ALERTS

Seventh Circuit Reads Bankruptcy Safe Harbor Broadly to Insulate Preferential Settlement Payment to Commodity Broker

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The United States Court of Appeals for the Seventh Circuit, on March 19, 2014, held that a corrupt debtor's pre-bankruptcy cash transfer to a commodity broker was a "settlement payment" made "in connection with a securities contract," thus falling "within [Bankruptcy Code] §546(e)'s safe harbor" and insulating the transfer from the trustee's preference claim. *Grede v. FCStone, LLC* (*In re Sentinel Management Group, Inc.*), 2014 WL 1041736, *7 (7th Cir. Mar. 19, 2014). Reversing the district court's "policy" decision that "Congress could not have intended the safe harbor provisions to apply" to this case, the Court of Appeals stressed that §546(e) makes no "exception for preferential transfers, although it does make an exception for actual fraud," a claim the bankruptcy trustee never made. *Id.*, at *8. As the court explained, "Congress enacted §546(e) to prevent a large bankruptcy from triggering a wave of bankruptcies among securities businesses....Those dealing in securities have an interest in knowing that a deal, once completed, is indeed final so that they need not routinely hold reserves to cover the possibility of unwinding the deal if a counter-party files for bankruptcy in the next 90 days....[E]ven a short term lack of liquidity can prove fatal to a commodity broker or other securities business." *Id.*, at *9. In a separate unrelated holding, the court also ruled that the debtor's court-authorized post-bankruptcy cash transfer to the commodity broker could not be set aside under Code §549.

Relevance

One of the Bankruptcy Code's safe harbor provisions, §546(e), insulates from the trustee's fraudulent transfer or preference attack a "settlement payment" or "margin payment" on a "securities contract," "commodity contract" or "forward contract," except when the debtor's payment is made with "actual intent to hinder, delay, or defraud" creditors. The Courts of Appeals have consistently refused to accept policy arguments made by trustees and creditors, choosing instead to follow the Code's plain language. In the past year alone, the Second Circuit held that payments by a debtor to a noteholder trustee for noteholders "in exchange for private placement notes clearly fell within the safe harbor for 'transfers made...in connection with a securities contract.'" *In re Quebecor World (USA) Inc.*, 719 F.3d 94 (2d Cir. 2013). The Fourth Circuit also held that commission payments to a stockbroker were shielded from recovery under the §546(e) "settlement payment" defense, finding no statutory exception for payments made in the context of a Ponzi scheme. *In re Derivium Capital LLC*, 716 F.3d 355, 366 (4th Cir. 2013). Just six months ago, the Seventh Circuit also held that "shares of stock issued by crooked mutual funds or hedge funds are 'securities'...for the purposes of [Code] §546(e)." *Peterson v. Somers Dublin Ltd.*, 729 F.3d 741, 750 (7th Cir. 2013).

Facts

The debtor in *Grede* was an investment management firm that had apparently violated federal securities and commodities laws by commingling client funds across different segments of investors. It used the investors' securities as collateral to take out large loans from a bank. After the subprime mortgage industry collapsed, when the bank demanded immediate payment, the debtor sought Chapter 11 reorganization relief. Immediately prior to bankruptcy, the debtor had improperly moved roughly $300 million from a liened account to a group of investors in its futures commission merchant ("FCM") segment. The debtor also distributed $22.5 million to its FCM investors, including the defendant here. After filing its Chapter 11 petition, but before a trustee was appointed, the debtor, with court approval, also sold more than $300 million of securities it was holding and transferred the sale proceeds to the same FCM group that included the defendant.

The trustee sued the FCM defendants in the district court, seeking to avoid both the pre-bankruptcy and post-bankruptcy transfers. The district

court held, in a test case with just one defendant, that §546(e) did not protect from avoidance the debtor's pre-bankruptcy transfer to the defendant. 2014 WL 1041736, at *8. In its view, "shielding the debtor's distribution of sale proceeds to customers would destabilize the financial system because it would be impossible to predict who would receive money in the event of a bankruptcy." The district court also held that the bankruptcy court's authorization of the post-bankruptcy transfer of sale proceeds to the defendant was not a proper authorization under Code §549.

The Court of Appeals

The Seventh Circuit held that the pre-bankruptcy transfer "qualified as a 'settlement payment' under §546(e)." *Id.*, at *7. Although the debtor's customers had no "rights to specific securities,...they were entitled to *pro rata* shares of the value of the securities in their group's portfolios." *Id.* The debtor could thus sell securities from the portfolio or pay its customers "with cash it had on hand" to satisfy customer redemptions. *Id.* "Regardless of how [the debtor] chose to fund customer redemptions, the redemptions were meant to settle, at least partially, the customer's securities accounts with [the debtor]." *Id.*

The court also found a second "independent basis for applying the safe harbor of §546(e)." *Id.*, at *8. Specifically, the debtor made the pre-bankruptcy transfer to the defendant "in connection with a securities contract." *Id.* Because the FCM "investment agreements were contracts for the purchase and sale of securities," the debtor's cash redemption "still served in part to satisfy [its] obligations to [the defendant] under the investment agreement," thus making the cash transfer a redemption "in connection with the investment agreement," a "securities contract" referred to in Code §546(e). *Id.*

The Seventh Circuit rejected the district court's policy-grounded "reasoning [as] directly contrary to the broad language of §546(e)." *Id.* Because the safe harbor insulates preferences from attack, "[t]he presence of an exception for actual fraud makes sense only if §546(e) applies as far as its language goes." *Id.*, citing *Peterson*, 729 F.3d at 749. With §546(e),

"Congress chose finality over equity for most pre-petition transfers in the securities industry -- i.e., those not involving actual fraud. In other words,

§546(e) reflects a policy judgment by Congress that allowing some otherwise avoidable pre-petition transfers in the securities industry to stand would probably be a lesser evil than the uncertainty and potential lack of liquidity that would be caused by putting every recipient of settlement payments in the past 90 days at risk of having its transactions unwound in the bankruptcy court."

Id., at *9. In other words, the safe harbor provision "protects the market from systemic risk and allows parties in the securities industry to enter into transactions with greater confidence." *Id.*, at *7.

Comments

1. The Seventh Circuit's broad reading of Code §546(e) is consistent with its earlier decision in *Peterson v. Somers Dublin Ltd.*, 729 F.3d 741 (7th Cir. 2013) (*held*, pre-petition redemption payments made to investors by Chapter 7 debtor-hedge funds operating as a Ponzi scheme fell within Code's safe harbor). In *Peterson*, the debtor funds "were not operating legitimately at the end and were conduits for the" debtor's fraudulent scheme, causing the trustee to argue that "Code §546(e) is irrelevant." *Id.*, at 748. Although other courts "have been restive at the idea that people who receive money from a crooked enterprise can keep it, to the detriment of other investors who did not get out while the going was good," causing them to "read §546(e) narrowly," the Seventh Circuit claimed to be interpreting "the Code clearly and predictably using well established principles of statutory construction." *Id.*, at 749, quoting *RADLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065, 2073 (2012). It would "apply the text...[but] not themes from a [legislative] history that was neither passed by a majority of either House nor signed into law." 729 F. 3d at 748. The court disagreed with the Fifth and Ninth Circuits, which refused to apply the safe harbor when "the operators of particular Ponzi schemes were not 'stockbrokers' for the purpose of the statute." *Id.*, at 749, citing *In re Slatkin*, 525 F.3d 805 (9th Cir. 2008); and *In re Wider*, 907 F.2d 570 (5th Cir. 1990). Instead, the Seventh Circuit followed two recent decisions from the Second Circuit. *In re Quebecor World (USA) Inc.*, 719 F.3d 94 (2d Cir. 2013) ("transfer" has its normal meaning); and *Enron Creditors Recovery Corp. v. Alfa, S.A.B.de C.V.*, 651 F.3d 329 (2d Cir. 2011) ("settlement payment" has its normal meaning).

2. The lower courts are still wrestling with the Code's safe harbor provisions. *See*, e.g., *In re Tribune Company Fraudulent Conveyance*

Litigation, 499 B.R. 310, 325 (S.D.N.Y. 2013) (*held*, granting defendants' motion to dismiss, "...§546(e) does not preempt the Individual Creditors' [fraudulent transfer] claims, but...§362(a)(1) nonetheless deprives the Individual Creditors of standing to avoid the same transactions that the estate representative is simultaneously suing to avoid."); *Whyte v. Barclays Bank P.C.*, 494 B.R. 196 (S.D.N.Y. 2013) (*held*, trustee barred by Code §546(g) [safe harbor for transfer to swap participant or financial participant under swap agreement] from asserting claims of creditors that had been assigned to liquidation trust when trustee would otherwise be expressly barred by §546(g) from asserting those claims; trustee's "clever" attempt to assert state law rights as "assignee," but not as trustee, would "render section 546(g) a nullity."); *In re Lyondell Chemical Co.*, 503 B.R. 348, 358 (Bankr. S.D.N.Y. Jan. 14, 2014) (*held*, safe harbor of §546(e) did not bar unsecured creditors from seeking, under state fraudulent transfer law, to recover payments made to former shareholders of a company acquired in a leveraged buyout). Finally, the Second Circuit is expected to rule soon on another factually provocative safe harbor case. *AP Services LLP v. Silva*, 483 B.R. 63, 68-69, 71 (S.D.N.Y. 2012) (*held*, §546(e) bars state common law claims such as unjust enrichment, aiding and abetting, or conversion when the underlying facts show that the plaintiff seeks to undo a transaction otherwise insulated by §546(e); dismissed fraudulent transfer complaint under New York law when failed LBO preceded bankruptcy by three years; debtor transferred funds "directly to [the selling shareholder defendants'] bank accounts and [the funds] did not pass...through a clearing house or [similar] intermediary;" "transaction fits within [the Code's] safe harbor.").

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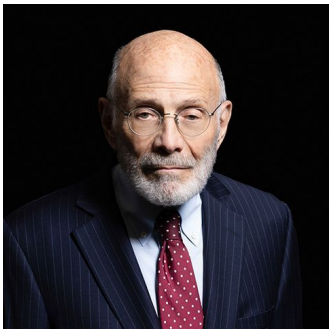

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