Avoidance of Securities Transactions – Investor Exposure

The finality of securities transactions is critical not only to investors but also to global securities markets whose stability depends upon a very basic, but crucial, assumption: once a securities transaction is complete, it cannot be undone. However, in the wake of the Ponzi scheme perpetrated by Bernard Madoff, this fundamental assumption has been challenged and courts have had to determine whether and under what circumstances a transfer in connection with a securities transaction can be recovered by a bankruptcy trustee. A series of high-profile decisions from the Southern District of New York in the Madoff bankruptcy case have explored the contours of Section 546(e) of the Bankruptcy Code, one of the so-called "safe harbor provisions" that seek to protect transferees from having to return money paid in connection with the closing of a securities transaction.[1] These decisions have been largely favorable to investors, even though the transferor (i.e. Bernard Madoff) was engaged in a Ponzi scheme. They are now on appeal before the Second Circuit Court of Appeals, but a recent decision by the Seventh Circuit Court of Appeals in the case of *Grede v. FCStone, LLC* ("*FCStone*") addresses several of the same issues and may shed some light on how the Second Circuit will rule.[2]

THE BACKGROUND AND DECISION IN FCSTONE

FCStone involved an investment management firm, Sentinel Management Group, Inc. ("Sentinel"), which misappropriated the assets of its customers for its own benefit in violation of federal securities law.[3] The assets belonged to two separate groups of customers, whose funds were supposed to be segregated but were instead lumped together.[4] As it raided the funds of both sets of customers, Sentinel issued misleading customer statements based on distorted calculations of the customers' income and the value of their *pro rata* share of the securities that were supposed to be in their segregated accounts.[5] As Sentinel continued to use its customers' assets to pay its own bills, customer accounts became chronically underfunded.[6] In the time leading up to the filing of its bankruptcy petition, Sentinel made several transfers to one group of customers at the direct expense of the second group.[7] The bankruptcy trustee subsequently sought to recover these pre-petition transfers on behalf of the bankruptcy estate, arguing that they were avoidable preference payments.[8] The district court removed the trustee's avoidance claim from the bankruptcy court and ruled that the pre-petition transfers could be avoided and recovered by the trustee.[9] However, on appeal, the Seventh Circuit Court of Appeals reversed, finding that Section 546(e) prevented the avoidance of the transfers.

In determining whether to apply the safe-harbor protections of Section 546(e), the Seventh

[1] *See Picard v. Katz*, 462 N.R. 447, 452 (S.D.N.Y. 2011); *see also Picard v. Grief*, 476 B.R. 715, 718 (S.D.N.Y. 2012).
[2] *Grede v. FCStone, LLC*, Case Nos. 13-1232 and 13-1278, 2014 U.S. App. LEXIS 5169 (7th Cir. Mar. 19, 2014).
[3] *See id*. at *2-3.
[4] *See id*. at *6-7.
[5] *See id*. at *7-8.
[6] *See id*. at *10.
[7] *See id*.
[8] The trustee also sought to void a separate post-petition transfer which had first been authorized by the bankruptcy court before the bankruptcy court subsequently sought to void its initial order. *See id*. at *13-14.
[9] *See id*. at *15.

Circuit had to determine whether the transfers by Sentinel were "settlement payment[s]" and whether they were made "in connection with a securities contract."[10] The Seventh Circuit concluded that the purpose of Section 546(e) was to protect honest investors and the securities markets from the turmoil that could be caused by unwinding otherwise valid securities transactions.[11] On the issue of "settlement payment[s]", the Seventh Circuit noted that the term itself is broadly defined under the Bankruptcy Code and pertains to transactions with a certain class of parties (e.g. commodities brokers, stockbrokers, etc.). The Court referred to its prior ruling that "swapping shares of a security for money (as happens in a customer redemption) is a settlement payment within the meaning of Section 546(e)."[12] Even though Sentinel's customers did not have rights to specific securities, they were entitled to *pro rata* share of the value of the securities in what was supposed to be their accounts.[13]

The Seventh Circuit concluded that the redemption of the customers' interest in these securities were meant to settle, in part or in whole, the customers' securities accounts with Sentinel and, as a result, the transfers qualified as "settlement payments" under Section 546(e).[14] Because Sentinel was a commodities broker, this alone was sufficient to bar the trustee's attempt to recover the pre-petition transfers. However, the Court also went on to conclude that "the agreements did authorize (and expect) Sentinel, [as a commodities broker], to purchase and sell securities as it saw fit for the benefit of its customers" and, as a result, the transfers by Sentinel were "in connection with a securities contract" under Section 546(e).[15] This provided a second independent basis for the dismissal of the trustee's avoidance claims.

[10] *See id*. at *17-18.
[11] *See id*. at *19-20.
[12] *See id*. at *21-22.
[13] *Id*. at *22.
[14] *See id*.
[15] *See id*. at *22-23.

The Seventh Circuit noted that its conclusions were not based only upon the language of Section 546(e), but also on its underlying purpose. The Court highlighted the broad language of Section 546(e), as well as its crucial role in preserving the stability of securities markets.[16] "By enacting Section 546(e)," the Court wrote, "Congress chose finality over equity for most pre-petition transfers in the securities industry—i.e., those not involving actual fraud."[17] In other words, "Section 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 bankruptcy court."[18]

THE IMPORTANCE OF THE FCSTONE DECISION

In articulating the scope of Section 546(e), the Seventh Circuit reaffirmed the breadth of its safe-harbor protections, even where the transferor is engaged in some form of fraudulent activity. The trustee in the Madoff-related litigation has argued that, because of the underlying Ponzi scheme, the pre-petition transfers by Madoff were not "settlement payments" or made in connection with "securities contracts." While, to date, these arguments have been rejected at the trial court level, it remains to be seen if the Second Circuit will affirm the district court's rulings on appeal. To be sure, the nature of the fraudulent activity in Sentinel differed from that perpetrated by Madoff in that Sentinel actually purchased securities on behalf of its customers, while Madoff did not. Nevertheless, the Seventh Circuit's reading of the broad language of Section 546(e) and its conclusions regarding the importance of its protections may guide the Second Circuit in addressing the Madoff cases now before it.

[16] *See id*. at *24-25.
[17] *See id*. at *25-26.
[18] *See id*. at *26.

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