Court Rejects Safe Harbor Defenses for Futures Customers

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On January 4, 2013, the U.S. District Court for the Northern District of Illinois issued an opinion that strikes a significant blow against the rights of futures customers that might otherwise enjoy the Bankruptcy Code's safe harbor protections. The opinion, arising out of the Chapter 11 bankruptcy case of Sentinel Management Group, Inc. (Sentinel), fashions a new exception to the safe harbor protections in the event of distributions or redemptions to customers of a failed futures commission merchant (FCM). The defendant on the losing end of the opinion, FCStone, LLC, has indicated that it will appeal the ruling, which sets the stage for a compelling battle in front of the U.S. Court of Appeals for the Seventh Circuit in the coming months.

Sentinel's Business Model, its Relationship with FCStone and its Eventual Downfall

Sentinel managed investments for clients, such as FCMs, hedge funds, financial institutions and pension funds. It was registered with the Securities and Exchange Commission as an investment adviser, and with the Commodity Futures Trading Commission (CFTC) as an FCM. Sentinel's registration as an FCM was due to a legal technicality; it did not perform the typical FCM roles of execution and clearing.

Sentinel provided its clients with a choice of various investment portfolios, based on the type of investment held in each. In addition to each client's election, Sentinel broke down its investor accounts into further classifications in accordance with the relevant CFTC regulations that applied to each customer. In Sentinel's nomenclature, "SEG 1" referred to FCMs' accounts used for domestic futures trading; "SEG 2" to FCMs' accounts used for foreign futures trading; and "SEG 3" for other financial institutions and individuals. Finally, there were sub-classifications into 11 groups within each of the three "SEGs," based on customers' risk and return goals.

FCStone is an FCM in the more traditional sense. Its business model consists of maintaining accounts and clearing trades for futures customers. FCStone was also a customer of Sentinel, pursuant to an Investment Advisory Agreement that governed the relations between the parties. FCStone had its accounts invested in the "SEG 1 Group 7" class – which met the regulatory requirements for an FCM holding customer funds, and invested in only government securities, corporate bonds and cash.

Sentinel maintained its accounts at Bank of New York (BONY) and JP Morgan. It also maintained a loan arrangement with BONY to cover haircuts associated with a series of repo trades that Sentinel executed from 2001 through 2007.

As credit markets contracted in 2007, Sentinel's repo counterparties began to close out positions – which, in turn, meant that the counterparties returned underlying securities to Sentinel and demanded cash payments in exchange. As a result, beginning in June 2007, Sentinel was forced to add additional collateral for its loan with BONY. In a series of transactions, Sentinel moved cash and securities out of customer accounts – sometimes to collateralize its loans, and sometimes to cover shortfalls in the accounts of other customer groups.

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On August 13, 2007, Sentinel informed customers that it had requested CFTC authority to halt redemptions. At that time, the cash and securities held by Sentinel comprised 80.4% of the total customer equity. Notwithstanding the "No Redemption Letter," on August 15, 2007, Sentinel made distributions to two customer groups – allowing the "SEG 1 Group 1" and the "SEG 1 Group 8" classes to be paid in full. After receiving a notice on August 16, 2007, that BONY intended to liquidate its collateral, Sentinel filed a petition for bankruptcy protection the next day.

The Sale of Securities to Citadel

On August 16, 2007 – shortly before filing for bankruptcy – Sentinel sold a portfolio of 98 securities to Citadel Investment Group, LLC. The sale netted approximately $337 million for Sentinel. Six of the 98 securities failed to settle on August 16; one of those six subsequently settled, raising an additional $4.9 million.

As a result of the Citadel sale, Sentinel distributed $22.5 million of cash to customers classified in "SEG 1 Group 7" and "SEG 1 Group 9" on August 17, 2007. As a member of the former group, FCStone received $1.1 million of the August 17 distributions. After the bankruptcy filing, Sentinel obtained a court order allowing for the distribution of additional proceeds by BONY from the Citadel sale. On August 21, 2007, the same two "SEG 1" groups received additional distributions from the Citadel sale. FCStone received $14.5 million in this later distribution.

In contrast to the groups in "SEG 1," the groups in "SEG 3" received no redemptions from Sentinel and were left with "a tiny pool of assets" for distributions in the bankruptcy case. The district court noted that if the distributions made between August 15 and 21 had been made on a *pro rata* basis to all customers, the distributions would have represented 32% of total customer obligations.

The Trustee's Avoidance Action and FCStone's Defenses

Frederick J. Grede, as Liquidation Trustee (the Trustee), commenced adversary proceedings against a number of Sentinel customers to avoid and recover transfers made by Sentinel shortly before and immediately after the bankruptcy filing. In his complaint against FCStone, the Trustee sought to avoid and recover approximately $15.6 million. The Trustee asserted several causes of action, but the most germane were for avoidance and recovery of unauthorized post-petition transfers and of preferential transfers.

Much of the district court's opinion focuses on the Trustee's ability to prove the affirmative elements of those causes of action. FCStone argued that (a) the funds it received were not property of the bankruptcy estate; (b) the bankruptcy court had authorized the post-petition transfers; and (c) it was not the initial transferee, nor an entity for whose benefit the transfer was made. After a lengthy analysis, the district court rejected each of those arguments, concluding that the Trustee had established his affirmative case.

That conclusion left FCStone with only the safe harbor defense. Section 546(e) of the Bankruptcy Code provides that notwithstanding the statutes that give rise to avoidance actions, "the trustee may not avoid a transfer that is a margin payment... or settlement payment ... made by or to (or for the benefit of) a commodity broker ..., or that is a transfer made by or to (or for the benefit of) a commodity broker ... in connection with a ... securities contract [or] commodity contract... that is made before the commencement

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of the case." Under the pertinent language of the statute, FCStone would be shielded from avoidance of any prepetition transfers if it could establish that it is a commodity broker, and either:

- The relevant transfer was a margin payment or settlement payment, or
- The relevant transfer was made in connection with a securities contract or a commodity contract.

The Bankruptcy Code's definition of commodity broker specifically includes FCMs. Therefore, it appears that FCStone would have readily established that it is a commodity broker. There would have been more ambiguity with regard to the remaining elements of FCStone's safe harbor defenses. If FCStone proceeded under the former prong, the Trustee would have contested whether the transfer to FCStone comprised a settlement payment. Unfortunately, the statutory definition of that term is quite circular, and provides little certainty. If, on the other hand, FCStone proceeded under the latter prong, the Trustee would have argued that the Investment Advisory Agreement could not qualify as a securities contract or a commodity contract.

The District Court's Ruling Creates a Judicial Exception to the Safe Harbors

The court chose not to analyze those issues, however. Instead, it stated: "I decline to address these specific arguments because, regardless of whether the distribution of the Citadel proceeds fits under a literal interpretation of § 546(e), I find it inconceivable that Congress intended the safe harbor provisions to apply to the circumstances of this case."

The court based its summary conclusion on two factors. First, it determined that applying the safe harbors would actually increase systemic risk, which would be a result explicitly at odds with the purpose of the safe harbor statutes. Second, the court asserted that whereas the safe harbors were intended to protect completed securities and commodity transactions, the decision not to apply the safe harbors in this case would not result in unwinding any such transactions. As a result, the court concluded that applying the safe harbor statute in this instance "would produce a result demonstrably at odds with the intentions of its drafters."

Because the court chose to refute the safe harbor defenses in this manner, one might speculate that it performed a preliminary analysis and determined that FCStone would have prevailed under a more traditional analysis. In other words, it is a fair presumption that the court would have preferred, if possible, to reject FCStone's defenses based on a technical reading of the Bankruptcy Code.

For that and other reasons, the appeal to the Seventh Circuit may prove to be a blockbuster. Elsewhere across the country, lower courts have been inconsistent in their treatment of the scope of the safe harbors, but the circuit courts have regularly held that the safe harbor defenses should be interpreted broadly. In recent months, both the Second Circuit and the Fifth Circuit have issued opinions reinforcing an expansive view of those statutes. The Seventh Circuit has a reputation as a very independent-minded tribunal, however, and therefore it is difficult to forecast how it will approach the issues.

Likewise, there is a high degree of uncertainty for customers of other failed commodity brokers, such as MF Global Inc. and Peregrine Financial Group Inc. The district court's opinion is imprecise regarding the scope of the exception it creates. As quoted above, the court's most direct statement simply states that it will not apply a literal interpretation of section 546(e) to "the circumstances of this case." It remains

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somewhat unclear which circumstances are contemplated, but a later portion of the opinion suggests that the relevant context is a debtor that (a) trades on behalf of third parties as part of its business, and (b) distributes proceeds from a completed securities or commodity transaction. If that is an accurate statement of the scope of the new exception, it would presumably apply to some distributions to MF Global and Peregrine customers, but perhaps not to others. Because of that lingering ambiguity, even if the Seventh Circuit ultimately upholds the district court's judicial exception, the market would benefit from a greater degree of certainty about the scope of that exception.

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