Seventh Circuit Reversal of *Grede v. FCStone, LLC* Shields Cash Payments to Customers of Sentinel Under § 546(e) Safe Harbor

On March 19, 2014, the U.S. Court of Appeals for the Seventh Circuit ruled that pre- and post-petition cash transfers from investment management firm Sentinel Management Group, Inc. ("Sentinel") to futures commission merchant FCStone, LLC ("FCStone") are protected from avoidance, while recognizing that the illegal actions of Sentinel's managers makes this case unprecedented. *See Grede v. FCStone, LLC*, Nos. 13-1232, 13-1278, 2014 WL 1041736 (7th Cir. Mar. 19, 2014) (the "Opinion"). Applying a plain reading of the "deliberately broad" text of the Bankruptcy Code's § 546(e) safe harbor,[1] the court held that a $1.1 million pre-petition cash distribution to FCStone was protected from avoidance as a settlement payment and a transfer in connection with a securities contract. The court also concluded that a payout of almost $300 million to a group of customers including FCStone, made pursuant to a bankruptcy court emergency order obtained on the first business day after the petition was filed, could not be avoided as an unauthorized transaction under § 549 of the Bankruptcy Code (the "Code").[2] The present case—a test case to resolve common issues in proceedings against other customers of Sentinel—overturns a district court ruling that held that to permit the "grossly inequitable" last minute distribution of Sentinel customer funds would "fly in the face of justice."[3]

Background

Prior to its collapse in the lead-up to the 2008 financial crisis, Sentinel offered investment services to its customers, which ranged from hedge funds, individuals and financial institutions to futures commission merchants ("FCMs"). Each customer entered into an investment agreement with Sentinel, under which it deposited cash and allowed the firm to purchase securities according to a particular investment profile. Sentinel divided its customers into one of

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[1] Section 546(e) of the Bankruptcy Code provides that "[n]otwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a . . . settlement payment . . . made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract . . . that is made before the commencement of the case, except under section 548(a)(1)(A) of this title."

[2] Section 549 of the Bankruptcy Code provides that "[e]xcept as provided in subsection (b) or (c) of this section, the trustee may avoid a transfer of property of the estate (1) that occurs after the commencement of the case; and (2) (A) that is authorized only under section 303(f) or 542(c) of this title; or (B) that is not authorized under this title or by the court."

[3] *Grede v. FCStone, LLC*, 485 B.R. 854, 889 (N.D. Ill. 2013) (the "District Court Opinion").

three "Segments"—each subject to varying regulatory requirements—and further divided each Segment into groups, each of which shared the proceeds of the sales of securities *pro rata* among its members. Customers did not acquire rights to specific securities, and were only entitled to redemptions of cash in proportion with their beneficial interest in a pool. As relevant to the decision, Segment 1 consisted of FCMs' customer funds, including those of FCStone, and Segment 3 consisted of funds belonging to hedge funds, other public and private trading funds, individual investors and FCMs investing their "house" funds. Opinion at *2.

Segments 1 and 3 were each subject to federal securities and commodities laws that required the segregation of customer funds from those of other customer groups and Sentinel's own assets and required Sentinel to hold customers' property in trust. In practice, Sentinel failed to respect such statutory trusts and engaged in various misconduct, including lumping all available cash together to purchase securities (including securities which did not comply with the pools' risk profiles), miscalculating interest payments, issuing misleading account statements, and transferring customer assets into a lienable account that served as collateral for a loan with Bank of New York ("BONY"). Customers were not aware of these practices. *Id*. at *2-4.

When credit markets contracted on the eve of the financial crisis, many of Sentinel's repo counterparties began closing out their positions, demanding cash in exchange for the return of high-risk and illiquid securities. Sentinel increased its borrowing with BONY to cover a cash shortfall that grew at one point to over $800 million.[4] When BONY notified Sentinel that it would no longer accept physical securities as collateral, the firm transferred customer securities into the BONY collateral account and sold both Segment 1 and 3 securities, supposedly held in trust, to pay down the loan. In a move that "virtually emptied" Segment 3 funds, Sentinel moved $290 million in securities from Segment 3 into the BONY collateral account, and returned $264 million in securities to the Segment 1 account. As the district court noted, "[t]his shift in loss of exposure was not based on customer activity, differing legal obligations to customers, or any other legitimate economic or legal grounds."[5] After BONY sent a notice that it would begin liquidating the collateral account unless Sentinel repaid the loan in full, the firm transferred $22.5 million to Segment 1 customers, including a $1.1 million distribution to FCStone (the "Pre-Petition Transfer"), and filed for bankruptcy protection just hours later, on Friday, August 17, 2007. Opinion at *4.

A mere three days later, on August 20, 2007, prior to the appointment of Frederick Grede as trustee, Sentinel filed an emergency motion with the United States Bankruptcy Court for the Northern District of Illinois, seeking approval for the distribution of proceeds from the sale of a portfolio of securities to remaining Segment 1 customers. The sale, to a company called Citadel, had taken place one day prior to Sentinel's bankruptcy filing. While various parties and regulators raised concerns to the court that Sentinel may have commingled the Segments' funds and securities, the court issued an order allowing BONY to release the sale proceeds it held, of which FCStone received $14.5 million (the "Post-Petition Transfer"). *Id*. at *5. Mr.

4 District Court Opinion at *864.

5 *Id.* at *866.

Grede was subsequently appointed as bankruptcy trustee in the case, and the trustee commenced an adversary proceeding seeking to avoid the Post-Petition Transfer as an unauthorized transfer under § 549 of the Code, and to avoid the Pre-Petition Transfer as a preferential transfer. Similar adversary proceedings were filed against other Segment 1 customers. The trustee also sought and obtained a "clarifying" order from the bankruptcy court, that stated that the bankruptcy court had not authorized the Post-Petition Transfer as a transfer of debtor property (as opposed to customer property) within the meaning of § 549, bolstering the trustee's avoidance action with respect to the Post-Petition Transfer. *Id*. at *10.

Lower Court Decision

The United States District Court for the Northern District of Illinois withdrew the reference for the FCStone adversary proceeding. The case was selected as a test case to decide common issues across the various customer adversary proceedings, including the application of § 546 safe harbors and whether the bankruptcy court's prior order precluded avoidance of the Post-Petition Transfer as an unauthorized transfer. The district court held that the Pre-Petition Transfer was avoidable as a preferential transfer, and the Post-Petition Transfer to FCStone constituted a transfer of property of the estate that was not authorized under the Code or by the bankruptcy court. District Court Opinion at *880-81, 87.

The district court's analysis of the Pre-Petition Transfer centered on whether the transfer is shielded by the securities contract safe harbor under § 546(e) of the Code. The court rejected a literal application of the Code, finding it "inconceivable that Congress intended the safe harbor provisions to apply to the circumstances of this case." *Id*. at *885. The court concluded that applying the safe harbor to shield Sentinel's "uneven and arbitrary" distribution among different counterparties "would create the very type of systemic market risks that Congress sought to prevent" in enacting the safe harbor provisions. The court also concluded that failing to apply the safe harbor here would not result in the unwinding of a completed securities transaction, as FCStone only had a right of cash redemption such that no securities were ever exchanged between it and Sentinel. The Opinion conceptually distinguished the present scenario, a contract between a debtor and a third party customer, from more common safe harbored transactions between a debtor and a buyer of securities. *Id*. at *885-87.

With respect to the Post-Petition Transfer, the court first undertook an extensive analysis to determine whether the almost $300 million distributed to Segment 1 customers was property of the estate, and whether FCStone was an initial transferee or beneficiary of the transfer such that the debtor could recover the value of property transferred under § 550(a) of the Code.[6] Given that both Segment 1 and Segment 3 were required by federal laws to be held as statutory trusts, and because the customers in each Segment have an "equally forceful claim to trust protection," the court first held that in order to demonstrate the proceeds were its own property, FCStone would be required under the common law to demonstrate that the proceeds of the

[6] Section § 550(a) of the Bankruptcy Code provides that "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 (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or (2) any immediate or mediate transferee of such initial transferee."

Post-Petition Transfer can be traced to the funds actually deposited in its group account at Sentinel. *See Id*. at 870-78. The court concluded that conventional tracing presumptions (including the inverse payment rule and the lowest intermediate balance test) do not apply where inadequate funds remain for co-equal trust claims, and because FCStone could not meet its tracing burden, the proceeds therefore constituted property of the estate. The court further concluded that the bankruptcy court's emergency order approving the Post-Petition Transfer did not approve the payment as a transfer of estate property. *See Id*. at *878-81.

The trustee appealed the rulings with respect to both transfers to the U.S. Court of Appeals in the Seventh Circuit.[7]

The Seventh Circuit Decision

The Seventh Circuit Court of Appeals reversed the lower court's judgment, finding "insurmountable legal obstacles" to granting the trustee's avoidance claims. Opinion at *1.

With respect to the Pre-Petition Transfer, the court found no "persuasive reason to depart from the deliberately broad text of § 546(e)," holding that the transfer was both a settlement payment and a transfer "in connection with a securities contract" protected by the statutory safe harbor. A cash redemption by a Sentinel customer, regardless of how it was actually funded, was meant to settle the customers' securities accounts with the firm, the court reasoned, citing to *Peterson v. Somers Dublin Ltd.* for the proposition that swapping securities for money is a settlement payment as defined in § 741(8) of the Code.[8] *Id*. at *7. Next, the court found that each customer's investment agreement with Sentinel authorized and expected the firm to purchase and sell securities on its behalf, making such agreement a "securities contract," as defined in § 741(7) of the Code, and Sentinel's transfer in partial redemption of FCStone's account was "in connection with" such securities contract.[9] *Id*. at *8. Recognizing the "powerful and equitable purpose" of the district court's policy-based reasoning, the court set forth countervailing reasons to apply the plain text of § 546(e), including the goal of the statutory safe harbor to protect the interests of those dealing in securities in "knowing that a deal, once completed, is indeed final." *Id*. at *8-9. "Congress chose finality over equity" for most pre-petition transfers by enacting § 546(e), the Opinion states, and "courts may not decline to follow those policy choices on equitable grounds, however powerful they may be in a particular case." *Id*. at *9.

[7] The district court also found the trustee's claim of unjust enrichment, as an alternative to the avoidance claims, was preempted by the Code as a matter of law. District Court Opinion at *888. In his appeal to the Seventh Circuit, the trustee sought reinstatement of his unjust enrichment claim in the event of reversal. The Seventh Circuit agreed with the district court's finding of preemption, explaining further that "to allow an unjust enrichment claim in this context would allow the trustee or a creditor to make an end run around the bankruptcy code's allocation of assets and losses." Opinion at *14.

[8] *See* 729 F.3d 741, 749 (7th Cir. 2013); Section 741(8) of the Bankruptcy Code defines a "settlement payment" somewhat circularly as "a preliminary settlement payment, a partial settlement payment, an interim settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade."

[9] The parties had already agreed that FCStone is a commodity broker, and that the relevant transfer occurred prior to the filing of the petition for bankruptcy, in satisfaction of the remaining elements of § 546(e). Opinion at *7.

The Seventh Circuit further disagreed with the district court's holding with respect to the post-petition avoidance claim. The court concluded that the bankruptcy court's emergency order did in fact authorize the transfer of nearly $300 million to Segment 1 customers, including the transfer to FCStone, and that the bankruptcy court's subsequent clarifying order constituted an abuse of discretion. The Seventh Circuit rejected the trustee's argument that certain general reservations of rights in the emergency order were sufficient to preserve a § 549 avoidance claim, and emphasized that FCStone relied on the terms of the order to immediately distribute the funds to its own customers, such that reversal of the order after the significant passage of time would harm FCStone and its current creditors. *Id*. at *9-13. The court disapproved of the bankruptcy court's attempt to "rewrite history" through a later interpretation of its order, and refused to look past its clear terms, noting the right of other parties to rely on the order. *Id.* at *13. Having established that the Post-Petition Transfer was authorized, the court did not need to reach the question of whether the other elements of § 549 were met, including, most importantly, whether the proceeds were property of the estate. The court suggested, however, that "a new rule may be in order for competing statutory trust claimants" seeking payments from an insufficient pool of commingled funds, such as requiring trust claimants to trace proceeds without relying upon tracing conventions to assert customer property claims, and if unable to do so, still giving such claims priority over those of unsecured creditors. *See Id*. at *14.

Conclusion

The Seventh Circuit's decision follows a string of recent decisions, including the court's own decision in *Peterson v. Somers Dublin Ltd*, determining that courts must apply the plain language of the Code safe harbors, even where it may be argued that the results appear inequitable.[10] The decision also builds on recent case law applying a broad reading to the definition of "settlement payment" and a "transfer in connection with a securities contract," in the context of the § 546(e) safe harbor. Finally, the court opens the door to consideration of alternative remedies to common law tracing requirements in future cases involving comingled customer property.

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[10] *See* 729 F.3d at 749 ("Ambiguity sometimes justifies resort to legislative history, but it is used to decipher the ambiguous language, not to replace it. The text is what it is and must be applied whether or not the result seems equitable.") *See also Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 476 B.R. 715, 721-22 (S.D.N.Y. 2012); *Lehman Bros. Holdings Inc. v. JPMorgan Chase Bank, N.A. (In re Lehman Bros. Holdings Inc.)*, 469 B.R. 415, 436 (Bankr. S.D.N.Y. 2012) ("the language of the safe harbors is to be strictly interpreted even when the outcome may be prejudicial to the interests of the estate and its creditors"); *Woodward v. PSEG Energy Technologies Asset Mgmt. Co. (In re Tougher Industries, Inc.)*, No. 08-90161, 2013 WL 5592902 (Bankr. N.D.N.Y. Oct. 10, 2013); *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329, 336 (2d Cir. 2011) (engaging in a factual determination about the impact of a transaction on the financial markets would result in commercial uncertainty and unpredictability); *Official Comm. of Unsecured Creditors v. Am. United Life Ins.(In re Quebecor World (USA) Inc.)*, 453 B.R. 201, 219 (Bankr. S.D.N.Y. 2011).

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