

FEB 17 2005

HAROLD S. MARENUS, CLERK  
U.S. BKCY. APP. PANEL  
OF THE NINTH CIRCUIT

## ORDERED PUBLISHED

UNITED STATES BANKRUPTCY APPELLATE PANEL  
OF THE NINTH CIRCUIT

In re: ) BAP No. SC-04-1028-KMoS  
)  
GRAFTON PARTNERS, L.P., ) Bk. No. 01-10606-H7  
a California Limited )  
Partnership, and ) Adv. No. 02-90555  
its Affiliates, )  
)  
Debtors. )  
\_\_\_\_\_)  
RICHARD M. KIPPERMAN, )  
Chapter 7 Trustee, )  
)  
Appellant, ) **OPINION**  
)  
v. )  
)  
CIRCLE TRUST F.B.O., MICHELE )  
MONTANO, n/k/a CIRCLE TRUST, )  
Trustee for The Stable Value )  
Fund, )  
)  
Appellee. )  
\_\_\_\_\_)

Argued and Submitted on July 30, 2004  
at San Diego, California

Filed - February 17, 2005

Appeal from the United States Bankruptcy Court  
for the Southern District of California

Honorable John J. Hargrove, Chief Bankruptcy Judge, Presiding.

\_\_\_\_\_

Before: KLEIN, MONTALI, and SMITH, Bankruptcy Judges.

1 KLEIN, Bankruptcy Judge:

2  
3 The federal securities laws intersect with the Bankruptcy  
4 Code in this appeal arising from a "Ponzi scheme" that collapsed  
5 into federal criminal prosecutions and bankruptcy.

6 The essential question is whether non-public transactions in  
7 illegally unregistered securities can be the subject of  
8 "settlement payments" that are "commonly used in the securities  
9 trade" within the meaning of 11 U.S.C. § 741(8). If so, then  
10 such payments made to appellee "financial institution" are  
11 immunized from trustee avoiding powers by 11 U.S.C. § 546(e).

12 Before the collapse, appellee, the trustee of a pooled  
13 investment fund, sought to withdraw all \$29 million of capital  
14 contributions it had made to a limited liability company that had  
15 funded the Ponzi scheme, the funds having been raised in  
16 violation of registration and anti-fraud provisions of the  
17 Securities Act of 1933 and Securities Exchange Act of 1934.

18 Although appellee actually withdrew \$22 million before the  
19 collapse, the LLC's chapter 7 trustee attacked only the \$4  
20 million transfer that was received 89 days before bankruptcy,  
21 arguing it was a preference to be retrieved and shared with  
22 fellow fraud victims who did not withdraw before the collapse.

23 The trustee appeals the ruling that the withdrawal of  
24 capital was a "settlement payment" that is "commonly used in the  
25 securities trade" made to a "financial institution" and, hence,  
26 immune from recovery per 11 U.S.C. § 546(e). We hold that non-  
27 public transactions in illegally unregistered securities are not  
28 "commonly used in the securities trade" and REVERSE.

- 1
- 2
- 3
- 4
- 5
- 6
- 7
- 8
- 9
- 0
- 1
- 2
- 3
- 4
- 5
- 6
- 7
- 8
- 9
- 0
- 1
- 2
- 3
- 4
- 5
- 6
- 7
- 8

Funds to make the loans came from investors in two limited partnerships (Allied Capital Partners and Grafton Partners) and Six Sigma, LLC ("Six Sigma"), that were formed for that purpose.

PinnFund agreed, under its Spot Loan Funding Agreement, to pay the funding entities a premium return for the use of their capital: "interest" at 10 percent; plus a share of participation fees on sales of loans. This compensation, according to the Subscription Agreement, was expected to withstand usury attack because "the transactions are more appropriately characterized as either: (i) agreements to advance money in exchange for a share in profits; or (ii) loans in which the amount of the interest payment is contingent upon events within the borrower's control."

The Ponzi scheme ended in 2001 when the Securities and Exchange Commission ("SEC") took action leading to a receivership and to criminal prosecutions of the principals, who eventually

1 confessed to running PinnFund as a Ponzi scheme.<sup>1</sup>

2 What made it a Ponzi scheme was that much of the return  
3 provided to investors monthly under the guise of "interest" or  
4 participation fees actually came from the corpus of invested  
5 funds, rather than from profits derived from business activity.<sup>2</sup>

6  
7 <sup>1</sup> The prosecutions are described in a published decision:

8 In March 2001, PinnFund went into receivership by order of  
9 this Court upon a motion by the United States Securities and  
10 Exchange Commission ("SEC"), based upon allegations that  
11 investors were being defrauded and their funds improperly  
12 distributed. See SEC v. PinnFund USA, Inc., Peregrine  
13 Funding, Inc., et al. [Allied Capital Partners, Grafton  
14 Partners, Six Sigma, LLC A/K/A 6 Sigma LLC, Michael J.  
15 Fanghella, James L. Hillman, Reliance Holdings, LLC, Kelly  
16 Cook A/K/A Kelly Jaye A/K/A Kelly Spagnola] .... Since that  
17 time, PinnFunds's Chief Executive Officer Michael J.  
18 Fanghella, its President and Chief Operating Officer Keith  
G. Grubba, and its Chief Financial Officer John D. Garitta  
have all pled guilty to criminal charges arising out of  
their roles at PinnFund, admitting that they operated  
PinnFund as a massive Ponzi scheme involving hundreds of  
millions of dollars of investor funds. See United States v.  
Fanghella, ...; United States v. Grubba, ...; and United  
States v. Garitta, ....

19 United States v. Kodzis, 255 F. Supp. 2d 1140, 1142 (S.D. Cal.  
20 2003) (docket nos. omitted)

21 <sup>2</sup> The term "Ponzi scheme" is the legacy of what Chief  
22 Justice Taft described as "the remarkable criminal financial  
23 career of Charles Ponzi." Cunningham, Trustee of Ponzi v. Brown,  
265 U.S. 1, 7 (1924); see D. DUNN, PONZI: THE BOSTON SWINDLER 247-48  
(1975).

24 The Ninth Circuit describes the classic Ponzi scheme as:

25 A Ponzi scheme is a fraudulent arrangement in which an  
26 entity makes payments to investors from monies obtained from  
27 later investors rather than from any "profits" of the  
28 underlying business venture. The fraud consists of  
funneling proceeds received from new investors to previous  
investors in the guise of profits from the alleged business  
(continued...)

1 In such a scheme, it was inevitable that PinnFund would run out  
2 of funds and plunge PinnFund, Peregrine, and the funding entities  
3 into bankruptcy. It was only a question of time.

4 One of the funding entities, Six Sigma, was a California  
5 limited liability company formed in 1999. Its operating  
6 agreement made Peregrine (controlled by Hillman) its manager,  
7 limited its business to providing funds for PinnFund loans, and  
8 precluded LLC members from participating in management.

9 Membership in Six Sigma was limited to 99 "qualified  
10 purchasers," as defined by the Investment Company Act of 1940.  
11 Six Sigma took the position that no registration statement under  
12 the Securities Act of 1933 was required. The membership  
13 interests could not be transferred without permission of the  
14 manager, who could involuntarily redeem an interest in order to  
15 permit Six Sigma to continue to qualify as a partnership for  
16 purposes of taxation or to comply with securities laws.

17 Each Six Sigma member had a capital account, consisting of  
18 the sum of that member's capital contributions and pro rata share  
19 of profits and losses. The capital account, adjusted monthly,  
20 would rise or fall to reflect the fortunes of the business.

21 The operating agreement provided that a member could  
22 withdraw from Six Sigma by withdrawing its entire capital account  
23 on 60-day notice ("or any lesser period at the Manager's sole and  
24 absolute discretion").

25  
26 <sup>2</sup>(...continued)

27 venture, thereby cultivating an illusion that a legitimate  
28 profit-making business opportunity exists and inducing  
further investment.

Wyle v. C.H. Rider & Family (In re United Energy Corp.), 944 F.2d  
589, 590 n.1 (9th Cir. 1991); Plotkin v. Pomona Valley Imps.,  
Inc. (In re Cohen), 199 B.R. 709, 717 n.9 (9th Cir. BAP 1996).

1 Appellee Circle Trust Company ("Circle Trust"), a member of  
2 Six Sigma, is a limited purpose trust company chartered by the  
3 State of Connecticut to provide fiduciary services only. It may  
4 not accept deposits and is not insured by the Federal Deposit  
5 Insurance Corporation. It provides investment management, trust,  
6 custody, and administrative services.

7 Circle Trust's Six Sigma capital contributions totaled \$29  
8 million, made as trustee of the Stable Value Plus Fund. Circle  
9 Trust represented to Six Sigma that it was acquiring its interest  
10 directly and without a compensated intermediary.

11 When Circle Trust decided to withdraw from Six Sigma,  
12 allegedly after doing "due diligence,"<sup>3</sup> it gave notice, by letter  
13 of September 28, 2000, to James L. Hillman and Peregrine, of its  
14 request to withdraw "all of its capital account in Six Sigma, LLC  
15 ("Capital Account"), as of the earliest permitted date." Three  
16 capital account payments ensued, totaling \$22 million of the \$29  
17 million invested: (1) \$10 million wire-transferred November 1,  
18 2000, the 60-day notice requirement having been waived; (2) \$8  
19 million by check of December 1, 2000; and (3) \$4 million by check  
20 dated January 2 and honored January 4, 2001, by the drawee bank.

21 When Six Sigma filed its chapter 7 case, Circle Trust still  
22 had \$7 million of capital on the books, on which it received  
23 "interest" during 2001: \$160,875.09 (January 10); \$100,642.82  
24 (February 12); and \$98,273.73 (March 12).

25 The total "interest" that Circle Trust had received monthly  
26

---

27 <sup>3</sup> Circle Trust's summary judgment evidence included  
28 evidence of allegations that it demanded to withdraw from Six  
Sigma "after conducting due diligence" and that the demand was  
the beginning of the Ponzi scheme's end. Decl. of Margaret M.  
Mann in Supp. of Circle Trust's Mot. for Summ. J., Ex. 5, p. 48,  
¶ 31.

1 from Six Sigma on account of capital contributions was  
2 \$3,989,041.64. The source of funds to pay such "interest" was,  
3 consistent with the fraud's status as a Ponzi scheme, the capital  
4 provided by the LLC and the limited partnerships.

5 Six Sigma and the limited partnerships filed chapter 7 cases  
6 in the Northern District of California on April 2, 2001, twelve  
7 days after the SEC sued. They were transferred to the Southern  
8 District of California, where they were consolidated under the  
9 name "Grafton Partners, LP, and Affiliated Entities," with  
10 Richard Kipperman as case trustee.

11 The trustee sued Circle Trust to avoid and recover the \$4  
12 million transferred January 4, 2001, as a preference.

13 Circle Trust moved for summary judgment, arguing that the  
14 partial withdrawal was a "settlement payment" as defined by 11  
15 U.S.C. § 741(8) and, thus, was immune from avoidance as a  
16 preference. The bankruptcy court agreed. This appeal ensued.

#### 17 18 JURISDICTION

19 The bankruptcy court had core proceeding jurisdiction per 28  
20 U.S.C. §§ 157(b)(2)(F) and 1334(b). We have jurisdiction under  
21 28 U.S.C. § 158(a)(1) because the summary judgment order was  
22 intended to be the court's last word on the adversary proceeding.

#### 23 24 ISSUE

25 Whether withdrawal of capital from a limited liability  
26 company, in a non-public, non-market transaction involving an  
27 illegally unregistered security, constitutes a "settlement  
28 payment" that is "commonly used in the securities trade," as

1 defined by 11 U.S.C. § 741(8), and hence immune from avoidance as  
2 a preference in bankruptcy by 11 U.S.C. § 546(e).

#### 4 STANDARD OF REVIEW

5 We review summary judgment de novo. Paine v. Griffin (In re  
6 Paine), 283 B.R. 33, 36 (9th Cir. BAP 2002).

#### 8 DISCUSSION

9 The parties agree that a membership interest in an LLC that  
10 is required to be the subject of a registration statement filed  
11 with the SEC is a "security" under the Bankruptcy Code. 11  
12 U.S.C. § 101(49) (A) (2000).

13 Our basic task is to construe the meaning of the definition  
14 of "settlement payment," which was first enacted in 1982. The  
15 current version of the definition reads:

16 (8) "settlement payment" means a preliminary settlement  
17 payment, a partial settlement payment, an interim settlement  
18 payment, a settlement payment on account, a final settlement  
19 payment, or any other similar payment commonly used in the  
20 securities trade;

11 U.S.C. § 741(8) (2000).

20 If the \$4 million withdrawal from Six Sigma 89 days before  
21 bankruptcy was a "settlement payment,"<sup>4</sup> then § 546(e) insulates  
22 the transfer from avoidance as a preference.<sup>5</sup>

---

24 <sup>4</sup> Since this is defendant's summary judgment motion, we  
25 assume that all elements of a preference (including "antecedent  
26 debt") are present and that no defense alleged in the answer is  
27 established. Further, we assume, without deciding, that a  
Connecticut limited purpose trust company as a "financial  
institution" as defined by 11 U.S.C. § 101(22).

28 <sup>5</sup> We reiterate the Ninth Circuit's United Energy footnote  
noting Ponzi schemes are more vulnerable to attack as fraudulent  
transfers than as preferences. In re United Energy Corp., 944

(continued...)



1       Ascertaining the meaning of "settlement payment" is a  
2 "holistic endeavor" that requires us to consider the entire  
3 statutory scheme associated with its enactment and to reject  
4 plausible readings of isolated terms that are not compatible with  
5 the rest of the law. Koons Buick Pontiac GMC, Inc. v. Nigh, 125  
6 S.Ct. 460, 466-467 (2004) ("Koons Buick"); McCarthy v. Bronson,  
7 500 U.S. 136, 139 (1991) (statutory language must be read in  
8 proper context and not viewed in isolation); United Sav. Ass'n of  
9 Tex. v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 371  
10 (1988).

---

14       <sup>5</sup>(...continued)  
15 F.2d at 594 n.4. This appeal would be very different if the  
16 trustee had alleged that the withdrawals of capital (potentially,  
17 all \$22 million, plus "interest" payments) were avoidable under  
18 11 U.S.C. § 548(a)(1)(A) as "actually fraudulent" transfers.  
19 Since only the intent of the transferor matters in the avoidance  
20 analysis, proof that the transferor was running a Ponzi scheme  
21 can suffice to warrant a finding of actual fraud, which is not  
22 protected from avoidance by § 546(e). E.g., Hayes v. Palm  
23 Seedlings Partners-A (In re Agric. Research & Tech. Group, Inc.),  
24 916 F.2d 528, 534-38 (9th Cir. 1990); Plotkin, 199 B.R. at 716-  
25 17; accord, Jobin v. McKay (In re M&L Bus. Mach. Co.), 84 F.3d  
26 1330, 1334-37 (10th Cir. 1996), aff'g 164 B.R. 657 (D. Colo.  
27 1994), aff'g 155 B.R. 131 (Bankr. D. Colo. 1993); Merrill v.  
28 Abbott (In re Indep. Clearing House Co.), 77 B.R. 843, 859-61 (D.  
Utah 1987) (en banc); Mark A. McDermott, Ponzi Schemes & the Law  
of Fraudulent & Preferential Transfers, 72 AM. BANKR. L.J. 157,  
173-75 (1998); cf. Wooten v. Barge (In re Cohen), 875 F.2d 508,  
511 (5th Cir. 1989) (dictum). In the concomitant recovery  
analysis, even if a particular transfer is a "settlement payment"  
(and hence was for "value"), the transferee of an avoided  
fraudulent transfer may retain property transferred only if it  
also establishes that it received the transfer in "good faith,"  
which question is a poor candidate for summary judgment. 11  
U.S.C. §§ 548(c) & (d)(2)(B); Jobin, 84 F.3d at 1334-39;  
McDermott, 72 AM. BANKR. L.J. at 175-81.

I

The pertinent statutory scheme was created in 1982 by the stockbroker-commodity broker amendments to the Bankruptcy Code. Pub. L. 97-222, 96 Stat. 235 (1982).

A

Public Law 97-222 was a package of amendments designed to protect the carefully-regulated mechanisms for clearing trades in securities and commodities in the public markets from dysfunction that could result from the automatic stay and from certain trustee avoiding powers.

The protection for the securities industry had several interrelated facets aimed at permitting securities transactions to be liquidated under the eye of the SEC and the Securities Investor Protection Corporation ("SIPC") without being vulnerable to a bankruptcy attack that could destabilize markets.<sup>6</sup>

---

<sup>6</sup> The House Committee report explained:

The commodities and securities markets operate through a complex system of accounts and guarantees. Because of the structure of the clearing systems in these industries and the sometimes volatile nature [of] the markets, certain protections are necessary to prevent the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market.

...

The amendments will ensure that the avoiding powers of a trustee are not construed to permit margin or settlement payments to be set aside except in cases of fraud and that, except as otherwise provided, the stay provisions of the Code are not construed to prevent brokers from closing out the open accounts of insolvent customers or brokers. The prompt closing out or liquidation of such open accounts freezes the status quo and minimizes the potentially massive losses and chain reactions that could occur if the market

(continued...)

1       The key provision was the creation in 11 U.S.C. § 555 of a  
2 power for a stockbroker or securities clearing agency to exercise  
3 a contractual right to liquidate a securities contract -  
4 including a right set forth in a rule or bylaw of a national  
5 securities exchange, national securities association, or  
6 securities clearing agency - that could only be limited in a  
7 bankruptcy case if authorized under the Securities Investor  
8 Protection Act ("SIPA") or a statute administered by the SEC.<sup>7</sup>

9       A second facet of the protection was that the Act excepted  
10 from the automatic stay any setoff made by a stockbroker or  
11 securities clearing agency on account of claims against a debtor  
12 for a margin or settlement payment arising out of a securities  
13

---

14       <sup>6</sup>(...continued)

15       were to move sharply in the wrong direction.

16 H. REP. NO. 97-420, at 1-2, reprinted at 1982 U.S.C.C.A.N. 583-  
17 584.

18       <sup>7</sup> The full provision as originally enacted was:

19       § 555. Contractual right to liquidate a securities contract.  
20       The exercise of a contractual right of a stockbroker or  
21 securities clearing agency to cause the liquidation of a  
22 securities contract, as defined in section 741(7) of this  
23 title, because of a condition of the kind specified in  
24 section 365(e)(1) of this title shall not be stayed,  
25 avoided, or otherwise limited by operation of any provision  
26 of this title or by order of a court or administrative  
27 agency in any proceeding under this title unless such order  
28 is authorized under the provisions of the Securities  
Investor Protection Act of 1970 (15 U.S.C. 78aaa et seq.) or  
any statute administered by the Securities and Exchange  
Commission. As used in this section, the term "contractual  
right" includes a right set forth in a rule or bylaw of a  
national securities exchange, a national securities  
association, or a securities clearing agency.

11 U.S.C. § 555 (1982), as enacted by Pub. L. 97-222, § 6(a).

1 contract against property held by or due from that stockbroker or  
2 securities clearing agency. Pub. L. 97-222, § 3(c).<sup>8</sup>

3 Third, margin and settlement payments made to or by  
4 stockbrokers and securities clearing agencies were, with the  
5 exception of actually fraudulent transfers, insulated from  
6 trustee avoiding actions. Pub. L. 97-222, § 4.<sup>9</sup>

7  
8 <sup>8</sup> The revised exception to the automatic stay, insofar as  
9 applied to the securities industry, provided:

10 (c) Section 362(b)(6) of title 11, United States Code, is  
11 amended to read as follows:

12 "(6) under subsection (a) of this section, of the  
13 setoff by a [commodities industry entities omitted],  
14 stockbroker, or securities clearing agency of any mutual  
15 debt and claim under or in connection with [commodities  
16 industry contracts], or securities contracts, as defined in  
17 section 741(7) of this title, that constitutes the setoff of  
18 a claim against the debtor for a margin payment, as defined  
19 in section 741(5) or [commodities definition omitted] of  
20 this title, or settlement payment, as defined in section  
21 741(8) of this title, arising out of [commodities industry  
22 contracts], or securities contracts against cash,  
23 securities, or other property held by such [commodities  
24 industry entities omitted], stockbroker, or securities  
25 clearing agency to margin, guarantee, or secure [commodities  
26 industry contracts omitted], or securities contracts;"

27 Pub. L. 97-222, § 3(c).

28 <sup>9</sup> The original avoiding power provision, insofar as applied  
to the securities industry, provided:

Sec. 4. Section 546 of title 11, United States Code, is  
amended by adding at the end thereof the following new  
subsection:

"(d) Notwithstanding sections 544, 545, 547, 548(a)(2),  
and 548(b) of this title, the trustee may not avoid a  
transfer that is a margin payment, as defined in section  
741(5) or 761(15) of this title, or settlement payment, as  
defined in § 741(8) of this title, made by or to a  
[commodities industry entities omitted], stockbroker, or  
(continued...)

1 Finally, the terms "margin payment," "settlement payment,"  
2 and "securities contract" were defined for purposes of the other  
3 provisions in this scheme in § 741.<sup>10</sup>  
4

5 B

6 In 1984, the provisions of Public Law 97-222 were amended by  
7 the Bankruptcy Amendments and Federal Judgeship Act of 1984.

8 The examples named in the § 741(8) definition of "settlement  
9 payment" had the phrase "final settlement payment" added.<sup>11</sup>

10 The § 741(7) definition of "securities contract" was  
11 expanded to cover more products in the securities industry:  
12 options for the purchase or sale of a certificate of deposit or  
13 group or index of securities and options entered into on a  
14

---

15 <sup>9</sup>(...continued)  
16 securities clearing agency, that is made before the  
17 commencement of the case, except under section 548(a)(1) of  
18 this title."

19 Pub. L. 97-222, § 4.

20 <sup>10</sup> The original definitions of "securities contract" and  
21 "settlement payment" provided:

22 (7) "securities contract" means contract for the  
23 purchase, sale, or loan of a security, including an option  
24 for the purchase or sale of a security, or the guarantee of  
25 any settlement of cash or securities by or to a securities  
26 clearing agency;

(8) "settlement payment" means a preliminary settlement  
payment, a partial settlement payment, an interim settlement  
payment, a settlement payment on account, or any other  
similar payment commonly used in the securities trade;

27 11 U.S.C. §§ 741(7)-(8), Pub. L. 97-222, § 8.

28 <sup>11</sup> Bankruptcy Amendments and Federal Judgeship Act of 1984,  
Pub. L. 98-353, § 482, 98 Stat. 383.

1 national securities exchange relating to foreign currencies.<sup>12</sup>

2 The newly-defined term "financial institution" was added to  
3 § 546(e)'s list of entities insulated from avoiding powers with  
4 respect to settlement payments and to the list of entities  
5 authorized by § 555 to exercise a contractual right to liquidate  
6 a securities contract.<sup>13</sup> The definition appeared in new 11  
7 U.S.C. § 101(19),<sup>14</sup> which later migrated to § 101(22) and was

---

10 <sup>12</sup> The revised definition was:

11 (7) "securities contract" means contract for the  
12 purchase, sale, or loan of a security, including an option  
13 for the purchase or sale of a security, certificate of  
14 deposit, or group or index of securities (including any  
15 interest therein or based on the value thereof), or any  
16 option entered into on a national securities exchange  
relating to foreign currencies, or the guarantee of any  
settlement of cash or securities by or to a securities  
clearing agency;

17 28 U.S.C. § 741(7), as amended by Pub. L. 98-353, § 482, 98 Stat.  
18 382-83 (new language emphasized).

19 <sup>13</sup> Id., §§ 461 & 469, 98 Stat. 377 & 380. A grammatical  
20 error in the amendment to § 546(e) - the omission of a comma  
21 after "stockbroker" - was corrected in 1986. Bankruptcy Judges,  
United States Trustees, and Family Farmer Bankruptcy Act of 1986,  
Pub. L. 99-554, § 283, 100 Stat. 3117.

22 <sup>14</sup> The definition added in 1984 was:

23 (19) "financial institution" means a person that is a  
24 commercial or savings bank, industrial savings bank, savings  
25 and loan association, or trust company and, when any such  
26 person is acting as agent or custodian for a customer in  
connection with a securities contract, as defined in section  
741(7) of this title, such customer;

27 11 U.S.C. § 101(19) (1984 Supp.), Pub. L. 98-353, § 421, 98 Stat.  
28 368 (1984), redesignated as § 101(21), Pub. L. 99-554, § 251, 100  
Stat. 3104 (1986), redesignated as § 101(22), Pub. L. 101-647,  
§ 2522, 104 Stat. 4867 (1990), redefined, Pub. L. 106-554,  
§ 1(a) (5) & App. E § 409, 114 Stat. 2763 & 2763A-393-394 (2000).

1 redefined in 2000.<sup>15</sup>

3 II

4 Resolving the question whether transactions in illegally  
5 unregistered securities can be protected as § 741(8) settlement  
6 payments requires, under the Supreme Court's Koons Buick original  
7 statutory context precept, that we assess the relationship of  
8 Public Law 97-222 to the securities laws and the Bankruptcy Code.

9 Indeed, in a leading decision regarding Public Law 97-222,  
10 the Third Circuit held that it must construe the literal language  
11 of that statute in the context of the precise congressional  
12 intent. Bevill, Bresler & Schulman Asset Mgmt. Corp. v. Spencer  
13 Sav. & Loan Ass'n (In re Bevill, Bresler & Schulman Asset Mgmt.

---

17 <sup>15</sup> Since 2000, the definition has been:

18 (22) the term "financial institution" -

19 (A) means -

20 (i) a Federal reserve bank or an entity (domestic  
21 or foreign) that is a commercial or savings bank, industrial  
22 savings bank, savings and loan association, trust company,  
23 or receiver or conservator for such entity and, when any  
24 such Federal reserve bank, receiver, conservator, or entity  
25 is acting as agent or custodian for a customer in connection  
26 with a securities contract, as defined in section 741 of  
27 this title, the customer; or

28 (ii) in connection with a securities contract, as  
defined in section 741 of this title, an investment company  
registered under the Investment Company Act of 1940; and

(B) includes any person described in subparagraph (A)  
which operates, or operates as, a multilateral clearing  
organization pursuant to section 409 of the Federal Deposit  
Insurance Corporation Improvement Act of 1991;

11 U.S.C. § 101(22) (2000), Pub. L. 106-554, § 1(a)(5) & App. E  
§ 409, 114 Stat. 2763 & 2763A-393-394 (2000).

1 Corp.), 878 F.2d 742, 751-53 (3d Cir. 1989).<sup>16</sup>

2 When we do so, it is apparent that Public Law 97-222 was  
3 designed to enhance enforcement of the securities laws and rules  
4 assuring the integrity of securities markets.

6 A

7 The bill that became Public Law 97-222, H.R. 4935, resulted  
8 from House Judiciary Committee oversight hearings at which there  
9 was testimony by, among others, the SEC, the Commodity Futures  
10 Trading Commission, SIPC, and National Securities Clearing  
11 Corporation regarding the need for protection of the organized  
12 markets against dysfunction in bankruptcy situations.<sup>17</sup>

13  
14 <sup>16</sup> The Third Circuit explained:

15 We believe that this is a classic instance where a  
16 court is required to ascertain the precise congressional  
17 intent represented by the words, as well as their literal  
18 meaning. This is because two important national legislative  
19 policies are on a collision course here, and it behooves the  
20 courts of the Third Article to decide which policy Congress  
21 intended must yield. On the one hand is the bankruptcy  
22 policy giving broad powers to a trustee to avoid  
23 transactions taking place within 90 days prior to the  
24 petition filing. This is reflected in sections 547 and 548  
25 of the Code, giving the trustee power to avoid preferential  
26 or fraudulent transfers.

27 On the other hand, the stated intent of the 97th  
28 Congress in the Bankruptcy Amendments of 1982 and the 98th  
Congress in the Bankruptcy Act of 1984 was to remove the  
right of the trustee to avoid transactions under certain  
instances.

25 Bevill, 878 F.2d at 751.

26 <sup>17</sup> The House Report summarizes this history:

27 On July 23 and September 17, 1981, the Subcommittee on  
28 Monopolies and Commercial Law held oversight hearings on the  
operation of the Bankruptcy Code with respect to the

(continued...)



The protection of settlement payments on securities trades responded to the concerns of the SEC and entities administering the market sales process that the bankruptcy of one firm in the clearance and settlement chain could produce a ripple effect that threatens other parties in the chain.

The Judiciary Committee's summary of its bill focuses on market trades that comply with the securities laws:

The commodities and securities markets operate through a complex system of accounts and guarantees. Because of the structure of the clearing systems in these industries and the sometimes volatile nature [of] the markets, certain protections are necessary to prevent the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market.

The Bankruptcy Code now expressly provides certain protections to the commodities market to protect against such a "ripple effect." One of the market protections presently contained in the Bankruptcy Code, for example, prevents a trustee in bankruptcy from avoiding or setting aside, as a preferential transfer, margin payments made to a commodity broker (see 11 U.S.C. Sec. 764(c)).

The thrust of several of the amendments contained in H.R. 4935 is to clarify and, in some instances, broaden the commodities market protections and expressly extend similar protections to the securities market. The amendments will ensure that the avoiding powers of a trustee are not construed to permit margin or settlement payments to be set aside except in cases of fraud and that, except as otherwise

---

<sup>17</sup>(...continued)

commodities and securities trading industries. The Subcommittee heard testimony from Philip McB. Johnson, Chairman of the Commodity Futures Trading Commission, Bevis Longstreth, Commissioner of the [SEC], Theodore H. Focht, General Counsel of [SIPC], and representatives of numerous commodities and securities brokers and clearing organizations. H.R. 4935 was introduced on November 10, 1981 as a result of those hearings.

H. R. REP. 97-420, at 2 (1982); see, e.g., Bankr. of Commodity and Sec. Brokers: Hearings before Subcomm. on Monopolies & Commercial Law of Comm. on Judiciary of the H.R., 97th Cong. 294 (1981) (statement of Jack Nelson, Nat'l Sec. Clearing Corp.).

1 provided, the stay provisions of the Code are not construed  
2 to prevent brokers from closing out the open accounts of  
3 insolvent customers or brokers. The prompt closing out or  
4 liquidation of such open accounts freezes the status quo and  
minimizes the potentially massive losses and chain reactions  
that could occur if the market were to move sharply in the  
wrong direction.

5 The bill provides that, ... [i]n the case of the  
6 securities industry, the contractual right of a broker or  
7 clearing agency to liquidate a securities contract may not  
be stayed, avoided, or otherwise limited in any bankruptcy  
proceeding unless an order affecting such right is  
authorized under the provisions of [SIPA] or any statute  
administered by the [SEC].

8  
9 H.R. REP. NO. 97-420, at 1-2 (1982).

10 It was, thus, axiomatic to the new § 555 contractual right  
11 to liquidate a securities contract that the relevant contractual  
12 rights had to be consistent with the securities laws. The main  
13 purpose was to protect legitimate securities markets from market  
14 fluctuations that, without specific protection from basic  
15 bankruptcy rules, created "an inordinate risk that the insolvency  
16 of one party could trigger a chain reaction of insolvencies of  
17 the others who carry accounts for that party and undermine the  
18 integrity of those markets."<sup>18</sup>

19  
20 <sup>18</sup> The House Report explained:

21 Section 6(a) adds a new section 555 to title 11 to  
22 provide that the exercise of a contractual right of a  
23 stockbroker or securities clearing agency to cause the  
24 liquidation of a securities contract, because of a condition  
25 of the kind specified in section 365(e)(1) of title 11,  
26 shall not be stayed, avoided, or otherwise limited in any  
27 proceeding under title 11 by a court or administrative  
28 agency, unless such order is authorized under the provisions  
of [SIPA] or any statute administered by the [SEC]. The  
prompt liquidation of an insolvent's position is generally  
desirable to minimize the potentially massive losses and  
(continued...)

1 Further, the protection was crafted to assure compliance  
2 with securities laws. Thus, § 555 stipulates that the right to  
3 liquidate a securities contract does not trump orders affecting  
4 trades that are issued under either SIPA or "any statute  
5 administered by the" SEC.

6 The House Report also clarified that the parallel exception  
7 to the automatic stay permitting setoff of margin or settlement  
8 payments, 11 U.S.C. § 362(b)(6), did "not permit a setoff which  
9 would be unlawful under any applicable law or regulation."<sup>19</sup>

---

10  
11 <sup>18</sup>(...continued)  
12 chain reaction of insolvencies that could occur if the  
13 market were to move sharply in the wrong direction.

14 H.R. REP. NO. 97-420, at 3-4.

15 The floor statement in the Senate was to the same effect:

16 It is essential that stockbrokers and securities  
17 clearing agencies be protected from the issuance of a court  
18 or administrative agency order which would stay the prompt  
19 liquidation of an insolvent's position, because market  
20 fluctuations in the securities markets create an inordinate  
21 risk that the insolvency of one party could trigger a chain  
22 reaction of insolvencies of the others who carry accounts  
23 for that party and undermine the integrity of those markets.  
24  
25 128 Cong. Rec. 15, 981 (July 13, 1982) (Remarks of Sen. Dole).

26 <sup>19</sup> The House Report explains the revised § 362(b)(6):

27 Section 3(c) is intended to clarify that, despite the  
28 automatic stay of section 362(a), a [commodities industry  
entities omitted], stockbroker, or securities clearing  
agency may set off a claim for a margin or settlement  
payment arising out of commodities contracts, forward  
contracts, or securities contract[s] against cash,  
securities or other property which it is holding to margin,  
guarantee, or secure such contracts, notwithstanding the  
bankruptcy of the party for whose account such cash,  
securities, or property is held. This section does not

(continued...)

1 Similarly, the limitation on avoiding powers in what is now  
2 § 546(e) does not extend to actually fraudulent transfers that  
3 were not received in good faith.<sup>20</sup> This connotes a statutory  
4 scheme designed to protect trades that comply with the securities  
5 laws, but not to protect the laundering of actual fraud.

6 It is in this context that the term "settlement payment" was  
7 defined in Public Law 97-222 and should be construed.

8  
9 2

10 The difficulty with the definition of "settlement payment"  
11 is that it relies on a conclusory laundry list of securities  
12 industry terms of art that contain the words "settlement payment"  
13 without articulating the elements of a settlement payment. The  
14 definition, however, is rescued from the apparent circularity by

15  
16 

---

<sup>19</sup>(...continued)

17 permit a setoff which would be unlawful under any applicable  
18 law or regulation.

19 H.R. REP. NO. 97-420, at 3 (emphasis supplied).

20 <sup>20</sup> The House Report explains:

21 Section 4 creates a new Section 546(d)[now e)]. This  
22 amendment is made simultaneously with the repeal of section  
23 764(c) of title 11. Section 546(d)[(e)], together with  
24 provisions of section 548, prohibits a trustee from avoiding  
25 a transfer that is a margin payment to a commodity broker or  
26 forward contract merchant or is a settlement payment made by  
27 a clearing organization, except where the transfer was made  
28 with intent to hinder, delay, or defraud other creditors and  
was not taken in good faith.

The new section 546(d) [(e)] reiterates the provisions  
of current section 764(c). The new section also encompasses  
both stockbrokers and securities clearing agencies.

H.R. REP. NO. 97-420, at 3.

1 the clause "or any other similar payment commonly used in the  
2 securities trade." 11 U.S.C. § 741(8) (emphasis supplied).

3 Determining common usage in the securities trade requires  
4 attention to the operation of trades in the securities industry.  
5 Whatever else a settlement payment may be, it is restricted to  
6 the securities trade and must be "commonly used."

7 This requirement of common usage in the securities trade  
8 necessarily excludes non-public trades in illegally unregistered  
9 securities. If integrity and compliance with securities laws are  
10 to be preserved as the hallmark of the brand name of the United  
11 States securities markets, then trades in illegally unregistered  
12 securities must flunk the common usage test. An essential  
13 purpose of the federal securities laws is to ban trafficking in  
14 illegally unregistered securities so as to promote the  
15 reputation of American securities markets as safe for investment.

16 In short, the statutory protection of settlement payments  
17 presupposes that securities laws are not being offended. In  
18 other words, Public Law 97-222 operated to coordinate and  
19 harmonize the securities laws and the Bankruptcy Code.

## 20 21 B

22 The next step in the "holistic endeavor" is to consider  
23 whether the 1984 amendments that added "financial institutions"  
24 to the list of entities protected by Public Law 97-222 changed  
25 the statutory context of furthering the securities laws.

26 The 1984 legislative history is scant. The additions of  
27 "financial institution" appeared in Subtitle H ("Miscellaneous  
28 Amendments to Title 11") of the Bankruptcy Amendments and Federal

1 Judgeship Act of 1984 amidst technical corrections that did such  
2 things as substitute "stockbroker" for "stock broker" in a  
3 definition and substitute "stockbroker" for "stockholder" in the  
4 section designating the applicability of the stockbroker  
5 liquidation provisions of chapter 7.<sup>21</sup> The absence of an  
6 explanation why a "financial institution" needed to become a  
7 protected entity implies that the change was regarded as neither  
8 significant, nor controversial.

9 Had Congress simultaneously meant to create a safe harbor  
10 from compliance with the securities laws and abandon common usage  
11 in the securities trade as the touchstone for construing  
12 protected settlement payments, Congress likely would have flagged  
13 so substantial a departure from the underlying premise of Public  
14 Law 97-222 that the securities laws were being harmonized, not  
15 preempted. See Koons Buick, 125 S.Ct. at 468.

16 It follows that the term "settlement payment" implies trades  
17 that comply with the securities laws.

### 18 III

19 The judicial decisions construing settlement payments  
20 comport with the view that the protection is directed to  
21 transactions involving legitimate securities markets.

22 Although the rhetoric of decisions describes the § 741(8)  
23 definition of "settlement payment" as being "broad" or "extremely  
24 broad," reality is different. The decisions that actually have

---

25  
26 <sup>21</sup> E.g., Pub. L. 98-353, § 421(e), 98 Stat. 368 ("Section  
27 101(24) of title 11 of the United States Code is amended by  
28 striking out 'stock broker' and inserting in lieu thereof  
'stockbroker'."), & § 423, 98 Stat. 369 ("Section 103(c) of the  
United States Code is amended by striking out 'stockholder' and  
inserting in lieu thereof 'stockbroker'.")

1 found protected settlement payments to exist have involved  
2 publicly traded securities in public markets in which an  
3 intermediary played a role. Wyle v. Howard, Weil, LaBouisse,  
4 Freidrichs Inc. (In re Hamilton Taft & Co.), 114 F.3d 991, 993  
5 (9th Cir. 1997); Jonas v. Resolution Trust Corp. (In re Comark),  
6 971 F.2d 322, 325-26 (9th Cir. 1992); Jonas v. Farmer Bros. Co.  
7 (In re Comark), 145 B.R. 47, 52 (9th Cir. BAP 1992); accord,  
8 Lowenschuss v. Resorts Int'l, Inc. (In re Resorts Int'l, Inc.),  
9 181 F.3d 505, 515-16 (3d Cir. 1999); Kaiser Steel Corp. v. Pearl  
10 Brewing Co. (In re Kaiser Steel Corp.), 952 F.2d 1230, 1237-41  
11 (10th Cir. 1991); Kaiser Steel Corp. v. Charles Schwab & Co. (In  
12 re Kaiser Steel Corp.), 913 F.2d 846, 848-50 (10th Cir. 1990);  
13 Bevill, 878 F.2d at 751-53.

14 Despite the breadth of the meaning of the term settlement  
15 payment, courts recognize that it nevertheless has limits. KSC  
16 Recovery, Inc. v. First Boston Corp. (In re Kaiser Merger  
17 Litig.), 168 B.R. 991, 1001 (D. Colo. 1994) (while "definition of  
18 'settlement payment' is broad, it is not boundless"); Weinman v.  
19 Fid. Capital Appreciation Fund (In re Integra Realty Res., Inc.),  
20 198 B.R. 352, 359-60 (Bankr. D. Colo. 1996) (same).

21 In determining those limits, courts consistently focus on  
22 the context of the statute as having been designed to protect  
23 public markets. E.g., Jackson v. Mishkin (In re Adler, Coleman  
24 Clearing Corp.), 263 B.R. 406, 478-80 (S.D.N.Y. 2001) ("Adler,  
25 Coleman Clearing"); Jewel Recovery, L.P. v. Gordon, 196 B.R. 348,  
26 352-53 (N.D. Tex. 1996); Wieboldt Stores, Inc. v. Schottenstein,  
27 131 B.R. 655, 663-65 (N.D. Ill. 1991) (no effect on clearance or  
28 settlement process).

1       The boundary that emerges from such decisions approximates  
2 the line between public transactions that involve the clearance  
3 and settlement process and non-public transactions that do not  
4 involve that process.

5       Thus, common elements in decisions finding that there is not  
6 a protected settlement payment are that the securities involved  
7 are not publicly traded and public markets are not utilized. In  
8 most of these situations, there is no intermediary. Zahn v.  
9 Yucaipa Capital Fund, 218 B.R. 656, 675-77 (D.R.I. 1998); Jewel  
10 Recovery, L.P., 196 B.R. 348, 351-53 (N.D. Tex. 1996); KSC  
11 Recovery, Inc., 168 B.R. at 1000-01; Official Comm. v. Asea Brown  
12 Boveri, Inc. (In re Grand Eagle Cos.), 288 B.R. 484, 491-95  
13 (Bankr. N.D. Ohio 2003); Weinman, 198 B.R. at 359-60.

14       The few decisions that involve outright illegality or  
15 transparent manipulation reject § 546(e) protection. In dealing  
16 with a preference action based on a Ponzi scheme that had been  
17 operated as a sham stock brokerage by an unlicensed ex-felon, the  
18 Fifth Circuit did not reach the settlement payment question  
19 because the debtor flunked the statutory test of being a  
20 “stockbroker” and, thus, could not have made a transfer protected  
21 by § 546(e). 11 U.S.C. § 101(46) (now § 101(53A)); Wider v.  
22 Wooton, 907 F.2d 570, 572-73 (5th Cir. 1990).

23       The definition of settlement payment was central to the  
24 district court’s appellate decision in Adler, Coleman Clearing,  
25 which involved “criminal conduct” by a stockbroker in  
26 manipulating prices of stocks through phony trades. Hanover,  
27 Sterling & Co. (“Hanover”), a stockbroker and market maker,  
28 knowing that regulators would shut it down for violating net



1 capital rules, illegally hid its predicament long enough to  
2 enable its brokers to execute fake purchases and fake short sales  
3 for selected clients. Hanover posted "payments" to the accounts  
4 of the favored customers based on the fake trades. The purpose  
5 of the phantom transactions was to increase the insured SIPA  
6 claims of favored Hanover clients, who were insiders and/or  
7 persons who might keep their business with individual Hanover  
8 brokers in later employment. Adler, Coleman Clearing, 263 B.R.  
9 at 417-23, adopting facts from Mishkin v. Ensminger (In re Adler,  
10 Coleman Clearing Corp.), 247 B.R. 51, 65-72 (Bankr. S.D.N.Y.  
11 1999). The phony trades generated fatal liability for Adler,  
12 Coleman Clearing, which serviced and guaranteed Hanover trades.  
13 The Adler, Coleman trustee challenged the phony payments.

14 The district court, after reviewing the history and context  
15 of the statute and surveying the decisional law, focused on the  
16 normative aspect of the § 741(8) definition of settlement  
17 payment: "commonly used in the securities trade." This, it  
18 reasoned, established a reference point based on "transfers in  
19 the ordinary course of business 'normally regarded [in the  
20 securities trade] as part of the settlement process' for the  
21 particular transaction." Adler, Coleman Clearing, 263 B.R. at  
22 481 (parenthetical in original), citing Bevill, 878 F.2d at 752.  
23 It concluded that the phantom payments were so steeped in fraud  
24 that they "can hardly be deemed so 'normally regarded.'" Id.  
25 Finally, it noted the irony that Hanover's fraud was specifically  
26 designed to undermine the statutory scheme enacted in Public Law  
27 97-222 to protect the securities industry. Id.

28 The essence of the Adler, Coleman Clearing analysis is that

1 the disputed payments were not "commonly used in the securities  
2 trade" within the meaning of § 741(8), which we find persuasive.

3  
4 IV

5 Having assessed the context of the statute and the patterns  
6 of judicial interpretations of "settlement payment," we return to  
7 the appeal at hand.

8 The transaction in question did not occur on a public market  
9 and did not involve the process of clearing trades. This places  
10 it within the pattern of cases that have concluded that a  
11 statutorily-protected "settlement payment" is not present.

12 Moreover, under the summary judgment rules that require us  
13 to construe the facts in the light most favorable to the non-  
14 moving plaintiff, we are obliged to presume that the payments on  
15 Circle Trust's demands to withdraw capital were made in an effort  
16 to prolong a Ponzi scheme that would have collapsed immediately  
17 if Six Sigma had paid the full amount of Circle Trust's demand at  
18 the time it was due under the Six Sigma operating agreement,  
19 sixty days after Circle Trust's September 28, 2001, notice.

20 Thus, the facts correspond with the Adler, Coleman Clearing  
21 situation that was so steeped in fraud that the particular  
22 transactions could not be "normally regarded" as part of the  
23 settlement process. Adler, Coleman Clearing, 263 B.R. at 481,  
24 citing Bevill, 878 F.2d at 752.

25 If we focus on the plain language of § 741(8), it is  
26 apparent that the Six Sigma transfer of \$4 million to Circle  
27 Trust as a withdrawal of capital was not designated by the  
28 participating parties by any term that included the words

1 "settlement payment." Hence, it was not one of the specific  
2 payments catalogued in § 741(8): it was neither a "preliminary  
3 settlement payment," nor a "partial settlement payment," nor an  
4 "interim settlement payment", nor a "settlement payment on  
5 account," nor a "final settlement payment." 11 U.S.C. § 741(8).

6 Since the \$4 million transfer was not designated by any term  
7 that included the words "settlement payment," the transfer would  
8 constitute a "settlement payment" under the language of § 741(8),  
9 only if it qualified as a "similar payment commonly used in the  
10 securities trade." Id.<sup>22</sup>

11 The fact that the transfer was a transaction in an illegally  
12 unregistered security can hardly be described as a "payment  
13 commonly used in the securities trade." Id. (emphasis supplied).  
14 To the contrary, the viability of the securities markets depends  
15 on the ability to enforce provisions outlawing trades in  
16

---

17 <sup>22</sup> We assume, without deciding, that Circle Trust's  
18 withdrawal of capital from Six Sigma can be construed as a  
19 "securities contract" under § 741(7). It is, however, not  
20 certain that withdrawal of net capital from a limited liability  
21 company requires settlement in the sense of a transaction in the  
22 securities industry. When the Ninth Circuit ruled that  
23 withdrawal from a Reverse Repo agreement was a Repo  
24 "transaction," it reasoned that return of the securities being  
25 held by the withdrawing party was necessary to return the parties  
26 "to a kind of status quo ante" and that, accordingly, a protected  
27 settlement payment ensued because "[n]either party reasonably  
28 could consider Comark's withdrawal 'settled' until GreatAmerican  
received the over \$9 million dollars worth of securities Comark  
had in its possession." Comark, 971 F.2d at 326. It is an open  
question whether this analysis would extend to Circle Trust's  
withdrawal demand, which contractually entitled it to no more  
than its "net capital account" that was supposed to reflect the  
net of Six Sigma's losses and profits - possibly zero. If the  
capital account had been accurately calculated, then Circle Trust  
may have been entitled to less than the \$22 million it received.

1 illegally unregistered securities. To construe a transaction in  
2 an illegally unregistered security as "commonly" occurring in the  
3 securities trade would amount to an absurd contradiction of the  
4 securities laws.

5 As noted, the decisions of the Third Circuit in Bevill and  
6 the district court in Adler, Coleman Clearing confirm that the  
7 meaning of "settlement payment" must be construed in light of  
8 "transfers which are normally regarded as part of the settlement  
9 process." Bevill, 878 F.2d at 752; Adler, Coleman Clearing, 263  
10 B.R. at 481. Since protecting trades in illegally unregistered  
11 securities cannot be described as "normally regarded" as entitled  
12 to any legitimacy in the securities trade, honoring such a trade  
13 would undermine the statutory scheme harmonizing the Bankruptcy  
14 Code and the securities laws.

15 It follows that the withdrawal of capital does not qualify  
16 as a "settlement payment" under § 741(8) because a non-public  
17 trade in an illegally unregistered security is not "commonly used  
18 in the securities trade."

19  
20 \*\*\*

21 The court incorrectly held that the \$4 million received by  
22 Circle Trust from Six Sigma 89 days before bankruptcy was a  
23 settlement payment within the meaning of § 741(8) and hence  
24 insulated from recovery by § 546(e).

25 REVERSED and REMANDED.  
26  
27  
28