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Outside Counsel

'FCStone' and the Absurdity Exception To the Securities Contract Safe Harbor

By
Shmuel Vasser

In January of this year, a District Court in Illinois issued a highly controversial opinion in the Sentinel bankruptcy case. *Grede v. FCStone*, 485 B.R. 854 (N.D. Ill. 2013). The district court refused to apply §546(e) of the Bankruptcy Code to bar a preference action brought by the Sentinel trustee against FCStone, a futures commission merchant (FCM), concluding that application of §546(e) would produce a result "demonstrably at odds with the intention of its drafters."[1] Litigation concerning §546(e) has taken center stage in some of the most prominent bankruptcies of recent times, including in *Lehman Brothers*[2] and *Madoff*,[3] with billions of dollars at stake.

Since the *FCStone* decision is inconsistent with the decisions of the bankruptcy court and the district court of the Southern District of New York in these, as well as other cases, it could sow tremendous uncertainty as to the scope of the protection that §546(e) actually provides. Rather than simply contrasting the *FCStone* decision with other relevant precedents, however, we find it more useful to test its soundness by examining the reasoning underlying it. (This article reflects the author's views only.)

SHMUEL VASSER *is a partner in the bankruptcy and restructuring department of Dechert, resident in the New York office.*

Facts

The facts involved in the case are complex and involve legal issues other than the preference cause of action and the dispute concerning the application of §546(e). For our purposes, however, the facts can be simplified. Sentinel filed for bankruptcy on Aug. 17, 2007. The day before the filing, Sentinel sold to Citadel a portfolio of securities for approximately $340 million. The proceeds were deposited in a segregated cash account of customers of a certain type (SEG 1 customers)[4] at the Bank of New York. On Aug. 17, 2007, but prior to the bankruptcy filing, Sentinel distributed $22.5 million of cash held at JPMorgan Chase to SEG 1 customers' segregated accounts. FCStone received approximately $1 million of that distribution.[5]

The court found that the various transfers engaged by Sentinel in the days prior to its bankruptcy filing significantly improved the treatment of the SEG 1 customers, to the direct detriment of the SEG 3 customers.[6] While the SEG 1 customers received pre- and post-petition distribution of all or substantially all of the Citadel sale proceeds, these transactions "left SEG 3 customers with a tiny pool of assets…. This resulted in a substantially lower recovery rate for SEG 3 customers than SEG 1 customers."[7] Further, if the distributions were made pro rata to all customers, FCStone would have received less than 50 percent of what it actually received.[8]

The §546(e) Defense

FCStone argued that the preference cause of action must be dismissed based on §546(e) of the Bankruptcy Code. Except for causes of action based on actual fraud, §546(e) prohibits avoidance of pre-petition transfers that are margin payments or settlement payments made to, among others, commodity brokers or made to the various protected parties, including commodity brokers, in connection with, among others, a commodity or a securities contract. FCStone argued that the alleged preferential payment qualified as both a settlement payment made to it as a commodity broker, and as a transfer made in connection with a securities contract.[9]

The Sentinel trustee argued that the transfer was not made in connection with a securities contract and that it was not a settlement payment since it was not made to complete a securities transaction.[10]

The Decision

As noted above, the court found FCStone liable. The analytical framework used by the court to reach its decision, however, deserves a closer look. The court did not rule whether §546(e) does, or does not apply to the transfer at hand; rather the court held that regardless of whether the transfer fits the literal interpretation of §546(e), "I find it inconceivable that Congress intended the safe harbor provisions to apply to the circumstances of this case."[11] Relying on Supreme Court precedent, the court held that "applying the safe harbor here would produce a result 'demonstrably at odds with the intentions of its drafters.'"[12]

The court cited two main reasons for its conclusion. First, the court held that the application of §546(e) to these facts would create the systemic risk that the safe harbor was designed to prevent. That is because, if a debtor distributes proceeds in an arbitrary manner, favoring certain customers over others, the application of §546(e) would destabilize the financial system by making it unpredictable as to how losses will be allocated.[13]

Second, the court concluded that the failure to apply §546(e) will not result in the unwinding of completed securities and commodities transactions that Congress sought to protect.[14]

The concluding paragraphs of the opinion make clear that the result was equity driven: "To allow Sentinel's management's baseless, eleventh hour choices over how to steer the company ship, sinking under the weight of their own fraud, to dictate the outcome of this case would fly in the face of justice and do nothing to advance any plausible Congressional purpose."[15]

Analysis

We do not intend here to take issue with whether the ultimate result of the *FCStone* decision is equitable or not, nor do we take a position on the underlying dispute between the trustee and FCStone; what we think deserves a closer look is the road taken by the court. We believe that it is the road less traveled.

> The 'FCStone' decision could saw tremendous uncertainty as to the scope of the protection that §546(e) actually provides.

First and foremost, the court refused to apply §546(e) without first deciding whether or not the transfer at issue was within the scope of §546(e). We believe that this is an extraordinary, if not unprecedented, path taken by the court. The court does not cite a single precedent it followed in this regard. After all, if §546(e) is inapplicable, or distinguishable, there was no need to take the extreme and rare step of refusing to enforce the statute.

As support for its decision, the court cited a single sentence from the Supreme Court's *Ron Pair* decision. The *Ron Pair* court held that "[t]he plain meaning of legislation should be conclusive, except in the 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters.'"[16] As the Supreme Court noted in *Griffin*, the case relied on by *Ron Pair*, there is no more persuasive evidence of the purpose of the statute than its language, and that only in rare cases the intentions are to be elevated over the language used.[17] Further, as *Griffin* held, in these rare cases where the intent is at odds with the language, "[w]e have reserved 'some scope for adopting a restricted, rather than a literal or usual, meaning of its words where acceptance of this meaning… would thwart the obvious purpose of the statute.'"[18]

Consistent with *Griffin*, in order to avoid unintended results, courts sometime rewrite a statute's words.[19] The *FCStone* court, however, did not adopt a restricted interpretation of any of the terms or words used in §546(e); it simply refused to apply it.

The *FCStone* decision, therefore, appears more in line with cases following the absurdity rule—a rule that allows a court not to enforce a statute in a particular situation because of the resulting absurdity: "[T]he Supreme Court has subscribed to the idea that judges may deviate from even the clearest statutory text when a given application would otherwise produce 'absurd' results."[20]

Whatever the exact parameters of the absurdity doctrine are, however, it is clear that it is to be applied in extremely unique situations. For example, the Marshall court held that it applies when "the absurdity and injustice in applying the provision to the case, would be so monstrous, that all mankind would, without hesitation, unite in rejecting the application."[21] A classic absurdity doctrine case drives this point home. In *United States v. Kirby*,[22] a sheriff executed an arrest warrant against a mail carrier for murder. A prosecutor then charged the sheriff under a statute making it a crime to interfere with the delivery of mail. The Supreme Court held the law not to apply based on common sense. The *Kirby* court cited two examples to support its ruling: A law punishing a person who drew blood on the street should not apply to a surgeon helping an ill person on the street, and a statute providing that it is a felony for a prisoner to break out of prison should not apply to a prisoner breaking out because the prison is on fire.[23]

Examined in the prism of the absurdity doctrine line of cases, it seems fair to question whether the application of §546(e) to the transfer at issue in *FCStone*, is such an extreme and rare case suitable for the application of the doctrine.

Moreover, in considering the application of the absurdity doctrine, a court must take stock of another relevant principle, i.e., that legislation often has unintended consequences: "Recognizing 'the reality that the reach of a statute often exceeds the precise evil to be eliminated,' the [Supreme] Court has emphasized that 'it is not, and cannot be, our practice to restrict the unqualified language of a statute to the particular evil that Congress was trying to remedy[.]'"[24] It is not clear how this principle would have impacted *FCStone* had it been considered by the court.

Finally, we look at the reasons given by the court for refusing to apply §546(e). First, the court found that applying §546(e) to distributions made to prefer some creditors over others would harm the market by making the allocation of losses unpredictable. The difficulty with this argument is that Congress, through the adoption of §546(e), barred preference and constructive fraudulent transfer avoidance actions for transfers that fit the section. Section 547 is designed to avoid debtors preferring one set of creditors over others; in §546(e) Congress essentially permitted preferences for transfers that fit §546(e). That result may be just or unjust, wise or unwise, but it is one specifically provided for by Congress.

Second, the court held that the refusal to apply §546(e) "will not result in the unwinding of completed securities and commodities transactions that Congress sought to protect."[25] That may or may not be the case. But, numerous cases addressed the proper scope of §546(e) to differing results; some shielding transaction, some do not. None of the cases, however, simply refused to apply the statute (or to decide whether or not it even applies).

Third, the court states that the "customer redemptions were not necessary to settle security sales and therefore did not affect the settlement chain that §546(e) is designed to protect."[26] This conclusion may or may not be correct; the point is that it should support a finding that the transfer at issue was not protected by §546(e), not that the section does not apply.

The 'FCStone' decision appears more in line with cases following the absurdity rule—a rule that allows a court not to enforce a statute in a particular situation because of the resulting absurdity.

Finally, the court was clearly concerned with the arbitrariness of the distributions and the intent to favor one set of customers over others, even making a passing reference to Sentinel "sinking under the weight of [management's] own fraud."[27] Depending on the underlying facts, this seems to be bordering on facts sufficient to assert an actual fraud cause of action.

Transfers made with actual intent to defraud are not protected by §546(e). Therefore, if fraud was involved, the §546(e) safe harbor would not have shielded the transfer from avoidance. Simply put, in §546(e) Congress made a clear policy choice—preferences and constructive fraudulent transfers are not avoidable; actual fraudulent transfers are.[28] Can a court simply disregard this policy choice by labeling its application absurd?[29]

Postscript

The *FCStone* decision is on appeal before the U.S. Court of Appeals for the Seventh Circuit. Briefs have yet to be filed. Ruling is far away. In the meantime, however, parties making credit decisions based in part on the applicability of the safe harbor provisions of the Bankruptcy Code may need to revaluate their models. If other courts were to follow the *FCStone* approach, there is no telling the true scope of the safe harbor.

1. *FCStone*, 485 B.R. at 885.
2. See, e.g. *Lehman Bros. v. JPMorgan Chase*, 469 B.R. 415 (Bankr. S.D.N.Y. 2012).
3. *SIPC v. Madoff*, 476 B.R. 715 (S.D.N.Y. 2012); *Picard v. Katz*, 462 B.R. 447 (S.D.N.Y. 2011).
4. SEG 1 customers were Sentinel's customers who were also FCMs themselves, trading on U.S. exchanges.
5. FCStone was also found liable for a post-petition transfer of more than $14 million; Section 546(e), however, was not at issue since it does not apply to avoidance actions brought under §549.
6. SEG 3 customers were hedge funds, trusts, individual investors and proprietary investments by other FCMs.
7. *FCStone*, 485 B.R. at 867.
8. Id.
9. *FCStone*, 485 B.R.at 884.
10. Id.
11. Id., at 885.
12. Id., citing *United States v. Ron Pair Enter.*, 489 U.S. 235, 242 (1989).
13. Id.
14. Id.
15. Id., at 889.
16. *Ron Pair*, 489 U.S. at 242, citing *Griffin v. Oceanic Contractors*, 458 U.S. 564, 571 (1982).
17. *Griffin*, 458 U.S. at 571.
18. Id., citing *Commissioner v. Brown*, 380 U.S. 563, 570 (1965).
19. Andrew S. Gold, "Absurd Results, Scrivener's Errors, and Statutory Interpretation," 75 U. Cin. L. Rev. 25 (2006) and examples cited in nn. 4, 5 and 6.
20. John F. Manning, "The Absurdity Doctrine," 116 Harv. L. Rev. 2387, 2388 (2003).
21. Id.
22. 74 U.S. (7 Wall.) 482 (1868), cited in "Absurd Results," id. n. 17, at 55.
23. "Absurd Results," id. n. 17, at 55.
24. "Absurdity Doctrine," at 2418 and n. 118.
25. *FCStone*, 485 B.R. at 885.
26. Id., at 887.
27. Id., at 885, 889.
28. The *FCStone* case is not the first to involve significant payments made pre-petition only to some creditors. In *Lehman Bros. v. JPMorgan Chase*, 469 B.R. 415 (Bankr. S.D.N.Y. 2012), the bankruptcy court granted the bank's motion to dismiss preference and constructive fraud claims that sought to avoid approximately $7 billion in transfers made to the bank. It cannot be disputed that these transfers provided the bank with a significantly higher distribution than it would have received had the transfers been avoided.
29. The *FCStone* court acknowledged the decisions in the *Madoff* case but viewed them as inapposite holding that they merely involved a broad interpretation of the section, rather than its application to a subsequent distribution of cash to customers. *FCStone*, 485 B.R. at 887, n. 27. A recent decision in the *Madoff* case, however, makes it plain that §546(e) does not require the debtor to be a party to the securities contract at issue, and that as long as the distribution of cash by the debtor relates to a securities contract (even one to which the debtor is not a party), §546(e) applies. See *In re Madoff Securities*, Case No. 12 MC 115 (JSR) (S.D.N.Y., April 15, 2013), at *19-21.