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Safe Harbor Provisions Intact in Recent Seventh Circuit Decision

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April 25, 2014 - Participants in the securities and futures markets rely on the Bankruptcy Code's safe harbor provisions to protect their transactions and assets when a counter-party enters bankruptcy. Reliance on the safe harbor provisions, whose objective is to increase the overall stability of the financial markets, was tested by a recent decision of the District Court for the Northern District of Illinois in *Grede v. FCStone LLC*[1] when the court refused to apply the safe harbor protections of section 546(e) to defeat a preference action by a liquidating trustee against a futures commission merchant that had received a pre-petition transfer from the debtor. Securities and futures market participants surely breathed a sigh of relief on March 19, 2014 when the Court of Appeals for the Seventh Circuit reversed the District Court's decision[2] and held that the "deliberately broad" text of section 546(e) protected the pre-petition transfers to the futures commission merchant despite the "powerful and equitable" arguments at the heart of the District Court's decision. The Seventh Circuit's decision is consistent with decisions in the Second, Sixth and Tenth Circuits and reemphasized the broad protections that the safe harbor provisions provide to financial market participants in events of counter-party bankruptcy.[3]

Grede focused on a transfer by Sentinel Management Group ("Sentinel") to FCStone LLC, a former customer of Sentinel, just prior to its collapse in 2007. The day before it filed for bankruptcy, Sentinel sold a portfolio of customer securities to an equity fund for more than $300 million and deposited the cash proceeds into an omnibus segregated customer cash account. Mere hours before filing its petition, Sentinel started paying out full and partial redemptions to certain customers, FCStone being one of them. After the bankruptcy court appointed a trustee for the estate, the trustee commenced adversary proceedings to avoid the transfer to FCStone (as well as transfers to other former customers) as preferential. The District Court withdrew the reference to the bankruptcy court, finding that the proceedings raised significant unresolved non-bankruptcy issues. It then held that the trustee could avoid the transfer as preferential because it constituted a mere "distributions of proceeds" and because applying the safe harbor could create systematic risk to the financial markets.

On appeal, the Seventh Circuit reversed, holding that safe harbor contained in section 546(e) prevented the avoidance of the transfer as preferential. Specifically, the court found that the transfer was a "settlement payment… in connection with a securities contract," and that the securities sale to the equity fund, a swap of shares for cash, fell squarely within section 546(e)'s definition of a "settlement payment." The Court also noted that even though the customers did not have rights to the specific securities in their investment portfolios, their investment agreements obligated Sentinel to purchase and sell securities for their benefit. As such, each agreement constituted a "contract for the purchase or sale of a security" thereby satisfying the requirements of section 546(e). The Seventh Circuit recognized the public policy reasons for the District Court's ruling, but held that, absent a finding of actual fraud in the pre-petition transfer, the District Court's decision was in direct conflict with the explicit, broad language of the safe harbor provision.

The Seventh Circuit's ruling paid particular attention to Congress's intention in enacting the safe harbor provision to prevent a large bankruptcy from having a domino effect of successive bankruptcies among affected securities or futures businesses. The court recognized that in the securities and futures industry, where large amounts of money are transacted rapidly to settle trades, the finality of a transaction is of critical importance. The safe harbor provision reflects Congress's decision to prioritize finality over equity, allowing some otherwise avoidable pre-petition transfers to stand rather than allowing uncertainty and lack of liquidity to persist for 90 days after every settlement payment.[4]

Although the District Court and the Seventh Circuit both took notice of Sentinel's wrongful conduct of commingling its customers' supposedly segregated assets with its own, ultimately, these facts did not serve to defeat Congress's clear intent in passing the safe harbors. The Seventh Circuit's ruling provides assurances to market participants that the protections of the Bankruptcy Code's safe harbor provisions will be applied regardless of the facts of a particular bankruptcy.

Footnotes

[1] 485B.R. 854 (N.D. Ill. 2013)

[2] *Grede v. FCStone, LLC*, Nos. 13-1232, 13-1278 (7th Cir. Mar. 19, 2014)

[3] *See, Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329, 334 (2d Cir. 2011); *QSI Holdings Inc. v. Alford (In re QSI Holdings Inc.)*, 571 F.3d 545, 547 (6th Cir. 2009); *Kaiser Steel Corp. v. Pearl Brewing Co. (In re Kaiser Steel Corp.)*, 952 F.3d 1230, 1235 (10th Cir. 1991).

[4] To reach this conclusion, the Seventh Circuit analyzed the two sets of transfers separately. The court held that the post-petition transfer could not be avoided under section 549 of the Bankruptcy Code because the bankruptcy court had specifically authorized the disbursement of funds and because the parties relied on that authorization. The safe harbor provision did not govern the post-petition transfer's analysis.

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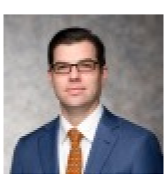

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