Stockbroker Defense Shields Ponzi-Scheme Broker Fees and Commissions From Avoidance

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Dara R. Levinson
Mark G. Douglas

In *Grayson Consulting, Inc. v. Wachovia Securities, LLC (In re Derivium Capital LLC)*, 716 F.3d 355 (4th Cir. 2013), the U.S. Court of Appeals for the Fourth Circuit examined whether certain securities transferred and payments made during the course of a Ponzi scheme could be avoided as fraudulent transfers under sections 544 and 548 of the Bankruptcy Code. The court upheld a judgment denying avoidance of pre-bankruptcy transfers of securities because the debtor did not have an "interest" in the securities at the time of the transfers. However, in an important victory for brokers, the court also held, in a matter of first impression, that the "safe harbor" in section 546(e) of the Bankruptcy Code precluded avoidance of payments for broker fees and commissions because such transfers qualified as "settlement payments."

Avoidance of Fraudulent Transfers

Section 548(a) of the Bankruptcy Code allows a bankruptcy trustee or chapter 11 debtor in possession ("DIP") to avoid "any transfer . . . of an interest of the debtor in property" or any obligation incurred by the debtor within the two years preceding a bankruptcy filing if: (i) the transfer was made, or the obligation was incurred, "with actual intent to hinder, delay, or defraud" any creditor; or (ii) the debtor received "less than a reasonably equivalent value in exchange for such transfer or obligation" and was, among other things, insolvent, undercapitalized, or unable to pay its debts as such debts matured. Section 544(b)(1) of the Bankruptcy Code similarly empowers a trustee or DIP, with limited exceptions, to "avoid any transfer of an interest of the

debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim." This provision allows a trustee or DIP to avoid, among other things, transactions that are avoidable as fraudulent transfers under applicable state law.

The Stockbroker Defense

Section 546(e) provides a broad exception to many of the avoidance powers of a trustee or DIP with regard to certain pre-bankruptcy payments made in connection with securities, commodity, and forward contracts. It provides that:

> [n]otwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

Section 546(e) expressly does not apply to section 548(a)(1)(A) of the Bankruptcy Code, which authorizes avoidance of transfers made or obligations incurred with actual intent to hinder, delay, or defraud creditors. Section 546(e), however, does apply to actions to avoid constructive fraudulent transfers under section 548(a)(1)(B) or 544.

The purpose of section 546(e) and other "safe harbors" in the Bankruptcy Code for financial contracts is to minimize "systemic risk"—disruption in the securities and commodities markets that could otherwise be caused by a counterparty's bankruptcy filing. Section 546(e) was amended in 2005 and 2006 to, among other things, clarify and expand its scope (e.g., by adding

the phrase "(or for the benefit of)" and by including within the scope of the safe harbor transfers made in connection with a "securities contract").

Section 101(51A) defines "settlement payment" as "a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, a net settlement payment, or any other similar payment commonly used in the forward contract trade." The term is similarly defined with respect to the "securities trade" in section 741(8), which applies to stockbroker liquidation cases.

Most courts interpret the term "settlement payment" broadly to include any transfer of securities in connection with the completion of a securities transaction. Qualifying transfers include both routine securities transactions and, according to several federal circuit courts of appeal, more complicated transactions, such as transfers made during the course of a leveraged-buyout transaction ("LBO"), even LBOs that involve nonpublic securities and thus have no impact on the public-securities markets.

In *Derivium Capital*, the Fourth Circuit considered whether the section 546(e) safe harbor precludes avoidance of broker-fee and commission payments made in connection with a pre-bankruptcy Ponzi scheme.

Derivium Capital

South Carolina-based Derivium Capital, LLC ("Derivium") marketed and administered a "stock loan program" whereby its customers pledged publicly traded stock to Derivium in exchange for loans in the amount of 90 percent of the value of the stock. Upon maturity of the loans, the

borrowers had the option of tendering principal and interest and recovering their collateral, electing to surrender the stock in satisfaction of the loans with no further obligation, or refinancing the transactions for additional terms.

At Derivium's insistence, customers participating in the program deposited their stocks into brokerage accounts maintained by Wachovia Securities, LLC, and an affiliate (collectively, "Wachovia") in Derivium's name. Derivium informed customers that it would hedge the collateral, but instead it directed Wachovia to transfer the stocks into other accounts, where they were liquidated. Derivium used the proceeds to fund loans to new customers and various start-up ventures of Derivium's owners.

Ultimately, Derivium could not satisfy its obligations to return customers' stocks as their loans matured. Wachovia closed the accounts at issue in late 2004 and early 2005.

The collapse of its Ponzi scheme forced Derivium to file for chapter 11 protection in New York in September 2005. The case was converted to chapter 7 and transferred from New York to South Carolina. In August 2007, the chapter 7 trustee sued Wachovia, seeking, among other things, to avoid as fraudulent transfers under sections 544 and 548: (i) transfers into Wachovia accounts of $161 million-worth in securities serving as collateral for customer loans; and (ii) approximately $672,000 in fees, commissions, and margin interest paid to Wachovia. Later in 2007, the chapter 7 trustee assigned the litigation claims to Grayson Consulting, Inc. ("Grayson"), which was substituted as the plaintiff.

The bankruptcy court granted summary judgment in favor of Wachovia on the fraudulent-transfer claims. The court concluded that the securities transferred to Wachovia were not Derivium's property and that payments to Wachovia for commissions and fees were protected from avoidance by the "stockbroker defense" in section 546(e). The district court affirmed, and Grayson appealed to the Fourth Circuit.

The Fourth Circuit's Ruling

A three-judge panel of the Fourth Circuit affirmed the rulings below.

On appeal, Grayson did not contend that Derivium had an interest in its customers' securities prior to their transfer to Wachovia. Instead, Grayson asserted that Derivium and Wachovia had simultaneously acquired an interest in the securities at the time they were deposited into the accounts at Wachovia.

The Fourth Circuit explained that the goal of the Bankruptcy Code's avoidance powers is to prevent debtors from making transfers which diminish the bankruptcy estate to the detriment of creditors. Because Derivium did not have rights to the securities until after the transfers to Wachovia had occurred, the court concluded that the transfers were not transfers "of an interest of the debtor in property" and could not be avoided under section 544 or 548.

For the same reason, the Fourth Circuit rejected Grayson's argument that portions of the transfers should be avoided as actual (as distinguished from constructive) fraudulent transfers under sections 548(a)(1)(A) and 546(e). According to the court, "Section 546 provides only a

defense to otherwise avoidable transfers; it does not establish a category of avoidable transfers of nondebtor property."

Next, the court considered whether the fees and commissions paid to Wachovia were protected from avoidance by section 546(e) as settlement payments. The court explained that nothing in the plain language of section 546(e) limits the definition of "settlement payment" to security purchase prices or excludes payments from which brokers benefit, such as fees and commissions. In fact, the Fourth Circuit noted, Congress amended section 546(e) in 2006 to add settlement payments made to "*or for the benefit of*" stockbrokers.

The Fourth Circuit noted that the purpose of section 546(e) when enacted was "to clarify and, in some instances, broaden the commodities market protections and expressly extend similar protections to the securities market" in an effort to "minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries." In accordance with the lawmakers' intent in enacting section 546(e), the court explained that several of its sister circuits have defined "settlement payment" very broadly.

Because Congress included the phrase "any other similar payment commonly used in the securities trade" as part of the definition of "settlement payment," the Fourth Circuit looked to standard securities-industry practices to determine whether the term could include broker fees and commissions. The court cited several industry texts suggesting that "settlement payment" means "the transfer of funds paid in connection with the completion of a securities transaction."

On the basis of this definition, the Fourth Circuit held that commissions and fees paid in connection with the completion of a securities transaction constitute settlement payments for purposes of section 546(e). The court underscored, however, that not all payments to brokers labeled as commissions are protected under section 546(e). For example, the court explained, commissions that are not part of the settlement of a securities transaction, such as commissions paid for the solicitation of investors or commissions whose dollar amounts indicate that they are not related to closing trades, are not covered by the safe harbor.

The Fourth Circuit rejected Grayson's argument that, even if Wachovia's commissions and fees were protected by section 546(e), the court should make an exception to the stockbroker defense because applying it in the context of a Ponzi scheme would allow "a broker to retain ill-gotten profits" and undermine the equitable goals of the Bankruptcy Code. The court acknowledged that section 546(e) "does not include a Ponzi scheme exception on its face," but wrote that the provision "does provide several express exceptions to the application of the defense," including claims brought under section 548(a)(1)(A) in cases of actual fraud.

The Fourth Circuit noted that courts have held that the existence of a Ponzi scheme gives rise to a presumption of actual fraud. However, in this case, neither the bankruptcy court nor the district court reached the issue of whether Grayson had established a claim for actual fraudulent intent under section 548(a)(1)(A). Furthermore, the Fourth Circuit noted that Grayson had failed to provide a convincing reason why "an extra-statutory fraud exception to the stockbroker defense" should be created.

Outlook

The Fourth Circuit's ruling in *Derivium Capital* is consistent with the broad definition of "settlement payment" applied by other circuits and lower courts. More broadly, the decision is emblematic of the expansive application by most courts of the Bankruptcy Code's safe harbors for financial-contract transactions, in keeping with the purpose of those provisions.