Pratt's Journal of Bankruptcy Law

LEXISNEXIS® A.S. PRATT™ JULY/AUGUST 2014

QUESTIONS ABOUT THIS PUBLICATION?

For questions about the **Editorial Content** appearing in these volumes or reprint permission, please call:
Kent K. B. Hanson, J.D. at .... 1-800-424-0651 ext. 3207
Email: .... kent.hanson@lexisnexis.com
For assistance with replacement pages, shipments, billing or other customer service matters, please call:

Customer Services Department at . . . . (800) 833-9844
Outside the United States and Canada, please call . . . . (518) 487-3000
Fax Number . . . . (518) 487-3584
Customer Service Web site . . . . http://www.lexisnexis.com/custserv/
For information on other Matthew Bender publications, please call

Your account manager or . . . . (800) 223-1940
Outside the United States and Canada, please call . . . . (518) 487-3000

Library of Congress Card Number: 80-68780

ISBN: 978-0-7698-7846-1 (print)
ISBN: 978-0-7698-7988-8 (eBook)

Cite this publication as:

[author name], [*article title*], [vol. no.] PRATT'S JOURNAL OF BANKRUPTCY LAW [page number] (LexisNexis A.S. Pratt);
Patrick E. Mears, *The Winds of Change Intensify over Europe: Recent European Union Actions Firmly Embrace the "Rescue and Recovery" Culture for Business Recovery*, 10 PRATT'S JOURNAL OF BANKRUPTCY LAW 349 (LexisNexis A.S. Pratt)

An A.S. Pratt™ Publication

Editorial Offices
121 Chanlon Rd., New Providence, NJ 07974 (908) 464-6800
201 Mission St., San Francisco, CA 94105-1831 (415) 908-3200
www.lexisnexis.com

MATTHEW BENDER

(2014–Pub.4789)

Editor-in-Chief & Board of Editors

PRATT'S JOURNAL OF BANKRUPTCY LAW is published eight times a year by Matthew Bender & Company., Inc.

Seventh Circuit Confirms the Independence of the "Settlement Payment" and "Securities Contract" Safe Harbors of 11 U.S.C. § 546(e)

Jason W. Harbour and Shannon E. Daily*

Finding that a certain pre-petition transfer fell under both the "settlement payment" and transfers made "in connection with a securities contract" safe harbors of § 546(e) and that a post-petition transfer was expressly authorized by the bankruptcy court under § 549, the Seventh Circuit recently held that neither the pre- nor post-petition transfers could be avoided. The decision is consistent with recent decisions by the Second and Fourth Circuits, which also applied broad interpretations of the § 546(e) safe harbors.

The United States Court of Appeals for the Seventh Circuit (the "Seventh Circuit") recently adopted a broad reading of the safe harbor of United States Bankruptcy Code (the "Bankruptcy Code") Section 546(e), which protects from avoidance "settlement payments" and transfers made in connection with a "securities contract," among other transfers.[1] In *FCStone*, the Seventh Circuit reversed the United States District Court for the Northern District of Illinois's decision to avoid $300 million in pre- and post-petition transfers made by Sentinel Management Group, Inc. ("Sentinel"). Finding that the pre-petition transfer fell under both the "settlement payment" and transfers made "in connection with a securities contract" safe harbors of § 546(e) and that the post-petition transfer was expressly authorized by the Bankruptcy Court for the Northern District of Illinois under § 549, the Seventh Circuit held that neither the pre- nor post-petition transfers could be avoided. The Seventh Circuit's decision is consistent with recent decisions by the Second and Fourth Circuits, which also applied broad interpretations of the § 546(e) safe harbors.[2]

CASE BACKGROUND

Sentinel was an investment management firm that provided its customers with a *pro rata* share of the value of the securities in their investment pool. This appeal related to transfers to Segments 1 and 3 of Sentinel's customers, both of which were protected by federal regulations requiring Sentinel to hold its customers' property in

[*] Jason W. Harbour is a partner and Shannon E. Daily is an associate in the Bankruptcy, Restructuring and Creditors' Rights practice at Hunton & Williams LLP. The authors may be reached at jharbour@hunton.com and sdaily@hunton.com, respectively.

[1] *Frederick J. Grede v. FCStone, LLC*, 2014 U.S. App. LEXIS 5169 (7th Cir. Mar. 19, 2014) ("*FCStone*").

[2] *See, e.g., 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) ("*Derivium*"); *Official Comm. of Unsecured Creditors of Quebecor World (USA) Inc. v. Am. Life Ins. Co. (In re Quebecor World (USA) Inc.)*, 2013 U.S. App. LEXIS 11615 (2d Cir. June 10, 2013) ("*Quebecor*").

trust. Sentinel, however, commingled all available cash, used it to purchase various securities, and used some of the Segment 1 and Segment 3 securities as collateral for a loan. In August 2007, Sentinel distributed $22.5 million in cash to two Segment 1 groups and subsequently filed its voluntary petition for relief under Chapter 11 of the Bankruptcy Code. Sentinel then sought an emergency order from the bankruptcy court allowing the lender to distribute $300 million in sale proceeds to Segment 1 customers. Over the concerns of the Securities and Exchange Commission, the Commodity Futures Trading Commission and a Segment 3 customer, the bankruptcy court approved the post-petition distribution.

The liquidating trustee (the "Trustee") subsequently initiated adversary proceedings seeking to avoid Sentinel's pre- and post-petition transfers. The proceeding against FCStone, LLC ("FCStone") was selected as a test case. The district court[3] held that the safe harbors of 11 U.S.C. § 546(e) did not apply because even assuming the investment agreement qualified as a "securities contract" or the pre-petition transfer qualified as a "settlement payment," to shield the pre-petition transfer from avoidance "would produce a result 'demonstrably at odds with the intentions of its drafters.'"[4] The district court also held that the bankruptcy court did not approve the post-petition transfer within the meaning of 11 U.S.C. § 549(a) and that FCStone was an "initial transferee" and beneficiary under 11 U.S.C. § 550(a)(1). Thus, the district court avoided both the pre- and post-petition transfers.

THE SEVENTH CIRCUIT DECISION

The Seventh Circuit reversed the avoidance of the pre- and post-petition transfers, holding that the safe harbor of § 546(e) protected the pre-petition transfer from avoidance under § 547(b) and that § 549 barred the avoidance of the post-petition transfer because the bankruptcy court approved such transfer.[5]

In analyzing the pre-petition transfer, the Seventh Circuit first addressed whether the transfer could be considered a "settlement payment" under § 546(e). The Seventh Circuit noted that it has previously held the definition of "settlement payment" to include "swapping shares of a security for money (as happens in customer redemption)."[6] The Seventh Circuit concluded that it was inconsequential how Sentinel chose to fund customer redemptions, whether by selling securities from the group's portfolio or by paying cash, because the redemptions were meant to partially settle the customers' securities accounts.[7] Thus, the pre-petition transfer was a "settlement payment" and therefore protected from avoidance by § 546(e).

---

[3] The district court withdrew the reference to the bankruptcy court, finding that the proceedings presented significant and unresolved issues of non-bankruptcy law.

[4] *See Grede v. FCStone, LLC*, 485 B.R. 854, 887 (N.D. Ill. 2013) (quoting *United States v. Ron Pair Enters.*, 489 U.S. 235 (1989)).

[5] *FCStone,* 2014 U.S. App. LEXIS 5169 at *18.

[6] *Id.* at *21–22 (citing *Peterson v. Somers Dublin Ltd.*, 729 F.3d 741, 748 (7th Cir. 2013)).

[7] *Id.* at *22.

Additionally, the Seventh Circuit concluded that the pre-petition transfer was made "in connection with a securities contract," which "is an independent basis for applying the safe harbor of § 546(e)."[8] While Sentinel's investment agreements did not provide its customers with rights to specific securities, the Seventh Circuit determined that they were nonetheless "securities contracts," as the term is defined in § 741(7), because they authorized Sentinel to purchase and sell securities for the customers' benefit.[9] The Seventh Circuit also noted that even though the pre-petition transfer to FCStone was made without selling securities from the Segment 1 portfolio, it nonetheless was made "in connection with" the investment agreement, which rendered it protected by the § 546(e) safe harbor.[10]

The Seventh Circuit rejected the district court's avoidance of the pre-petition transfer, which was based on policy and equitable grounds, and noted that the Supreme Court recently reiterated "that Congress has balanced many of the difficult choices that must be made in bankruptcy cases, and that courts may not decline to follow those policy choices on equitable grounds, however powerful they may be in a particular case."[11]

With respect to the post-petition transfer, the Seventh Circuit was not persuaded by the Trustee's argument that the bankruptcy court never authorized the transfer within the meaning of § 549 because it never determined whether the property transferred was property of the bankruptcy estate. The Seventh Circuit reasoned that § 549 only requires a court to find that a transfer involves estate property before avoiding that transfer. Thus, the Seventh Circuit concluded that a court does not need to decide whether a transfer involves estate property when approving the transfer for the transfer to be authorized by the court within the meaning of § 549.[12] Nevertheless, the Seventh Circuit declined to decide whether it might be possible for a court to approve a transfer without authorizing the transfer within the meaning of § 549.[13]

The Seventh Circuit also held that the bankruptcy court abused its discretion by clarifying its order authorizing the post-petition transfer to provide that it had not actually authorized the transfer under § 549.

The Seventh Circuit concluded that giving deference to the bankruptcy court's subsequent order, rendered over a year after its original order, would undermine the ability of the parties and non-parties to rely on a court order.[14] The Seventh Circuit noted, however, that the situation might be different if the bankruptcy court had

[8] *Id.*

[9] *FCStone,* 2014 U.S. App. LEXIS 5169 at *23.

[10] *Id.* at *23.

[11] *Id.* at *26 (citing *Law v. Siegel* (U.S. 2014).

[12] *Id.* at *31.

[13] *Id.* at *30.

[14] *Id.* at *38.

clarified its order earlier, before the parties and non-parties relied on its plain meaning to their detriment.[15]

IMPLICATIONS

FCStone reiterates the breadth of § 546(e)'s "settlement payment" and "securities contract" safe harbors. This decision conforms with at least two other recent circuit court decisions confirming the independence of the "settlement payment" and "securities contract" safe harbors of § 546(e).[16] In *Quebecor*, the Second Circuit held that the transfers at issue were protected by the "securities contract" safe harbor and declined to address whether the transfers would also be protected under the "settlement payment" safe harbor. In *Derivium*, the Fourth Circuit held that the transfers at issue were protected as "settlement payments" and declined to address the "securities contract" safe harbor. By contrast, in *FCStone*, the Seventh Circuit analyzed both safe harbors and concluded that each safe harbor provided an independent defense.

Further, in *FCStone*, the Seventh Circuit held that redemptions qualify as both settlement payments and transfers made in connection with a securities contract. The Second Circuit in *Quebecor*, however, expressly had avoided deciding whether a redemption would qualify as a "securities contract" as defined in § 741(7).

In addition to the implications *FCStone* has on interpreting § 546(e), it also raises a question regarding § 549: whether a court can ever authorize a transfer without authorizing it within the meaning of § 549. The Seventh Circuit doubts such approval would be possible, but declined to definitively answer that question.[17]

---

[15] *Id.* at *39–40.

[16] *See, e.g., Derivium*, Case No. 12-1518 (4th Cir. May 24, 2013) (holding that the transfers at issue were protected as "settlement payments," and as a result, declining to discuss whether they would be protected as transfers made in connection with a "securities contract"); *Quebecor*, 2013 U.S. App. LEXIS 11615 (2d Cir. June 10, 2013).

[17] *FCStone,* 2014 U.S. App. LEXIS 5169 at *40.