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A Narrow Interpretation Of Section 546(e)

Law360, New York (April 01, 2013, 1:10 PM ET) -- FCStone, a New York-based commodities brokerage firm, was recently ordered to return a transfer of $15.6 million to the bankruptcy estate of Sentinel Management Group. Approximately $1.1 million of this amount constituted a prepetition transfer of proceeds the debtor obtained from the sale of securities, which proceeds the debtor distributed to a certain segment of its customers, including FCStone.

Judge James B. Zagel of the United States District Court for the Northern District of Illinois in Grede v. FCStone LLC (N.D. Ill. 2013), determined that this prepetition transfer constituted a preference that was not protected under the safe harbor of section 546(e), which immunizes certain settled financial transactions from avoidance.

Judge Zagel declined to analyze whether or not the transaction in question constituted a “settlement payment” or a transfer made “in connection with a securities contract” pursuant to a “literal interpretation” of section 546(e), but instead relied on the public policy considerations underlying the section. Judge Zagel’s approach represents a departure from the Second Circuit’s approach in In re Enron Creditors Recovery Corp. v. Alfa SAB de CV, 651 F.3d 329 (2d Cir. 2011), in which the court of appeals broadly interpreted the language of section 546(e) to protect a transaction that did not involve the traditional purchase or sale of securities, albeit under a distinguishable set of facts.

The Purpose of Section 546(e)

The Bankruptcy Code contains several provisions that grant special protections for participants in the financial markets. Section 546(e) restricts the ability for a trustee to avoid certain transactions — including, among others, settlement payments, margin payments and commodity contracts — even when these transactions would otherwise constitute constructively fraudulent conveyances or preferential payments.

Congress’s stated intent in enacting section 546(e) was “to minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries.” H.R. Rep. 97-420, at 2 (1982). Specifically, Congress was concerned with a “ripple effect” that would occur if a participant in settled financial transactions filed for bankruptcy and sought to unwind such transactions in bankruptcy, placing its counterparties and other downstream participants at undue risk.

Factual Background

Sentinel was an investment advisory firm that specialized in offering CFTC-compliant investment programs for its customers — primarily future commission merchants and other participants in the futures and commodities market. Sentinel customers deposited funds into particular investment programs and received a pro rata beneficial interest in the securities that backed that investment group. Pursuant to applicable CFTC regulations, Sentinel was required to segregate commodity customer funds from those of other customer groups and from Sentinel's own assets.

Starting in 2001, however, Sentinel improperly entered into a number of repurchase agreements (or "repos") that were collateralized by certain of the same securities that Sentinel used to support its investor programs, which left the customer accounts chronically underfunded. The collapse of the subprime mortgage industry resulted in several repo counterparties closing out positions in Sentinel's repo portfolio and demanding cash payments. Eventually, Sentinel was unable to service the repayment demands or to meet its collateral maintenance obligations and was forced to file Chapter 11.

On Aug. 16, 2007, in a hasty effort to begin selling securities to redeem customer funds, Sentinel sold to Citadel numerous securities allocated to certain customer accounts. The next day, before filing for bankruptcy, Sentinel distributed $22.5 million from the Citadel sale to certain customers, including FCStone, which received approximately $1.1 million.

Additionally, on Aug. 21, 2007, just days after filing bankruptcy, Sentinel sought and obtained an order from the bankruptcy court approving the turnover of the Citadel sale proceeds to certain customer accounts, pursuant to which order FCStone received another $14.5 million. In total, FCStone recovered nearly 70 percent of what it invested in Sentinel, whereas the majority of other customers in the same investment group recovered approximately 32 percent.

Sentinel's plan of liquidation established a liquidating trust, which was administered by Fredrick J. Grede, as liquidating trustee. In September 2008, the trustee sought to avoid certain transfers, including the transfer of $15.6 million to FCStone.

The Decision

Judge Zagel determined that the debtor's postpetition transfer of $14.5 million to FCStone constituted a transfer of property of the estate that was not authorized by the Bankruptcy Code or bankruptcy court and, accordingly, was avoidable as an unauthorized postpetition transfer pursuant to section 549.[i] The court also determined that the prepetition transfer of $1.1 million on Aug. 17, 2007, constituted a preference under section 547(b).

FCStone contended that each of these payments was protected under section 546(e) as a "settlement payment" as well as a "transfer made in connection with a securities contract." Judge Zagel opted not to analyze whether or not this transaction fell within the meaning of either term and instead stated that, "regardless of whether the distribution of 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 in this case."

The court reasoned that to permit the avoidance of this transfer would manifest the very type of destabilization that Congress sought to prevent by enacting section 546(e). Specifically, Judge Zagel found that, in situations in which the debtor is an investment advisor or financial institution, such as Sentinel, that sells securities on behalf of third-party customers, permitting such a debtor to favor certain customers over others in the distribution of proceeds would itself create systemic risk by leaving the market unable to predict how losses would be apportioned in the event of an investment advisor's bankruptcy.

Furthermore, the court found the often-employed "ripple effect" argument unavailing in light of the fact that investment advisors constitute a larger stake in the economy than futures commission merchants, and thus greater destabilization would be created by not requiring losses to be shared proportionally by the entire customer base in the event of an investment advisor's bankruptcy.

Finally, the court determined that avoiding these transfers would not result in the unwinding of a completed securities transaction because no securities were transferred between Sentinel and FCStone — only between Sentinel and Citadel. Therefore, the court suggested that section 546(e) was inapplicable to a debtor's distribution of proceeds from a completed securities transaction simply because that debtor happens to trade on behalf of third parties.

In sum, Judge Zagel declined to apply the safe harbor of section 546(e) on the basis that to do so would produce a result "demonstrably at odds with the intentions of its drafters."

Testing the Boundaries of Section 546(e)

In the wake of the financial crisis, the majority of the decisions applying section 546(e) have focused on whether certain transactions qualify as a "settlement payment" or "transfer made in connection with a securities contract." In the summer of 2011, in Enron the U.S. Court of Appeals for the Second Circuit provided some clarity in holding that the term "settlement payments" should be construed broadly and required only "an exchange of money or securities that completes a securities transaction." Enron, 651 F.3d at 337.

As a result of the Second Circuit's interpretation, section 546(e)'s reach has been applied broadly by lower courts. For example, Judge James Peck noted shortly following Enron that "[t]he test has become quite simple and all-encompassing and does not lend itself easily to the formulation of nuanced exceptions." In re Quebecor World (USA) Inc., 453 B.R. 201, 206 (Bankr. S.D.N.Y. 2011).[2]

However, the U.S. District Court for the Northern District of Illinois joined a minority of courts that have relied on the specific legislative intent underlying section 546(e) to hold that the section's scope should be interpreted narrowly. Under this interpretation, a transaction only receives safe harbor protection when its avoidance would implicate the stability of the financial markets.

FCStone has appealed the district court's decision to the U.S. Court of Appeals for the Seventh Circuit. The Court of Appeals may limit its holding to distinguishing the factual circumstances in this case from previous cases that have given a broad scope to 546(e), but which have frequently involved the application of section 546(e) to insulate transfers that were payments made to selling shareholders in a private or public LBO. The court may decide, however, to address how broadly section 546(e) should be applied in future cases and could potentially result in a circuit split depending on the outcome of the appeal.

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[1] While the bankruptcy court issued an order permitting the distribution of the sale proceeds to Sentinel's customers, the court explicitly stated that it was not determining whether or not the proceeds were property of the estate, and therefore, this order did not constitute bankruptcy court authorization within the meaning of section 549(a)(2)(B).

[2] Interestingly, before the Second Circuit ruled in Enron, some bankruptcy judges in the Southern District of New York published opinions restricting the scope of section 546(e). For example, just two months before the Enron decision, U.S. Bankruptcy Judge Robert D. Drain held that Congress clearly "did not intend section 546(e)'s exemption to apply to [a] modest private LBO transaction." In re MacMenamin's Grill, 450 B.R. 414, 421-422 (Bankr. S.D.N.Y. 2011).

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