discharging an arbitrary amount of the principal, interest accrued or attorney's fees; by instituting a repayment schedule; [or] by deferring the debtor's repayment of the student loans").

27 *See generally* Student Loan Bill Tracker, www.studentloanbilltracker.com.

28 *See Precision Instrument Mfg. Co. v. Auto. Maint. Mach. Co.*, 324 U.S. 806, 814-15 (1945) ("[Equity requires] that [the invoking party] shall have acted fairly and without fraud or deceit as to the controversy in issue.").

29 Ron Lieber, "Student Debt and a Push for Fairness," *New York Times* (June 4, 2010) (citing that for-profit lender Sallie Mae is in support of dischargeable student loans, if there is waiting period between graduation and eligibility).