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Grayson Consulting, Inc. v. Wachovia Securities, LLC, f/k/a First Union Securities, Inc., et al. (In re Derivium Capital, LLC), Case No. 12-1518 (4th Cir. May 24, 2013)

On a matter of first impression, the Fourth Circuit issued an opinion in the Derivium Capital, LLC bankruptcy case on May 24, 2013,[1] affirming the District Court's ruling that Grayson Consulting Inc. ("Grayson"), the chapter 7 Trustee's assignee, could not avoid as fraudulent conveyances Wachovia's[2] commissions, fees, and margin interest payments because those payments were protected from recovery by the safe harbor of United States Bankruptcy Code (the "Bankruptcy Code") section 546(e). The Fourth Circuit also affirmed the District Court's ruling that Grayson could not avoid transfers of $161 million worth of securities by customers of Derivium to Wachovia because they were not property of the estate. Last, the Fourth Circuit affirmed the District Court's dismissal of Grayson's tort claims as barred by the doctrine of *in pari delicto*, thereby limiting the power of bankruptcy trustees in Ponzi scheme cases to assert potentially lucrative tort claims.

Case Background

Derivium was a financial services firm that operated a "stock-loan" program, alleged to be a Ponzi scheme. Under this program borrowers could pledge at least $100,000 worth of publicly traded stock to Derivium in exchange for a loan of 90% of the stock's value. On maturity, borrowers could repay the loan and recover their stock, surrender the collateral as payoff for the loan, or refinance the transaction for another term. Unbeknownst to the borrowers, Derivium was immediately selling the stock and transferring the proceeds through various accounts, including brokerage accounts with Wachovia, into a number of start-up businesses owned by Derivium's owners (collectively, the "Derivium Owners"). Many of the start-up businesses failed and the stock appreciated, leaving Derivium unable to satisfy its obligation to return the pledged stock to borrowers following maturity of the stock-loans. Its bankruptcy petition followed.

On August 31, 2007, Grayson commenced an adversary proceeding against Wachovia seeking to avoid certain transfers under sections 548 and 544 of the Bankruptcy Code and alleging nine tort claims. The transfers at issue fell into five categories: (i) transfers of stock from borrowers into Wachovia accounts (the "Customer Transfers"); (ii) transfers of cash by the entities the Derivium Owners employed to process stock loans (the "Stock Loan Entities") into Wachovia accounts (the "Cash Transfers"); (iii) transfers of commissions from the Wachovia accounts to Wachovia (the "Commission Transfers"); (iv) margin interest payments (the "Margin Interest Payments"); and (v) wire transfer and prepayment fees (collectively, the "Other Transfers"). The Bankruptcy Court dismissed Grayson's tort claims under the equitable doctrine of

[1] *Grayson Consulting, Inc. v. Wachovia Securities, LLC, f/k/a First Union Securities, Inc., et al. (In re Derivium Capital, LLC)*, Case No. 12-1518 (4th Cir. May 24, 2013).

[2] Defendants Wachovia Securities Financial Network, LLC and First Clearing, LLC (are referred to collectively as "Wachovia").

in pari delicto,[3] granted Wachovia summary judgment on the fraudulent transfer claims relating to the Customer Transfers, the Cash Transfers, and the Margin Interest Payments finding that the property transferred was not estate property,[4] and were protected by the section 546(e) safe harbor.[5] The District Court affirmed all of the Bankruptcy Court's rulings, and Grayson subsequently appealed to the Fourth Circuit, which affirmed the District Court decision.[6]

The Fourth Circuit Decision

1. The Customer Payments

The Fourth Circuit agreed that the Customer Transfers were not avoidable transfers because they did not involve property of the estate. The Customer Payments were made not by Derivium, but instead by the stock loan borrowers.[7] On appeal, Grayson conceded that Derivium did not hold an interest in the securities prior to the Customer Transfers, but argued that it acquired an interest in them as a result of the Customer Transfers, at which time Wachovia simultaneously acquired an interest in the securities under the account agreements governing the Wachovia accounts.[8] Like the Bankruptcy Court, the Fourth Circuit distinguished *Manhattan Investment*, reasoning that the purpose of the avoidance powers under the Bankruptcy Code is to prevent the debtor from making transfers that diminish the value of the bankruptcy estate to the detriment of the estate's creditors.[9] The Customer Transfers involved transfers of stock by third parties "*to* Derivium, not from or through Derivium."[10] There was no transfer of estate property or diminution of the bankruptcy estate because Derivium had no rights to the securities until *after* the transfers were effectuated.[11]

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[3] The doctrine of *in pari delicto* is an affirmative defense that may be invoked in disputes among wrongdoers to prevent judicial aid to the plaintiff when the plaintiff bears equal or greater fault than the defendant. *See Grayson Consulting, Inc. v. Wachovia Securities, LLC, et al. (In re Derivium Capital, LLC)*, C/A No. 05-15042, Adv. Pro. No. 07-80119, Dkt. No. 92 at 4-5 (Bankr. D.S.C. June 10, 2008) (dismissing Grayson's nine tort claims).

[4] *See Grayson Consulting, Inc. v. Wachovia Securities, LLC, et al. (In re Derivium Capital, LLC)*, C/A No. 05-15042, Adv. Pro. No. 07-80119, Dkt. No. 419 at 29-30 (Bankr. D.S.C. Sept. 14, 2010) (granting summary judgment in part and denying it in part) ("First Summary Judgment Order").

[5] *See Grayson Consulting, Inc. v. Wachovia Securities, LLC, et al. (In re Derivium Capital, LLC)*, C/A No. 05-15042, Adv. Pro. No. 07-80119, Dkt. No. 488 at 4-5 (Bankr. D.S.C. Feb. 15, 2011) ("Second Summary Judgment Order").

[6] *See Grayson Consulting, Inc. v. Wachovia Securities, LLC, et al. (In re Derivium Capital, LLC)*, Case No. 12-1518 (4th Cir. May 24, 2013) ("Derivium").

[7] Summary Judgment Order at 12-13.

[8] The core of Grayson's argument focused on the decision of the United States District Court for the Southern District of New York in *In re Manhattan Inv. Fund Ltd.*, 391 B.R. 1 (S.D.N.Y. 2007) (affirming a bankruptcy court's holding that a trustee could recover transfers made by a debtor into its margin account maintained by a brokerage firm because the firm had sufficient dominion and control over the account to be an "initial transferee" under 11 U.S.C. § 550) ("Manhattan Investment").

[9] *Derivium*, Case No. 12-1518 at 7.

[10] *Id*. at 7 (citing 437 B.R. 798, 807) (emphasis in original).

[11] *Id*.

Grayson argued alternatively that portions of the Customer Transfers could be avoided as "settlement payments" or "margin payments" under 11 U.S.C. §§ 548(a)(1)(A) and 546(e). The Fourth Circuit was not persuaded by this argument. First, the Fourth Circuit explained, section 548 only provides for the avoidance of settlement payments made from debtor property.[12] Second, section 546 only provides a defense to otherwise avoidable transfers. Because the Customer Transfers were not transfers of debtor property, they were not avoidable under section 548, and thus, not otherwise avoidable as required by section 546.[13]

2. The Cash Transfers

The Fourth Circuit rejected Grayson's argument that Wachovia was the "initial transferee" of the Cash Transfers and affirmed the District Court's decision that they were not recoverable under Bankruptcy Code section 550. The Bankruptcy Court ruled that Grayson failed to demonstrate that Wachovia exercised dominion or control over the accounts in question, therefore Grayson could not establish that Wachovia was the initial transferee as required to avoid Cash Transfers as fraudulent transfers.[14] Although the Bankruptcy Court did not define "initial transferee," the Fourth Circuit found that the Bankruptcy Court's findings were not erroneous when analyzing the Cash Transfers under the "dominion and control" test.[15] The Fourth Circuit ultimately agreed with the Bankruptcy Court that the deduction of fees, commissions, and margin interest payments from the Wachovia accounts was not sufficient evidence of dominion and control to subject Wachovia to liability as the initial transferee.[16]

3. The Commission Transfers

The Fourth Circuit affirmed the ruling that the Commission Transfers were protected "settlement payments" under the section 546(e) safe harbor. The Fourth Circuit first examined the plain language of section 546(e) and found that the definition of "settlement payment" was sufficiently ambiguous to warrant a review of legislative intent and case law from other circuits.[17] The Fourth Circuit concluded that the District Court did not err in affirming the Bankruptcy Court's protection of the Commission Transfers because such transfers were paid to stockbrokers as a part of settling securities transactions.[18] The Fourth Circuit also found that the evidentiary record supported the conclusion that the commissions were

[12] *Id*. at 8.

[13] *Id*.

[14] Specifically, the Bankruptcy Court held that Wachovia's deduction of fees, commissions, and margin interest payments from the accounts in question is not sufficient evidence of dominion and control to subject Wachovia to liability as the initial transferee. *See* Summary Judgment Order at 16.

[15] The "dominion and control" test requires that an initial transferee have (i) legal dominion and control over the property (i.e. the right to use the property for its own purpose) and (ii) exercise such dominion and control. *Derivium*, Case No. 12-1518 at 9 (citing *Bowers v. Atlanta Motor Speedway, Inc. (In re Se. Hotel Props., Ltd. P'ship)*, 99 F.3d 151, 155-56 (4th Cir. 1996)).

[16] *Id*. at 10.

[17] *Id*. at 12.

[18] *Id*. at 13.

customary and reasonable.[19] Significantly, the Fourth Circuit qualified its holding with respect to section 546(e) by explaining that not all payments to brokers labeled as commission would be protected from recovery as "settlement payments" under section 546(e).[20] Specifically, commissions that are unrelated to the settlement of securities transactions, such as commissions for soliciting investors, would not fall under section 546(e)'s safe harbor.[21] The Fourth Circuit noted that section 546(e)'s safe harbor also protects transfers made "in connection with a securities contract," but did not consider whether the Commission Transfers and the Margin Interest Payments would be protected under this alternative because they were already protected as "settlement payments."[22]

4. The Margin Interest Payments

The Fourth Circuit affirmed the conclusion that the Margin Interest Payments were "margin payments" protected by the section 546 safe harbor. In order to be "margin payments," the Bankruptcy Court held that Margin Interest Payments must reduce a deficiency in a margin account.[23] The Bankruptcy Court concluded that because accrued interest increases the total debt owed, the Margin Interest Payments did reduce a deficiency in a margin account. Finding nothing in the record to suggest the Bankruptcy Court erred, the Fourth Circuit affirmed this holding.[24]

Relying on an unclean hands theory, Grayson argued that the Commission Transfers and the Margin Interest Payments should be excepted from the safe harbor provision of section 546(e) because applying the safe harbor in an alleged Ponzi scheme would permit a broker to retain ill-gotten profits.[25] The Bankruptcy Court never held an evidentiary hearing on this claim due to the settlement of certain related claims, therefore, the Fourth Circuit declined to establish "an extra-statutory fraud exception to the stockbroker defense."[26]

5. The In Pari Delicto Defense

Last, the Fourth Circuit affirmed the dismissal of Grayson's tort claims under the doctrine of *in pari delicto*. The Fourth Circuit distinguished the Seventh and Ninth Circuit cases[27] relied on by Grayson because they involved receivers, who, unlike trustees, are not subject to section 541.[28] Because a trustee stands in the

[19] *Id*. at 15.

[20] *Id*. at 13.

[21] *Id*.

[22] *Id*. at 11, n. 7.

[23] *Id*. at 16.

[24] *Id*.

[25] *Id*.

[26] *Id*. at 17.

[27] *Id*. at 18 (citing *Scholes v. Lehmann*, 56 F.3d 750 (7th Cir. 1995) and *FDIC v. O'Melveny & Myers*, 61 F.3d 17 (9th Cir. 1995)).

[28] Under section 541, a trustee may assert the same rights and causes of action and be subject to the same defenses as the debtor. *See id*.; 11 U.S.C. § 541.

shoes of a debtor under section 541, the Fourth Circuit concluded that *in pari delicto* bars Derivium, the trustee, or Grayson as the trustee's successor from asserting those tort claims.[29] Like the Bankruptcy Court, the Fourth Circuit rejected Grayson's "adverse interest" exception[30] to *in pari delicto*, concluding that the sole actor rule applied in this case and imputed the agent's conduct to the principal if that agent is the principal's sole representative.[31]

Implications

Derivium is the first Fourth Circuit case to substantively discuss "settlement payments" and "margin payments" under the section 546(e) safe harbor. The Fourth Circuit qualified its determination that the Commission Transfers were "settlement payments" under section 546(e), suggesting that the Fourth Circuit may not construe "settlement payments" as broadly as other some other circuit courts.[32] For example, the Fourth Circuit stated that 546(e) would not protect commissions if the amount of the commission when compared with the transaction amount indicated that the commissions were not actually related to closing trades.[33]

This decision also limits the power of bankruptcy trustees in Ponzi scheme cases to assert tort claims, concluding that unlike receivers, trustees and their successors "take no greater rights than the debtor himself had" and, therefore, are barred by the doctrine of *in pari delicto* from prevailing on tort claims that could not be brought by the debtor.[34] Relying on Grayson's own allegations, the Fourth Circuit rejected the argument that the adverse interest exception should be applied to save the tort claims. Because Grayson alleged that Derivium's Owners completely controlled the company and operated the 90% Stock-Loan Program, the Fourth Circuit concluded that the Derivium Owners were "sole actors" whose actions were imputed to Derivium.

[29] *Derivium*, Case No. 12-1518 at 19.

[30] The "adverse interest" exception provides that the wrongs of an agent are not imputed to the principal if the agent acted adverse to the principal's interests. *Id*.

[31] *Id*. at 19-20.

[32] The Sixth Circuit, for instance, defined "settlement payment" in the context of section 546 as "extremely broad." *Id*. at 12 (quoting *QSI Holdings, Inc. v. Alford (In re QSI Holdings, Inc.)*, 571 F.3d 545, 549 (6th Cir. 2009)).

[33] *See id.* at 13.

[34] *Id*. at 18.

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