EXHIBIT A

KeyCite Red Flag - Severe Negative Treatment
Reversed and Remanded by Grede v. FCStone, LLC, 7th Cir.(Ill.), March 19, 2014

485 B.R. 854
United States District Court,
N.D. Illinois,
Eastern Division.

Frederick J. GREDE, not individually but as Liquidation Trustee of the Sentinel Liquidation Trust, Plaintiff,
v.
FCSTONE, LLC, Defendant.

No. 09 C 136.
|
Jan. 4, 2013.

Synopsis
Background: Liquidation trustee appointed under debtor's confirmed Chapter 11 plan brought adversary proceeding to avoid certain pre and postpetition transfers effected by debtor, a registered investment adviser and futures commission merchant (FCM).

Holdings: Reference of proceeding was withdrawn from the Bankruptcy Court, and the District Court, James B. Zagel, J., held that:

[1] futures commission merchant (FCM) customer to which portion of proceeds from sale of portfolio of securities were distributed postpetition bore burden of demonstrating that these securities could be traced back to deposits made by itself and other similarly situated FCM customers, in order to rely on trust provisions of the Commodity Exchange Act (CEA) to assert that proceeds were not property of the estate, and that transfer was not avoidable as unauthorized postpetition transfer;

[2] customer failed to satisfy burden of tracing;

[3] transfer was not authorized by bankruptcy court;

[4] customer was liable on this transfer as both "initial transferee" and "entity for whose benefit the transfer was made"; and

[5] "safe harbor" exception to avoidability of certain transfers could not be applied, even if, by its plain terms, it literally applied to challenged transaction.

Judgment for trustee.

West Headnotes (16)

[1] **Bankruptcy**
Post-petition transactions
To prevail on complaint to avoid allegedly unauthorized postpetition transfer, trustee must prove the following: (1) that debtor made transfer of property of the estate; (2) that transfer occurred after commencement of bankruptcy case; and (3) that it was not authorized under the Bankruptcy Code or by bankruptcy court. 11 U.S.C.A. § 549(a).

1 Cases that cite this headnote

[2] **Bankruptcy**
Avoidance rights and limits thereon, in general
To recover a transfer once avoided, trustee must prove that defendant is (1) initial transferee of such transfer, or (2) entity for whose benefit transfer was made. 11 U.S.C.A. § 550(a)(1).

Cases that cite this headnote

[3] **Bankruptcy**
Effect of state law in general
Determination of whether, and to what extent, debtor has ownership interest in property, of kind included in bankruptcy estate upon commencement of case, is made by looking to applicable non-bankruptcy law, which typically means state property law, unless case involves overriding federal interests that require application of federal law. 11 U.S.C.A. § 541(a)(1).

1 Cases that cite this headnote

[4] **Commodity Futures Trading Regulation**
Contract markets, commission merchants and brokers

Securities Regulation
Investment Advisers

Regulation promulgated under the Investment Advisers Act (IAA), that requires investment advisers registered with the Securities and Exchange Commission (SEC) to segregate their customers' assets from those of other customer groups, as well as from their own assets, creates specific statutory trust that protects customer funds from investment adviser and its creditors, just as analogous provision of the Commodity Exchange Act (CEA), that requires futures commission merchants (FCMs) to segregate their customers' funds from those of other customer groups and of the FCM, protects customer funds from the FCM and its creditors. Commodity Exchange Act, § 4d(a)(2), (b), 7 U.S.C.A. § 6d(a)(2), (b); 17 C.F.R. §§ 1.20, 275.206(4)–2.

2 Cases that cite this headnote

[5] **Commodity Futures Trading Regulation**
Contract markets, commission merchants and brokers

Securities Regulation
Investment Advisers

Regulation promulgated under the Investment Advisers Act (IAA), that required investment advisers registered with the Securities and Exchange Commission (SEC) to segregate their customers' assets from those of other customer groups, as well as from their own assets, provided statutory trust protections for benefit of customers of Chapter 11 debtor, in its capacity as registered investment adviser, as robust as those provided by analogous provision of the Commodity Exchange Act (CEA) for benefit of other customers of debtor, in its capacity as futures commission merchant (FCM); both sets of customers had equally forceful claims to trust protection with regard to insufficient pool of commingled assets held by debtor as of commencement of its Chapter 11 case. Commodity Exchange Act, § 4d(a)(2), (b), 7 U.S.C.A. § 6d(a)(2), (b); 17 C.F.R. §§ 1.20, 275.206(4)–2.

1 Cases that cite this headnote

[6] **Securities Regulation**
Investment Advisers

Regulation promulgated under the Investment Advisers Act (IAA), that required investment advisers registered with the Securities and Exchange Commission (SEC) to segregate their customers' assets from those of other customer groups, as well as from their own assets, had same force and effect as if it had been enacted directly by Congress, as being in nature of properly promulgated, substantive agency regulation. 17 C.F.R. § 275.206(4)–2.

Cases that cite this headnote

[7] **Bankruptcy**
Property held by debtor as trustee, agent, or bailee

Bankruptcy
Post-petition transactions

Bankruptcy
Burden of Proof

Bankruptcy
Construction, execution, and performance

Commodity Futures Trading Regulation
Liability of brokers or commission merchants

Futures commission merchant (FCM) customer to which portion of proceeds from sale of portfolio of securities owned by Chapter 11 debtor, a registered investment adviser and FCM, were distributed postpetition bore burden of demonstrating that these securities could be traced back to deposits made by itself and other similarly situated FCM customers, in order to rely on trust provisions of the Commodity Exchange Act (CEA) to assert that proceeds were not property of the estate, and that transfer was not avoidable by liquidation trustee as unauthorized postpetition transfer, where debtor, in violation of laws and regulations governing its business as registered investment adviser and FCM, had not segregated customer funds and had entered bankruptcy with insufficient pool of commingled assets. 11 U.S.C.A. § 549(a); Commodity Exchange Act, § 4d(a)(2), (b), 7 U.S.C.A. § 6d(a)(2), (b); 17 C.F.R. § 1.20.

Cases that cite this headnote

[8] **Bankruptcy**
Property held by debtor as trustee, agent, or bailee
Bankruptcy
Post-petition transactions
Bankruptcy
Construction, execution, and performance
Commodity Futures Trading Regulation
Liability of brokers or commission merchants

Manner in which Chapter 11 debtor, a registered investment adviser and futures commission merchant (FCM), had operated its business, using pooled investment model, and buying and selling securities, not in response to customer deposits and withdrawals, but independently with financing that it obtained from third party lender, and only later allocating interests in securities which it acquired to different customer groups depending upon whether securities in question were appropriate for investment objectives of the group, prevented FCM customer to which postpetition distribution was made using proceeds generated from sale of portfolio of securities from tracing these securities back to deposits that it had made, as required for this FCM customer to rely on trust provisions of the Commodity Exchange Act (CEA) to assert that proceeds were not property of the estate, and that transfer was not avoidable by liquidation trustee as unauthorized postpetition transfer. 11 U.S.C.A. § 549; Commodity Exchange Act, § 4d(a)(2), (b), 7 U.S.C.A. § 6d(a)(2), (b); 17 C.F.R. § 1.20.

1 Cases that cite this headnote

[9] **Bankruptcy**
Post-petition transactions
Bankruptcy
Construction, execution, and performance

Bankruptcy court's order indicating that bank at which Chapter 11 debtor, a registered investment adviser and futures commission merchant (FCM), maintained account "m[ight]" distribute proceeds from sale of portfolio of securities in accordance with an approved pro rata plan, was not authorization for bank to distribute proceeds to class of FCM customers to which debtor had arbitrarily allocated these securities, despite fact that it operated its business on pooled investment model, and that securities could not be traced to any deposits that this class of FCM customers had made; accordingly, since payment was not authorized by any provision of the Bankruptcy Code, it was subject to avoidance by liquidation trustee as unauthorized postpetition transfer. 11 U.S.C.A. § 549.

Cases that cite this headnote

[10] **Bankruptcy**
Avoidance rights and limits thereon, in general

Recipient of avoidable transfer is considered an "initial transferee," for purposes of bankruptcy statute governing liability of transferees on avoided transfers, only if it had "dominion" over the money or other asset transferred, i.e., the right to put that asset to its own purpose; if party is an initial recipient of funds, but does not exercise dominion and control over them, then that party is not "initial transferee." 11 U.S.C.A. § 550(a)(1).

Cases that cite this headnote

[11] **Bankruptcy**

Avoidance rights and limits thereon, in general

Futures commission merchant (FCM) and customer of Chapter 11 debtor to whose account an unauthorized postpetition payment was made, in amount of more than $14 million, was liable thereon as "initial transferee," even though account in question was segregated account that the FCM had established for benefit of its own customers; because challenged transfer raised account balance to amount more than $75 million in excess of amount required to be segregated for benefit of the FCM's customers, and because the FCM had right to draw on excess funds under governing federal regulations, it possessed requisite "dominion and control" over funds, regardless of whether it ever exercised that right by making draw. 11 U.S.C.A. § 550(a)(1); 17 C.F.R. § 1.23.

Cases that cite this headnote

[12] **Bankruptcy**

Avoidance rights and limits thereon, in general

"Dominion and control" test utilized by bankruptcy courts to determine whether recipient of avoidable transferee is liable thereon as "initial transferee" turns on whether recipient of transfer has "the right" to put transferred property to its own purposes, regardless of whether it actually does so. 11 U.S.C.A. § 550(a)(1).

Cases that cite this headnote

[13] **Bankruptcy**

Avoidance rights and limits thereon, in general

Futures commission merchant (FCM) and customer of Chapter 11 debtor to whose account an unauthorized postpetition payment was made, in amount of more than $14 million, was liable thereon as "entity for whose benefit the transfer was made," given that, by law, it functioned as de facto guarantor for all its customer funds invested with debtor, and would have gone out of business had it attempted to shift loss arising from debtor's failure to properly segregate funds to its customers. 11 U.S.C.A. § 550(a)(1).

Cases that cite this headnote

[14] **Bankruptcy**

Avoidance rights and limits thereon, in general

Bankruptcy

Construction, execution, and performance

Regardless of whether "safe harbor" exception to avoidability of certain margin and settlement payments could, by its plain terms, be applied to transaction by which Chapter 11 debtor, an entity that sold securities on behalf of third-party customers, distributed proceeds of already completed securities transaction to a certain preferred group of customers, "safe harbor" provision could not be invoked to prevent liquidation trustee from setting aside these customer payments as preferences, as this would lead to an absurd result demonstrably at odds with intentions of Congress in enacting "safe harbor" exception; allowing debtor to distribute proceeds of completed securities transaction, which it had carried out for its customers in uneven and arbitrary manner, safe from challenge by liquidation trustee, would not promote stability in securities and commodities markets, but would lead to further instability by making it utterly unpredictable how losses would be apportioned in event that futures commission merchant (FCM) or investment adviser became bankrupt. 11 U.S.C.A. §§ 546(e), 547(b).

2 Cases that cite this headnote

[15] Bankruptcy
Avoidance rights and limits thereon, in general

"Safe harbor" exception to avoidability of margin and settlement payments that involve certain specifically enumerated entities functions as firewall, to insulate legitimate securities and commodities transactions from avoidance, because of potential destabilizing effects that unwinding such trades could have upon the broader market. 11 U.S.C.A. § 546(e).

2 Cases that cite this headnote

[16] Bankruptcy
Trustee as representative of debtor or creditors

Bankruptcy
Construction, execution, and performance

Unjust enrichment claim asserted by liquidation trustee appointed under debtor's confirmed Chapter 11 plan, in effort to unwind asset transfers effected by debtor, was preempted by federal bankruptcy law.

Cases that cite this headnote

Attorneys and Law Firms

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MEMORANDUM OPINION AND ORDER

JAMES B. ZAGEL, District Judge.

I. INTRODUCTION

Sentinel Management Group, Inc. ("Sentinel") filed under Chapter 11 of the Bankruptcy Code in August 2007. In September 2008, Plaintiff Liquidation Trustee filed adversary proceedings in the Bankruptcy Court for the Northern District of Illinois for avoidance and recovery of pre and post-petition transfers made by Sentinel to or for the benefit of certain customers. On October 29, 2008, I withdrew the reference to the Bankruptcy Court, finding that the adversary proceedings raised "significant open and unresolved issues" of non-bankruptcy law regarding the applicability of common law trust principles to statutory trusts, and the duty of futures commission merchants ("FCMs") to cover customer segregation shortfalls under the Commodity Exchange Act ("CEA") and its regulatory provisions. *Grede v. Fortis Clearing Americas LLC,* No. 09 C 138, 2009 WL 3518159, at *3–4 (N.D.Ill. Oct. 28, 2009).

The instant adversary proceeding was chosen as a "test case" (as least in part) to resolve common legal issues among the Trustee's actions. Here, the Trustee seeks to avoid or reduce the transfer of approximately $15.6 million to Defendant FCStone. He alleges five counts: 1) avoidance and recovery of post-petition transfers (11 U.S.C. §§ 549(a) and 550); 2) ***859** avoidance and recovery of preferential transfers (11 U.S.C. §§ 547(b) and 550); 3) declaratory judgment that cash and securities held by Sentinel in allegedly segregated bank accounts is property of the Debtor's estate; 4) unjust enrichment; and 5) disallowance or reduction of claims (11 U.S.C. § 502(d)).

A bench trial was held on October 1 through 17, 2012. [1] Pursuant to Fed.R.Civ.P. 52(a), my findings of fact and conclusions of law are laid out below.

II. FINDINGS OF FACT [2]

Parties

1. The Sentinel Liquidation Trust (the "Trust") is a liquidating trust created under the Fourth Amended Chapter 11 Plan of Liquidation (the "Plan") for Sentinel. The effective date of the Plan was December 17, 2008. Plaintiff Frederick J. Grede was formerly the Chapter 11 trustee for Sentinel. On December 17, 2008, pursuant to the terms of the Plan, Grede was appointed Liquidation Trustee of the Trust (the "Trustee").

2. Defendant FCStone is an Iowa limited liability company with its principal place of business in Chicago, Illinois. FCStone is a futures commission merchant ("FCM"). As an FCM, FCStone maintains accounts and clears trades for customers in the futures markets; FCStone acts as a financial intermediary between its customers and the futures markets.

Sentinel's Business

3. Sentinel was an Illinois corporation headquartered in Northbrook, Illinois. Sentinel managed investments for various clients, including FCMs, hedge funds, financial institutions, pension funds, and individuals.

4. Sentinel offered its customers several different portfolios as investment options. Sentinel represented to its customers that all of its portfolios met the dual objectives of low risk and high liquidity. Sentinel's marketing materials described the allowable investments in the three primary portfolios as follows:

• Treasury Only Portfolio—Direct obligations of the U.S. Treasury.

• 1.25 Portfolio—Obligations of the U.S. Treasury, short term commercial paper rated A1/P1, medium and long term debt rated AA or higher, bank time deposits and repurchase agreements collateralized by the above.

• Prime Portfolio—Short term commercial paper rated A1/P1, investment grade corporate bonds, bank time deposits, repurchase agreements collateralized by the above and other highly rated marketable securities.

5. Sentinel classified its customers into three distinct segments or "SEGs" based on their regulatory status and the source and nature of their investments. The SEGs were comprised as follows:
SEG 1: Comprised of FCMs' customer funds required to be invested in compliance with CFTC Rule 1.25 and held in compliance with CEA and CFTC segregation requirements;

SEG 2: Comprised of FCMs' foreign futures and foreign options customer funds required to be invested in compliance with ***860** CFTC Rule 1.25 and held in separate accounts in compliance with CFTC Rule 30.7;

SEG 3: Comprised of hedge funds, other public and private trading funds, individual investors and FCMs investing proprietary or "House" funds.

6. Within each SEG, Sentinel further divided its customers into 11 groups, each of which consisted of customers with the same risk and return goals. Each customer participating within a specific group held an indirect beneficial ownership interest based on its pro rata share of the value of the securities held in that group's portfolio. The breakdown of the 11 customer groups by SEG, and their investment guidelines, were as follows:
SEG 1: FCM customers trading on U.S. exchanges

Group 1: Rule 1.25—Overnight reverse-repo government securities only

Group 7: Rule 1.25—Government securities, corporate bonds, cash

Group 8: Rule 1.25—Direct obligations of the U.S. Treasury only

Group 9: Rule 1.25—Government securities (no agency), corporate bonds, cash

SEG 2: FCM customers trading foreign futures and options

Group 5: Rule 30.7—Cash only

Group 6: Rule 30.7—Government securities and cash

SEG 3: Hedge funds, trusts, individual investors, FCM proprietary or "House" funds

Group 2: Prime—Government, corporate, sovereign debt rated as "investment grade" by an NRSRO.

Group 3: TOP—Direct obligations of the U.S. Treasury only

Group 4: Prime

Group 10: Rule 1.25—Government securities, corporate bonds, cash

Group 11: Prime—Government, corporate, sovereign debt rated as "investment grade" by an NRSRO. [3]

7. Defendant FCStone was a Sentinel customer. Defendant's funds were invested in the SEG 1, Group 7 customer portfolio.

8. Sentinel also managed a "House" or "Street" portfolio comprised of securities that were managed on a proprietary basis on behalf of Sentinel and certain employees, insiders and investors.

9. Prior to 2004, Sentinel entered into Investment Advisory Agreements, and post 2004 entered into Investment Management Agreements (collectively, "Customer Agreements"), with each of its investing customers. The Customer Agreements governed the terms of Sentinel's relationship with its customers. The Customer Agreements appointed Sentinel as a discretionary investment adviser with respect to assets deposited by customers. The Customer Agreements specified that the client's assets in a particular program would be invested along with the assets of other Sentinel clients in the same program and that the client would own an indirect interest in the segregated portfolio of the relevant program.

10. Sentinel's customers did not own any particular securities and were entitled only to redemptions of cash. All of Sentinel's transactions with customers were cash transactions.

861** ***The Regulatory Framework that Governed Sentinel's Business

11. Sentinel was registered with the Securities and Exchange Commission ("SEC") as an investment adviser and with the Commodity Futures Trading Commission ("CFTC") as a futures commission merchant. FCM registration was necessary for Sentinel to provide its investment advisory services to FCMs investing funds of their commodity customers. Sentinel did not itself execute or clear futures transactions, as registered FCMS typically do.

12. The Commodity Exchange Act (CEA) and CFTC Rules promulgated thereunder required Sentinel to segregate commodity customers' funds from those of other customer groups and from Sentinel's own assets. The CEA and its related CFTC rule applied to Sentinel's SEG 1 FCM customers with respect to the funds of the FCMs' commodity customers.

13. 17 C.F.R. 275.206 (the "SEC Custody Rule"), a regulatory provision promulgated under the Investment Advisers Act (IAA,) required Sentinel to segregate its customers' assets from those of other customer groups and from Sentinel's own assets. The SEC Custody Rule applied to all of Sentinel's customers.

Sentinel's Account Structure at the Bank of New York and JP Morgan

14. Sentinel maintained several accounts at the Bank of New York ("BONY") to process daily transactions related to securities trading and customer cash deposit and withdrawal activity. BONY also functioned as the custodian of securities held on behalf of Sentinel's customers.

15. Sentinel maintained several accounts at JP Morgan, which functioned as the custodian for customer cash.

16. Specifically, Sentinel maintained three segregated cash accounts at BONY that were held for Sentinel's customers in SEGs 1, 2 and 3. The three BONY cash accounts were the transactional accounts through which all of Sentinel's customer deposits and withdrawals were received and paid. Customer deposits and withdrawals were wired in and out of these accounts on a daily basis.

17. Sentinel also maintained a House cash account at BONY.

18. Sentinel established three segregated securities accounts at BONY to hold government and governmental securities for customers in SEGS 1, 2 and 3.

19. Sentinel established three segregated securities accounts at BONY to hold Depository Trust Company registered corporate securities ("DTC securities") for customers in SEGs 1, 2 and 3.

20. The BONY account structure also included the SEN and SLM accounts. The SEN account was a lienable account that served as the central settlement account at BONY for Sentinel's investment and trading activity. All purchases and sales of government securities were processed through the SEN, whether for SEGs 1, 2, 3 or the House account. In addition to securities settlements, Sentinel used the SEN account for cash management. Cash from all SEGS as well as the House was commingled in the SEN account. The SEN account was active only

during the business day and did not hold securities or cash overnight.

21. BONY provided an overnight loan to Sentinel. The loan's original purpose was to provide Sentinel with liquidity for customer redemptions and failed trades. Later, Sentinel used the BONY loan to fund its own proprietary repurchase agreements as part of a leveraged trading strategy.

***862** 22. The SLM account was Sentinel's lienable overnight loan account at BONY. At the close of each trading day, Sentinel would reset its overnight loan in the BONY system. BONY required an offsetting amount of securities to be held as collateral for Sentinel's loan each night. After the amount of the overnight loan was determined, Sentinel would transfer securities via the SEN account to the SLM account at an amount equal to or greater than the amount of the overnight loan. The following morning, the securities in the SLM account were returned to the SEN account.

23. The BONY account structure also included a lienable, non-segregated clearing account used to settle all DTC securities transactions (the "DTC Securities/Clearing Account" or "FC1"), including those made for the House. The FC1 account was not used for cash transactions. Cash transactions relating to DTC corporate transactions were processed in the SEN account.

24. Sentinel established a single clearing account at BONY for securities registered with Euroclear. Sentinel also established segregated Euroclear accounts at BONY, but never activated them.

25. Sentinel established three non-interest bearing cash accounts at JP Morgan as well as three interest bearing cash accounts that were linked to the corresponding non-interest bearing cash accounts. Two of the non-interest bearing accounts and their interest bearing counterparts were available to be used for both SEG 1 and SEG 3 customer funds. The other non-interest bearing account and its interest bearing counterpart was used to hold SEG 2 funds.

26. The JPMorgan cash accounts were non-transactional. Their sole purpose was to hold cash in segregation. Sentinel allocated interest earned on deposits at JP Morgan to customer accounts on a daily basis. SEG 1 and SEG 3 cash was pooled in at least one of the JP Morgan cash accounts. No cash belonging to Sentinel was held in the JP Morgan cash accounts.

Sentinel's Investment Model

27. In order to invest with Sentinel, customers would wire cash to the applicable segregated cash account at BONY and, in exchange, receive a pro rata beneficial interest in securities held by Sentinel at BONY.

28. Sentinel managed customer group investments in securities on a daily basis by allocating suitable securities held by Sentinel to each group according to the group's investment guidelines and applicable regulatory restrictions.

29. The purpose of the allocation process was to invest customer funds deposited with Sentinel in a pool of securities. Sentinel allocated securities it held to each customer group with the total market value (less a small deduction called a "haircut") of the securities in the pool equaling the total value of the customers' accounts in that pool.

30. The daily allocation process was based upon: 1) changes in individual customer account balances due to deposit and withdrawal activity and the resulting changes in each group's total balance; 2) changes in market value of securities due to changing market conditions; and 3) changes in securities holdings of Sentinel due to securities trading and settlement activity.

31. Generally, the same or similar securities were allocated to each pool daily. However, Sentinel was free to move securities between customer groups without customer permission so long as those securities met the investment standards of the customer group portfolios. Sentinel was also free to liquidate securities held for ***863** customers at any time without customer permission.

32. During the relevant time period, Sentinel held billions of dollars in securities that it did not allocate to customers.

33. Sentinel did not generally buy and sell securities in response to daily customer deposits and redemptions. Rather, it operated under a pooled investment model in which one customer's withdrawal or another's deposit would affect the total balance of the customer group and shift each customer's pro rata interest in the group portfolio.

34. Sentinel also allocated interest income to each customer on a daily basis. The interest income was an approximation based on the interest earned by the entire pool of securities that Sentinel managed, not a calculation based on customers' indirect ownership interest in their group portfolio. This included interest earned on billions of dollars of securities that did not appear on any customer statements and the interest earned on securities listed on the account statements of other customer groups.

35. Sentinel issued daily statements ("Customer Statements") to its customers that summarized the daily account activity and detailed the net equity and net interest earned by the customer. The Customer Statements included a description of the securities reported to be held within the customer's group portfolio on the date of the statement, the number of units held for the customer, the cost per unit and the current market value of the securities.

36. The securities reflected on a given Customer Statement generally were not purchased with the cash the customer deposited, but instead came from Sentinel's large pool of pre-existing unallocated securities that was financed by the BONY loan and cash received from repo [4] counterparties.

37. Customer redemptions were generally funded by other customer deposits or with proceeds of the BONY loan.

38. Sentinel represented to its customers and to regulators that all of its customer funds were properly held in segregation.

39. In fact, Sentinel treated its own and its customers' assets as a single, undifferentiated pool of cash and securities.

40. All sources of cash, including cash deposited by customers, proceed from the BONY loan, cash received from repo counterparties, proceeds of securities transactions, and interest income received on securities were commingled in the unsegregated SEN Account on a daily basis.

Sentinel's Accounting Systems

41. Sentinel used two main accounting systems to track its customers' indirect beneficial ownership interests in its pool of cash and securities: FoxPro and Excel spreadsheets.

42. The FoxPro system was the primary ledger system used by Sentinel in recording and tracking daily accounting and transaction activity. FoxPro was comprised of two primary ledgers: 1) the ***864** Customer Ledger, which tracked customer transactions and balances, and formed the book-entry accounting system for Sentinel's customer accounts; and 2) the Securities Inventory, which recorded all securities held or controlled by Sentinel (whether for customers or the House).

43. The FoxPro system generated daily reports that provided detailed information on customer activity and accounts, including account deposits and withdrawals, beneficial interests in securities, interest received, and management fees and other expenses. Sentinel's daily Customer Statements were also produced from the Customer Ledger in FoxPro.

44. Sentinel also maintained a number of detailed Excel spreadsheets that complemented the FoxPro system. The Excel spreadsheets were, among other things, used to summarize the allocation of interest earned for the day by group; compute the current market value for all securities held in Sentinel's inventory; summarize characteristics of securities allocated to each customer group portfolio; reconcile cash and securities activity at BONY and JP Morgan to the FoxPro Securities Ledger; reconcile the FoxPro Securities Ledger and the FoxPro Customer Ledger; and summarize and aggregate daily customer activity by SEG.

45. Using the FoxPro System and the Excel spreadsheets, it is possible to identify: 1) the custodial location of every Sentinel security held at BONY for all relevant time periods; and 2) the indirect beneficial ownership interest in these securities that Sentinel assigned its customers.

The BONY Loan and Sentinel's Leveraged Trading Strategy

46. Beginning in 2001, and increasingly in 2004 and onwards, Sentinel entered into a number of repo trades with counterparties such as FIMAT USA and Cantor Fitzgerald & Co ("Repo Counterparties"). Sentinel used the overnight BONY loan to cover the haircuts associated with these trades.

47. In order to secure the overnight loan, BONY required Sentinel to place securities into its lienable accounts to serve as collateral.

48. Sentinel routinely pledged hundreds of millions in securities that were reflected in the FoxPro ledger as being allocated to SEG 1 and SEG 3 customers, and which were also reported on the daily Customer Statements to SEG 1 and SEG 3 customers as being held in segregation for their benefit, as collateral for the BONY loan.

49. Sentinel's use of securities allocated to customers as collateral for the BONY loan left its segregated accounts chronically underfunded. In other words, the amount of securities held in segregation on behalf of Sentinel's customers was consistently far below what it owed its customers.

50. As Sentinel expanded its leveraged trading strategy, the BONY loan, and the number of securities allocated to customers needed to secure the loan, grew. Sentinel's guidance line for the BONY loan, a preapproved amount for nightly loans, increased from $55 million in May 2004 to $300 million in September 2006. The average loan balance from June 1, 2007 to August 13, 2007, was $369 million.

51. By early 2007, Sentinel held more than $2 billion in securities through repo arrangements.

52. Between December 2004 and June 2007, Sentinel's segregation shortfalls—the difference between what Sentinel owed its customers and the amount of assets actually held in segregation for those customers—grew from roughly $150 million to over $800 million.

***865** 53. Prior to June 2007, Sentinel mostly used government securities to secure the BONY loan. However, DTC securities were occasionally used as collateral during this period.

Sentinel's Collapse

54. During the summer of 2007, credit markets contracted significantly due in part to the collapse of the subprime mortgage industry. The unavailability of credit led to a liquidity crisis throughout U.S. financial markets.

55. In response to this credit/liquidity crisis, the Repo Counterparties began to close out positions in Sentinel's repo portfolio, returning securities that Sentinel had loaned out and demanding cash payments in return. The widespread return of repos required Sentinel to repay the Repo Counterparties hundreds of millions of dollars. Sentinel did not have enough of its own funds to meets its repayment obligations to the Repo Counterparties, so it drew even more heavily on the BONY Loan. In late June 2007, the BONY loan topped out at $573.8 million.

56. On June 26, 2007, BONY accepted physical securities (CDOs) as collateral in addition to government securities in order to cover the increased loan. On June 29, 2007, BONY notified Sentinel that it no longer would accept physical securities as collateral.

57. In order to provide adequate collateral that BONY deemed acceptable for the increasing loan, on June 29, 2007, Sentinel moved $166 million of corporate securities from the SEG 1 segregated custodial account to the FC1 Account.

58. In July 2007, Sentinel was able to sell securities to pay down the BONY Loan. Many of the securities Sentinel sold to pay down the loan had been allocated to SEG 1 and SEG 3 customers.

59. Proceeds from the sale of SEG 1 and SEG 3 securities were used to pay down the loan largely because Sentinel was unable to sell the securities that were returned by Repo Counterparties. The securities that had been out on repo tended to be high risk, illiquid CDOs that had been allocated to the House and had not appeared on Customer Statements.

60. As Sentinel's pool of assets decreased, it had to allocate the CDOs that had been out on repo to SEG 3 customers since the higher quality government and corporate securities had been already sold or were allocated to customers with Rule 1.25 compliant portfolios.

61. On July 17, 2007, Sentinel moved $84 million of additional SEG 1 corporate securities to the FC1 account from the SEG 1 segregated custodial account.

62. On July 30, 2007, the BONY Loan was $362.2 million, collateralized by $384.2 million in securities. The collateral chosen by BONY was comprised of government securities with a collateral value of $354.0 million and two DTC securities with a collateral value of $30.2 million. The total par value of DTC securities held in the FC1 account and subject to lien on July 30 was $366.7 million.

63. On July 30 and 31, 2007, Sentinel moved securities with a par value of $263.9 million from the FC1 account to the SEG 1 DTC securities account. Most of the securities returned to the SEG 1 DTC securities account on July 30,

2007, were the same ones that had been moved from the SEG 1 DTC securities account to the FC1 account on June 28 and July 17, 2007. None of these transfers was related to customer activity.

64. To maintain sufficient collateral following the transfer of SEG 1 DTC securities back into segregation, Sentinel transferred securities with a par value of $289.9 ***866** million from the SEG 3 DTC securities account to the FC1 account. As a result of this transfer, the SEG 3 segregated security accounts were virtually emptied. The transfer of SEG 3 DTC securities into the FC1 account was not related to customer activity.

65. The swap of SEG 1 securities for SEG 3 securities to meet Sentinel's collateral obligations to BONY resulted in a massive shift of loss exposure in the weeks preceding Sentinel's bankruptcy. Specifically, between July 27 and 31, 2007, Sentinel's SEG 1 customer segregation shortfalls decreased by $543.8 million, while its SEG 3 customer segregation shortfalls increased by $289.7 million. This shift in loss exposure was not based on customer activity, differing legal obligations to customers, or any other legitimate economic or legal grounds.

66. Sentinel's liquidity and solvency problems continued into August as Repo Counterparties continued to unwind their positions. On August 13, 2007, Sentinel sent its customers a letter informing them that it had asked the CFTC for permission to halt redemptions to customers ("No Redemption Letter"). On that same date, the par value of securities and cash controlled by Sentinel was 80.4% of total Customer Equity.

67. Despite the No Redemption Letter, Sentinel paid out full and partial redemptions to its SEG 1 customers.

68. On August 15, 2007, Sentinel distributed $111,229,456.41 to the accounts of SEG 1 customers participating in Group 1 and 8, which constituted the full values of those accounts.

69. On August 16, 2007, BONY sent a letter to Sentinel requesting that it immediately repay its loan in full, and notifying Sentinel of its intention to commence liquidating the collateral that was pledged to secure the loan.

70. On August 17, 2007, BONY sent another letter to Sentinel notifying it that due to its failure to repay the loan, on or after August 22, 2007, BONY would liquidate the collateral pledged to secure the loan.

71. On August 17, 2007, Sentinel filed for bankruptcy.

The Citadel Sale

72. On August 16, 2007, Sentinel sold to Citadel a portfolio of 98 securities that Sentinel had allocated to SEG 1 customers for a purchase price equal to the purported market value of the securities ($384 million), less a "market uncertainty concession" of $47.1 million (the "Citadel Sale"). 92 of the securities settled on August 16, 2007, while six failed to settle. The proceeds of the 92 securities sold were deposited in the SEG 1 segregated cash account at BONY.

73. On August 17, 2007, Sentinel distributed $22.5 million of cash held at JP Morgan to the customer segregated accounts of SEG 1 customers participating in Group 7 and Group 9. One security that failed to settle on August 16, 2007 was settled, and the related $4.9 million in proceeds were deposited in the SEG 1 segregated cash account at BONY.

74. FCStone received $1,097,925 of the August 17, 2007 distribution.

75. The same day, Sentinel filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code.

76. On August 20, 2007, Sentinel filed an emergency motion with the United States Bankruptcy Court for the Northern District of Illinois in which it sought entry of an order approving the turnover and distribution by BONY of the proceeds from the Citadel sale to the customer segregated ***867** accounts of Sentinel's remaining SEG 1 FCM customers. The Bankruptcy Court issued an order stating that BONY "may" distribute the Citadel sale proceeds to Group 7 and Group 9 customers without violating three extant TROs. The order also stated that it was "without prejudice to all rights, defenses, claims and/or causes of action, if any, of the Debtor ... against the Distributee ... with respect to any claim for priority under Section 761–767, or other applicable law."

77. On August 21, 2007, $297 million in proceeds from the Citadel sale were distributed to the customer segregated accounts of Sentinel's remaining SEG 1 customers in Groups 7 and 9. FCStone received $14,479,039 of the August 21, 2007 distribution. Following the distribution, $20.5 million remained in the SEG 1 account at BONY, which consisted of a $15.6 million holdback and $4.9

million in proceeds received on August 17, 2007, from the security sold to Citadel that failed to settle on the first attempt.

78. FCStone received a total $15,576,964 in proceeds from the Citadel Sale.

79. SEG 3 customers were unable to redeem any of their funds from Sentinel prior to bankruptcy.

80. The August 15 to 21, 2007, SEG 1 customer redemptions, coupled with the August 17, 2007 lien asserted by BONY over the $286 million in the SEG 3 securities pledged as collateral, left SEG 3 customers with a tiny pool of assets (relative to what they were owed) from which their funds could be redeemed post-filing. This resulted in a substantially lower recovery rate for SEG 3 customers than SEG 1 customers.

81. If the August 15–21, 2007 distributions of $430.8 million to SEG 1 customers had been made on a *pro rata* basis to all customers, the distributions would have represented 32% of total Sentinel customer obligations. Had Defendant received a 32% distribution, the total amount of this distribution would have been $6,977,653.

III. DISCUSSION AND CONCLUSIONS OF LAW

A. Count I and III—Avoidance of Post–Petition Transfer and Declaratory Judgment

[1] **[2]** The Trustee's first claim seeks to avoid and recover as a postpetition transaction the August 21, 2007 distribution of $14,479,039 from the SEG 1 BONY cash account to Defendant. To avoid this transfer, the Trustee must prove (1) that the debtor made a transfer of property of the estate; (2) that it occurred after the commencement of the bankruptcy case; and (3) that it was not authorized under the Bankruptcy Code or by the bankruptcy court. 11 U.S.C. § 549(a). To recover the transfer once avoided, the Trustee must further prove that the Defendant is (1) the initial transferee of such transfer, or (2) the entity for whose benefit such transfer was made. 11 U.S.C. § 550(a)(1).

Defendant argues that the Trustee cannot avoid and recover the post-petition transfer because (1) the funds were not property of the estate; (2) the Bankruptcy Court authorized the transfer; and (3) Defendant was neither the initial transferee nor the entity for whose benefit the transfer was made. I address each issue in turn.

1. *Whether the Proceeds of the Citadel Sale are Property of the Estate*

[3] 11 U.S.C. § 541(a)(1) provides that "property of the estate" includes "all legal or equitable interests of the debtor in property as of the commencement of the case." Section 541(d) provides:

> ***868** "Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest ... becomes property of the estate under subsection (a) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold."

The Bankruptcy Code itself does not set forth rules for determining whether or to what extent a debtor has an ownership interest in property. This determination is made by looking to "applicable non-bankruptcy law," which typically means state property law. *Butner v. U.S.,* 440 U.S. 48, 55, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979). However, cases that involve overriding federal interests may require application of federal law. *Id.* Because federal interests are central to the regulation of the securities and commodity futures markets, federal law should be used to the greatest extent possible in determining ownership interests in this case.

Defendant argues that the CEA and its regulatory provisions constitute the applicable non-bankruptcy law that governs ownership interests in this case. Specifically, Defendant points to Sections 6d(a)(2) and 6d(b) of the CEA and regulatory provisions 17 C.F.R. §§ 1.20–1.29, which prescribe rules for the treatment of commodity customer funds by registered FCMs. Section 6d(a)(2) requires that FCMs "treat and deal with all money, securities, and property received ... to margin, guarantee, or secure the trades or contracts of any customer of such person, or accruing to such customer as the result of such trades or contracts as belonging to such customer." Section 6d(a)(2) and 17 CFR § 1.20 require that customer funds be kept segregated from the funds of the FCM. Section 6d(b) requires that depositories of commodity customer funds not "hold, dispose of, or use any such [assets] as belonging to the depositing futures commission merchant or any person other than the customers of such futures commission merchant."

Courts have widely recognized that the CEA and its regulatory provisions create a statutory trust over FCM customer funds. *See In re Sawyer,* 112 B.R. 386, 390–91 (D.Colo.1990); *In re Scheuer,* 125 B.R. 584, 590–92 (Bankr.C.D.Cal.1991). Because commodity customer assets in SEG 1 accounts were subject to this trust, Defendant argues, Sentinel held only bare legal title to the Citadel securities and not an equitable interest. Therefore, the proceeds of the securities cannot be considered "property of the estate" under 11 U.S.C. § 541(a)(1).

i) Begier v. IRS *and Defendant's Argument that Funds Held in Trust Cannot be Property of the Estate*

In support of its argument, Defendant points to *Begier v. Internal Revenue Service,* 496 U.S. 53, 110 S.Ct. 2258, 110 L.Ed.2d 46 (1990). In *Begier,* a Chapter 7 trustee brought suit seeking to avoid as preferences certain prepetition tax payments to the IRS. The debtor, American International Airways, Inc. (AIA), a commercial airline company, was subject to several federal income taxes levied against employers and airliners, the total amount of which was "held to be a special fund in trust for the United States," under 26 U.S.C. § 7501. Taxes subject to § 7501 were referred to as "trust-fund taxes." *Id.* at 56, 110 S.Ct. 2258. Prior to filing for bankruptcy, AIA had fallen behind on its trust-fund tax payments to the IRS. As a result, the IRS ordered AIA to deposit all subsequently collected trust-fund taxes into a separate, segregated bank account. AIA established the account but did not deposit adequate funds to cover its trust-fund tax obligations. *Id.* Nevertheless, ***869** AIA remained current on its tax obligations by covering the shortfall in its segregated account with payments of roughly $950,000 from its general operating funds. *Id.* at 56, 110 S.Ct. 2258. AIA and the IRS agreed that the payments from both the segregated bank account and the general operating funds would be allocated to specific trust-fund tax obligations. *Id.*

At the outset of its opinion, the Court stated that "[b]ecause the debtor does not own an equitable interest in property he holds in trust for another, that interest is not 'property of the estate.' " *Id.* at 59, 110 S.Ct. 2258. The question for the Court, then, was whether the money AIA had transferred from its general accounts to the IRS —money which was not traceable to a segregated account established for the purposes of holding money in trust—was property that AIA had, nevertheless, held in trust for the IRS. *Id.* at 59, 110 S.Ct. 2258.

The Court held that the money AIA transferred from its general accounts was trust property based on a number of specific findings. First, the Court found that it was not necessary to segregate funds to establish a § 7501 trust. Based on the timing of the collection or withholding of funds referenced in the statute, the Court concluded that the § 7501 trust was created "at the moment the relevant payments (from customers to AIA for excise taxes and from AIA to its employees for FICA and income taxes) were made." *Id.* at 61–62, 110 S.Ct. 2258. If segregation was needed to create a § 7501 trust, the Court noted, the IRS would be protected "only insofar as dictated by the debtor's whim [in deciding whether or not to segregate funds]"—a result Congress clearly did not intend. *Id.* at 61, 110 S.Ct. 2258.

Second, the Court found that § 7501 trusts are "radically different" from common law trusts in terms of specific property requirements. *Id.* 62–63, 110 S.Ct. 2258. Whereas common law trusts require the settlor to designate particular property as the trust res, "§ 7501 creates a trust in an abstract 'amount'—a dollar *figure* not tied to any particular assets—rather than in the actual dollars withheld." *Id.* 62, 110 S.Ct. 2258. This was a critical finding because it meant that common law tracing rules —which, in the context of bankruptcy, require a trust beneficiary to identify particular trust property to exempt it from the estate, *Cunningham v. Brown,* 265 U.S. 1, 44 S.Ct. 424, 68 L.Ed. 873 (1924)—were inapplicable. [5]

Third, examining the legislative history of the Bankruptcy Reform Act of 1978, the Court determined that, while common law tracing requirements did not apply to § 7501 trusts, "Congress expected that the IRS would have to show *some* connection between the § 7501 trust and the assets sought to be applied to a debtor's trust-fund tax obligations." *Begier,* 496 U.S. at 65–66, 110 S.Ct. 2258 (emphasis in original). In determining precisely what connection was necessary, the Court found that Congress specifically intended courts to apply reasonable presumptions—or ***870** tracing fictions (discussed in greater detail below)—in identifying § 7501 trust property. *Begier,* 496 U.S. at 66–67, 110 S.Ct. 2258. Based on the House Report, the Court determined it was reasonable to assume that trust-fund taxes had been properly held for payment if the debtor is able to make the payments. *Id.* at 66–67, 110 S.Ct. 2258. In other words, the IRS did not need to trace specific tax property in order to exempt it from the estate; it merely had to show the debtor held an amount sufficient to satisfy its § 7501 obligations. [6]

Using *Begier* as its backdrop, Defendant makes the following arguments as to why the Citadel proceeds cannot be considered "property of the estate." First, the CEA's language and legislative history demonstrate that segregation violations and commingling of funds do not destroy a CEA trust. Thus, regardless of any segregation violations that occurred, Sentinel never held more than bare legal title to the Citadel securities. Second, as a federal statutory trust, CEA trusts are not subject to common law tracing principles, so Defendant need not identify specific property to exempt the transferred funds. Third, the CEA's legislative history makes clear that Congress intended that CEA trust beneficiaries (FCM customers) would not be subject to *any* tracing requirements. Fourth, if Defendant is required to trace, it should at least be afforded the *Begier* "nexus" presumption. Fifth, if necessary, Defendant can trace under common law tracing principles. Thus, Defendant argues, anyway you slice it the Citadel proceeds cannot be considered property of the estate.

ii) *Whether SEG 3 Customers Have an Equally Valid Trust Claim*

The Trustee does not dispute that SEG 1 customer funds were protected by a statutory trust under the CEA. The problem with Defendant's theory, the Trustee argues, is that it ignores the fact that Sentinel's advisory clients in SEG 3 were also protected by a statutory trust under the IAA. Thus, ownership interests cannot be determined by looking to the CEA alone.

[4] The custody rule promulgated by the SEC pursuant to the IAA's antifraud provision, Section 206(4), provides:

> it is a fraudulent, deceptive, or manipulative act, practice or course of business ... [for an investment adviser registered or required to be registered under section 203 of the IAA] to have custody of client funds or securities unless: ... [a] qualified custodian maintains those funds and securities: ... [i]n a separate account for each client under that client's name; or ... [i]n accounts that contain only [the investment adviser's] clients' funds and securities, under [the investment adviser's] name as agent or trustee for the clients.

17 C.F.R. § 275.206 ("Rule 275.206"). Courts, including this one, have concluded that this language creates a specific statutory trust that protects customer funds from the investment advisor and its creditors, just as the CEA protects customer funds from the FCM and its creditors. *See, e.g., Grede v. Fortis Clearing Americas LLC,* No. 09 C 138, 2009 WL 3518159, at *3 (N.D.Ill. Oct. 28, 2009); *Griffiths v. Peterson (In re Peterson),* 96 B.R. 314, 323 (Bankr.D.Colo.1988) ([t]he import of [the custody rule,] as well as [a recordkeeping rule,] is that client funds never lose that character merely because an investment adviser ... takes possession of them"); ***871** Investment Advisors Act Release No. 123, 27 Fed. Reg. 2149, 2149 (Mar. 6, 1962) ("[IAA custody rule is designed to require] an investment advisor who has custody of funds or securities of any client to maintain them in such a way that they will be insulated from and not be jeopardized by financial reverses, including insolvency, of the investment advisor.").

[5] Defendant agrees that Rule 275.206 imposes a federal statutory trust over Sentinel's advisory client funds, but argues that the protections afforded by the CEA are stronger than the IAA. Defendant makes three arguments in support of this assertion. [7] First, Defendant argues that the CEA trust is stronger because it stems from a statute, whereas the IAA trust stems from a regulation. Second, Defendant argues that because, in addition to segregation, the CEA requires that all customer property be treated "as belonging to" customers regardless of location, the CEA creates the same type of "floating" trust that existed in *Begier.* By contrast, the IAA custody rule requires only segregation, which, according to Defendant, demonstrates that Congress did not intend to protect advisory client funds to the same extent as commodity customer funds. Finally, Defendant argues that risks unique to the commodity futures market demand that

FCM customer funds be afforded heightened protections over investment adviser funds.

[6] I am not persuaded by these arguments. There is absolutely no basis in law for elevating one federal statutory trust over another absent the tracing of specific property. Defendant's suggestion that the CEA trust trumps the IAA trust because it stems directly from a statutory provision is simply incorrect. *See Chrysler Corp. v. Brown,* 441 U.S. 281, 295, 99 S.Ct. 1705, 60 L.Ed.2d 208 (1979). The IAA custody rule is a "properly promulgated, substantive agency regulation" and thus has the same "force and effect" as if it had been passed directly by Congress. *Id.* at 295, 99 S.Ct. 1705.

I am also unable to discern from the relevant legislative history and text any Congressional intent to provide CEA-protected customer property heightened protection over IAA customer property. As the SEC stated in its supplemental *Amicus Curiae* memorandum, the IAA custody rule and the commodities law "share a common purpose and a similar methodology." [8] (SEC Supp. Mem. at 2). Both sets of custody rules were designed specifically to protect client property against 1) misuse by the custodian; and 2) use as payment to the custodian's general creditors in the event of insolvency. *Compare* IAA Release No. 2176, 68 Fed. Reg. 56690–01, 56692 (Oct. 1, 2003) ("[IAA custody rule] requires advisers that have custody of client securities or funds to implement a set of controls designed to protect those clients assets from being lost, misused, misappropriated or subject to the advisers' financial reverses."); *with* S.Rep. No. 90–947 (Jan. 18, 1968), 1968 U.S.C.C.A.N. 1673 (Section 6(b) ... is [designed] to prohibit expressly customers' funds from being used to offset the liabilities of the futures commission merchant or otherwise being misappropriated."). The demonstrably common purpose behind the CEA and IAA custody rules renders Defendant's ***872** claim to uncommon treatment difficult to maintain.

It is true that, unlike the CEA, the IAA custody rule does not explicitly state that client assets are always to be treated as belonging to the client. But that is hardly probative of Congress's intent to elevate protections for customer funds regulated by the CEA over customer funds regulated by the IAA. Notably, the CEA and IAA rely on the exact same methodology—segregation—for implementing protections to client property. If Congress intended this methodology to function differently between CEA-protected customers and IAA-protected customers (i.e. segregation violations destroy the latter trust but not the former, which is where Defendant's argument ineluctably leads), one would expect to see a clearer indication from Congress regarding the specific interplay between the IAA and the CEA than Section 6d's "belonging to" provision.

Defendant next argues that Congress's intent to elevate the protections afforded by the CEA over the IAA can be found in the legislative history of the commodity broker subchapter of the 1978 amendments to the Bankruptcy Code. [9] I disagree. The 1978 amendments included provisions that clarified protections for both securities and commodities customers; nowhere is a clear intent to elevate the interests of one over the other evidenced. *Cf.* H.R. Rep. No. 95–595, at 6 (1978), 1978 U.S.C.C.A.N. 5963, 5967 ("Chapter 7 contains two subchapters to handle the unique problems of stockbrokers and commodity brokers."). The Senate report states that commodity customer claims are "granted the highest priority against the bankrupt's estate," but this does not appear to add any protections beyond those afforded by the CEA. S. Rep. No. 95–989, at 8 (1978), 1978 U.S.C.C.A.N. 5787, 5794 ("This policy maintains consistency with the Commodity Exchange Act, which establishes customer protection as a primary objective."). Specifically, this "highest priority" status appears to simply elevate commodity customer claims over those of general creditors, which is not helpful here. S. Rep. 95–989, at 106, 1978 U.S.C.C.A.N. 5787 at 5892, ("[as a result of the 1978 amendments a commodity] customer need not trace any funds in order to avoid treatment as a general creditor.").

The fact is that the CEA and its regulatory provisions and the IAA custody rule create similar segregation obligations, but neither provides any guidance as to what happens where, as here, the property of multiple statutory trusts is commingled and recoverable assets are insufficient to satisfy the claims of all beneficiaries. [10] Again, if Congress intended one federal trust to trump all others—a concept that has no basis in past acts of Congress or the common law of trusts—one would expect to see some very clear statutory language. Congress either did not contemplate the scenario of competing federal trust beneficiaries with equal claims to an inadequate pool of recoverable assets in bankruptcy [11] , or it intended courts to apply common law trust principles if and when such a scenario arose. Either way, there are no grounds in the relevant statutory and regulatory texts or the legislative ***873** history to elevate the CEA-protected claimants over those protected under the IAA.

Finally, Defendant raises a number of policy arguments as to why I should treat SEG 1 commodity customer claims as superior to the claims of Sentinel's SEG 3 advisory clients. Many of these policy arguments were presented through the expert testimony of Andrea Corcoran, who, among other qualifications, served for 27 years as a CFTC regulator. Ms. Corcoran's report can be summarized as a list of reasons why the CFTC believes commodity customers ought to have "super priority" in bankruptcy. Corcoran Rep. at 105. Her arguments are based largely on distinguishing traits of the futures market that make it, in her view, subject to greater systemic risk than securities markets in the event of loss of customer funds due to a custodian's insolvency. I regard Ms. Corcoran's testimony as cogent, if perhaps a bit biased by her specific agency service. [12] The problem is that her arguments are better suited for a Congressional committee considering amendments to the federal bankruptcy laws than this Court. My job is to say what the law is, not what it should be, and the policy arguments are not so one-sided as to compel the result Defendant urges. Until Congress demonstrates a clear intention to give commodity customers so-called "super priority" in bankruptcy, I have no basis for elevating the interests of CEA-protected customers over IAA-protected customers. [13]

FIRST CONCLUSION OF LAW: The IAA's custody rule creates statutory trust protections as robust as the CEA's. Sentinel's SEG 3 customers therefore have an equally forceful claim to trust protection as SEG 1 customers.

iii) Cunningham *and the Law of Similarly Situated Trust Claimants in Bankruptcy*

[7] Absent clear statutory guidance on how to deal with competing CEA and IAA trust claimants, I turn to the common law. *See Begier,* 496 U.S. at 62, 110 S.Ct. 2258. In *Cunningham v. Brown,* 265 U.S. 1, 44 S.Ct. 424, 68 L.Ed. 873 (1924), the Supreme Court first addressed the scenario of multiple trust claimants competing over an insufficient pool of commingled assets in bankruptcy. *Cunningham* involved the recovery rights of Charles Ponzi's duped investors following the collapse of his now famous investment scam. Ponzi induced thousands of investors to lend him money in exchange for promissory notes in which he guaranteed payment within 90 days of ***874** $150 for every $100 loaned. Ponzi told his investors he was able to earn such high returns through the targeted sale of international postal coupons that capitalized on excessive exchange rate differences following World War I. *Id.* at 7–9, 44 S.Ct. 424. Ponzi, of course, did not use the funds to purchase postal coupons; in fact, he did not invest the funds at all. He simply used new investors' funds to redeem the promissory notes of prior investors. Ponzi's initial ability to meet his extraordinary promised returns rapidly attracted new investors. But as the business became more "successful," his pit of insolvency grew deeper. Eventually, Ponzi drew the attention of law enforcement and word got out about the true nature of his business. This led to a run on the bank by holders of unmatured promissory notes. Soon, Ponzi's accounts were emptied and he filed for bankruptcy. Some investors were able to recover their money before Ponzi's accounts were drained, most were not. In the end, millions were lost.

Cunningham concerned six suits brought by the trustees of Ponzi's bankruptcy estate to recover certain pre-petition payments made during the run on the bank as unlawful preferences. The Supreme Court rejected the lower courts' position that the early redemptions constituted rescissions for fraud that left the defendants in a different legal position than those investors who had not redeemed their notes in time and whose funds remained under Ponzi's control at the time he filed for bankruptcy. Once it became clear that Ponzi was insolvent, the Court stated, there were only two ways for the defendants to recover their original loan without running afoul of statutory rules against preference. The first was to trace their specific property, i.e. the actual currency given by the lender to Ponzi in exchange for a promissory note, and thereby assert a constructive trust. The second option was to establish a lien over any fund to which the investor could trace his specific property. *Id.* at 9–12, 44 S.Ct. 424.

The Court thought it permissible for defendants to trace their property and impose a constructive trust over it because, in doing so, the defendants "would have been endeavoring to get their own money, and not the money in the estate of the bankrupt." *Id.* However, the Court found that the defendants could not trace their property because the specific funds they had deposited with Ponzi were withdrawn prior to defendants' application for and payment on their unmatured notes. The defendants, the Court found, had been paid with funds that Ponzi had transferred from outside bank accounts once the run on the bank had begun. *Id.* Because the redemptions had not been made with the defendants' initially deposited funds, they could not assert a constructive trust over them. *Id.* The Court stated that "[i]n such a case [where the original trust res has been destroyed], the defrauded lender becomes merely a creditor to the extent of his loss ..." *Id.*

The Court next considered the appropriateness of applying two common law tracing fictions. A tracing fiction is a presumption about the identity of trust property that courts may apply, in certain contexts, when it is not possible to trace the actual trust res. The first tracing fiction the Court considered was the presumption that Ponzi withdrew against customer deposits in the order in which the deposits were made (first withdrawals charged against first deposits, etc.). Under that presumption, customers would recover in the inverse order in which they made their deposits, with the last depositor given first claim to recoverable assets and so ***875** forth.[14] The Court found that the inverse payment rule was inapplicable to the case because Ponzi had already withdrawn defendants' specific property prior to their giving any indication of purpose to rescind. *Id.* at 12–14, 44 S.Ct. 424.

The second tracing fiction the Court considered was what is today called "the lowest intermediate balance test," or the presumption that trust property is the last to leave a pool of commingled assets. The Court found that this rule was also inapplicable because the remaining pool of funds was composed entirely of customer property: "The rule is useful to work out equity between a wrongdoer and a victim; but when the fund with which the wrongdoer is dealing is wholly made up of the fruits of fraud perpetrated against a myriad of victims, the case is different." *Id.* at 12–14, 44 S.Ct. 424.

Because tracing the specific trust res was not possible and the application of tracing fictions was deemed inappropriate, the Court decided to treat the defendants and those who had not redeemed their notes in time as a single class with equal rights to the remaining funds: "It is a case the circumstances of which call strongly for the principle that equality is equity, and this is the spirit of the bankrupt law." *Id.* This resulted in a clawback of defendants' redemptions, which were then distributed pro rata amongst all Ponzi's victims.

Cunningham itself does not stand for the principle that trust rules cannot be used to promote individual recovery when recoverable assets are insufficient to satisfy all the claims of similarly situated investors, as the Trustee asserts. To the contrary, the Court explicitly stated that it was the defendants' "inability to identify their payments" that left them in the position of a general creditor. *Id.* In other words, if the *Cunningham* defendants could have traced their specific property, the Court would have imposed a constructive trust over the property and exempted it from the estate. However, what *Cunningham* has come to stand for is that tracing fictions should not be applied to elevate any one claimant above others similarly situated. *Id.* at 12–14, 44 S.Ct. 424. *See also Hill v. Kinzler,* 275 F.3d 924, 928 (10th Cir.2001) ("a tracing fiction should not be employed to elevate [an investor's] claim over other [investors] if those [investors] are similarly situated."); *Hatoff v. Lemons & Assoc., Inc. (In re Lemons & Assoc., Inc.),* 67 B.R. 198, 214 (Bankr.D.Nev.1986) ("[T]he *Cunningham* line of cases rejects the fictional tracing rule which allows a claimant to trace the trust res through a commingled account.").

Cunningham remains the essential legal framework that governs the distribution of commingled funds between competing trust claimants in bankruptcy.[15] *See Lemons,* 67 B.R. 198, 213; *Distral Energy Corp. v. Michigan Boiler and Engineering Co. (In re Michigan Boiler and Engineering Co.),* 171 B.R. 565, 571 (Bankr.E.D.Mich.1993); *SEC v. Wealth Management, LLC,* 628 F.3d 323, 333–34 (7th Cir.2010) (approving *Cunningham*-based pro ***876** rata distribution plan in securities-fraud receivership because, "[t]he goal in both securities-fraud receiverships and liquidation bankruptcy is identical—the fair distribution of the liquidated assets."). Although the case dealt specifically with constructive trusts, courts have applied its equitable principles to determine distribution rights in cases involving commingled funds protected under express statutory trusts.

For example, in *Michigan Boiler,* 171 B.R. 565, a debtor commingled its own funds with funds that were required under state law to be held in trust for the payment of several of the debtor's subcontractors. One subcontractor brought an adversary proceeding seeking the declaration of a trust fund in the amount it was owed and a determination the funds held in trust were not property of the estate. *Id.* The court denied the requested relief based on the equally valid claims of the multiple trust beneficiaries:

> [I]n a multiple commingled trust fund situation ... any presumptions as to which monies were used first, and for what, are baseless and purely arbitrary and would lead to inequitable results which favor one similarly situated trust fund cestui over another for no cognizable reason ... All were equally innocent in the aftermath of the debtor's failure to deal appropriately with each of their trust funds, and all are (or were) in a position to make similar arguments to those of [the plaintiff]" *Id.* at 573.

Instead, the court relied on *Cunningham*' s "equality is equity" principle and allowed the trust funds to remain in the bankruptcy trustee's hands to be distributed pro rata. *Id.* at 576. [16]

Several courts have extended *Cunningham* to hold that tracing is *per se* inequitable in certain contexts and should not be allowed *even when claimants can identify their specific property. See* *Lemons,* 67 B.R. at 213 ("*Cunningham* and its progeny stands for the proposition that ... a creditor cannot sufficiently identify or trace the trust res through a commingled fund where the fund is too small to satisfy the claims of similarly situated parties," because "[t]o do so would allow that claimant to benefit at the expense of those who have equally strong equitable claims to the same fund."); *U.S. v. Durham,* 86 F.3d 70, 73 (5th Cir.1996) (upholding district court's decision not to trace as a permissible exercise of discretion despite fact that most funds could be traced to particular claimants); *SEC v. Forex Asset Mgmt., LLC,* 242 F.3d 325, 331–32 (5th Cir.2001) (affirming pro rata distribution even where objecting investors' funds were never commingled, noting that whether funds are commingled or traceable is "a distinction without a difference"); *SEC v. Credit Bancorp, Ltd.,* 290 F.3d 80, 89 (2d Cir.2002) (tracing inappropriate in Ponzi scheme because "whether at any given moment a particular customer's assets are traceable is a result of the merely fortuitous fact that the defrauders spent the money of the other victims first." (internal quotations omitted).); *SEC v. Elliott,* 953 F.2d 1560, 1569–70 (11th Cir.1992) (approving pro rata distribution where tracing would lead ***877** to inequitable result.). [17]

Applying *Cunningham* and its progeny to the instant case, I make the following conclusions. First, I reject Defendant's argument that it should not be required to trace at all. The argument is based on an attempted analogy between CEA trusts and trusts created under the Perishable Agricultural Commodities Act (PACA). The analogy fails. PACA trusts are explicitly designed to operate as nonsegregated "floating" trusts. 7 C.F.R. § 46.46(b) ("Trust assets are to be preserved as a nonsegregated 'floating' trust. Commingling of assets is contemplated."). In other words, the PACA trust does not require a specific trust res—it covers an abstract dollar figure based on the value of the underlying agricultural products and their derivatives. *See, e.g.,* *C.H. Robinson Co. v. Alanco Corp.,* 239 F.3d 483, 486–87 (2d Cir.2001). Courts do not require PACA trust claimants to trace precisely because there is no specific trust property to trace. The PACA trust is similar [18] to the § 7501 trust in *Begier,* which, as the Supreme Court explained, "creates a trust in an abstract 'amount'—a dollar figure not tied to any particular asset." *Begier,* 496 U.S. at 62, 110 S.Ct. 2258.

The CEA trust, by contrast, requires a specific trust res, specifically "all money, securities, and property" received from FCM customers. There is no language in the CEA or its regulatory provisions to indicate that the trust protects an abstract dollar figure like PACA and § 7501 trusts. This, of course, is unsurprising: if the CEA created a floating trust, as Defendant contends, its elaborate segregation requirements would be entirely superfluous.

Defendant also points to the Senate Report accompanying the 1978 passage of the commodity-broker liquidation rules, 11 U.S.C. § 761 *et seq.,* as evidence that Congress intended to excuse CEA beneficiaries from any tracing requirement. The report, in relevant part, states, "a customer need not trace any funds in order to avoid treatment as a *general creditor.*" S. Rep. No. 95–989, 95th Cong., 2d Sess. 106 (1978), 1978 U.S.C.C.A.N. 5787 at 5892 (emphasis added). But in finding that the Defendant bears at least some burden to trace, I am not treating it as a general creditor; I am treating it as one of several ***878** similarly situated trust claimants. *See In re Sentinel Management Group, Inc.,* 398 B.R. 281, 298 (Bankr.N.D.Ill.2008) (finding that the claims of SEG 1 and SEG 3 customers "are similar in their legal nature, character, and effect."). If the facts of this case were different, and I were merely determining distribution rights between SEG 1 customers and unsecured creditors whose property was not held in trust, Defendant would be on solid ground. But that is not the case.

The closer question is whether I ought to apply a tracing fiction to preserve SEG 1 customer property. Defendant points to no case in which a trust claimant is excused from tracing where multiple trust beneficiaries can assert co-equal claims over an insufficient pool of commingled assets.[19] *Begier* did not involve similarly situated claimants so, coupled with the fact that the CEA trust does not protect an abstract dollar figure like the § 7501 trust, there is no basis for applying its "nexus" fiction. And because the lowest intermediate balance test is inappropriate where "the fund with which the wrongdoer is dealing is wholly made up of the fruits of the frauds perpetrated against a myriad of victims," I likewise decline to apply that fiction. Due to the co-equal trust claims of SEG 1 and SEG 3 customers, I find that *Cunningham* and its progeny rule out the application of tracing fictions to this case.

To be clear: if I was merely dealing with competing claims of SEG 1 customers and unsecured creditors not protected by statutory trust, I believe the law would require me to apply every reasonable tracing fiction available to preserve the CEA trust. But because the claimants are similarly situated, equity prevents the application of any fiction. Thus, in order to exempt the proceeds of the Citadel sale from the property of the estate, Defendant must demonstrate that the Citadel securities can be traced back to the actual deposited funds of Group 7 customers.

SECOND CONCLUSION OF LAW: Defendant is subject to common law tracing requirements due to the co-equal claims of the competing trust claimants.

iv) *Whether Defendant Has Met its Burden of Tracing the Citadel proceeds to Group 7 Customer Deposits*

[8] Defendant claims that, through the report of its expert Frances McCloskey, it has met the common law requirement of tracing specific trust property. Defendant is wrong. What Ms. McCloskey has done is identify the custodial location of all securities that Sentinel recorded as being allocated to customers on its internal ledgers and on customer statements during relevant time periods. In her own words, she "trace[d] ... customers' indirect beneficial ownership in securities." McCloskey Dep at 163.19–22. This statement is nonsensical in the context of common law tracing rules, and it is indicative of why tracing is not ***879** possible in this case.[20] Ms. McCloskey's report demonstrates only that: 1) the securities that Sentinel listed on its ledgers and customer statements actually existed (i.e. there were no fictitious securities that appeared on Sentinel's ledgers or customer statements); and 2) the allocation of securities reflected in Sentinel's internal ledgers consistently matched—with a few limited exceptions—the information reflected on customer statements.

The Trustee does not dispute any of this. Instead, he argues it is irrelevant because neither the ledgers nor the customer statements reflect the massive segregation violations that occurred at Sentinel, or the consequent jeopardy all customer funds were placed under while held in lienable accounts. True enough. But for tracing purposes the critical shortcoming of Ms. McCloskey's report is that it fails to adequately account for the fact that none of Sentinel's customers held specific ownership interests in securities. Rather, they owned pro rata portions of investment portfolios, which Sentinel was free to fill with any of the securities in its pool of assets so long as those securities met the portfolio's investment criteria. Further, these securities were generally purchased with commingled funds from the BONY SEN account or the JP Morgan cash accounts. The upshot is that the securities held in a given customer group portfolio at any time were not necessarily—indeed, were most improbably—the converted form of the original trust property (i.e. cash deposits) of the customers within that group.[21]

The fungible nature of cash alone makes it impossible to trace specific securities back to original customer deposits in this case. And it gets worse for Defendant.

As explained in Ms. McCloskey's report, Sentinel's "buy and hold" strategy meant that "Sentinel did not generally buy and sell securities in response to daily customer deposits and withdrawals. The nature of Sentinel's pooled investment concept meant that one customer's withdrawal and another's deposit affected the total balance in the group along with every customer's pro-rata (proportional) interest in the group." McCloskey Rep. at 16. So, commingling aside, Sentinel's investment model makes tracing essentially impossible because, upon deposit, customer funds were immediately converted into an abstract ownership interest. In other words, Sentinel's pooled investment model renders tracing impracticable because *there is no specific form of converted trust property to trace.*

In summary, the removal of SEG 1 cash from segregation did not itself destroy the CEA trust. *See Dameron,* 155 F.3d at 723–24 ("courts have consistently rejected the notion that commingling of trust property, without more, is sufficient to defeat tracing."). It would be paradoxical, to say the least, if Sentinel could abrogate a federal statutory trust and obtain an ownership interest over customer funds simply by removing the funds from segregation. But the commingling of customer deposits made tracing specific customer property impossible. Anytime fungible property is commingled it is, by definition, necessary to apply a tracing fiction to recover it. As ***880** explained above, if SEG 1 cash had been commingled only with House cash, Defendant would simply have to point to the particular fund into which the CEA-protected cash had gone in order to recover an equivalent amount. *See, e.g., Marcus v. Otis,* 169 F.2d 148, 149–50 (2d Cir.1948); Corpus Juris Secondum, Trusts, § 738: Money or other property of fungible nature. But because the SEG 1 and SEG 3 claimants are similarly situated in every meaningful respect, tracing fictions are inappropriate in this case. [22]

So the bottom line is that Defendant cannot meet its burden of tracing the Citadel proceeds to its initial deposits of customer funds and therefore cannot exempt the proceeds from the estate. *See, e.g., In re United Cigar Stores Co.,* 70 F.2d 313, 316 (2d Cir.1934) ("There can be no recovery ... where all that can be shown is enrichment of the trustee. [The trust property] must be clearly traced and identified in specific property."). Defendant, in its inability to identify Group 7 customer deposits, is a similarly situated creditor, and nothing more. *Cunningham,* 265 U.S. at 13, 44 S.Ct. 424.

THIRD CONCLUSION OF LAW: The Citadel proceeds are property of the estate under 11 U.S.C. § 541.

JUDGMENT for the Trustee and against Defendant on Count III.

1. *Whether the Post–Petition Transfer was Authorized under the Bankruptcy Code or by the Bankruptcy Court*

[9] I next turn to the question of whether the August 21, 2007, transfer of funds from BONY to Defendant was authorized by the Bankruptcy Code or the Bankruptcy Court. 11 U.S.C. § 549(a)(2)(B). The Bankruptcy Code does not allow for unequal treatment of similarly-situated creditors. *See* 11 U.S.C. § 726; 11 U.S.C. § 1123(a)(4). Based on my finding that SEG 1 and SEG 3 customers had co-equal trust claims over the assets held by Sentinel on the day it filed for bankruptcy, I conclude that the payout of the Citadel proceeds to Group 7 customers was not authorized by the Bankruptcy Code.

The question, then, is whether the Bankruptcy Court authorized the distribution. On August 20, 2007, Sentinel filed an emergency motion with the United States Bankruptcy Court for the Northern District of Illinois in which it sought entry of an order approving the turnover and distribution by BONY of the proceeds from the Citadel sale to the customer segregated accounts of Sentinel's remaining SEG 1 FCM customers. The Bankruptcy Court issued an order stating that BONY "may" distribute the Citadel sale proceeds, less a $15.6 million holdback, to Sentinel's clients in accordance with an approved pro rata plan. *In re Sentinel Management Group, Inc.,* Case No. 07 B 14987 (Bankr. N.D. Ill., Dkt. (hereinafter "Bankr. Dkt.") No. 978–1). The order also stated that it was "without prejudice to all rights, defenses, claims and/or causes of action, if any, of the Debtor ... against the Distributee ... with respect to any claim for priority under Section 761–767, or other applicable ***881** law." *Id.* The order said nothing about whether the proceeds were property of the estate, and the Bankruptcy Judge explicitly stated in open court that he was not deciding that issue because he did not have enough information. (Bankr. Dkt. No. 978–2 at 39–47).

On August 8, 2008, the Trustee filed a Motion to Clarify or in the Alternative to Vacate or Modify the Court's August

20, 2007 Order. (Bankr. Dkt. No. 978). After briefing and oral argument, the bankruptcy judge granted the Trustee's motion to clarify. The judge explained in open court that the August 20, 2007 Order did not "authorize," within the meaning of 11 U.S.C. § 549(a)(2)(B), the August 20, 2007 transfer, because such authorization is premised on a determination of whether the transferred property belonged to the estate, which the court had made clear it was not deciding back on August 20, 2007.

Defendant argues that the plain language of the August 20, 2007 Order indicates that the Bankruptcy Court did in fact authorize the transfer. This is a fair argument, but I am not in a position to second guess the bankruptcy judge's interpretation of his own order. *See Ill. Inv. Trust No. 92–7163 v. Allied Waste Indus., Inc., (In re Resource Tech. Co.),* 624 F.3d 376, 386 (7th Cir.2010) ("[Reviewing courts] owe substantial deference to the bankruptcy court's interpretation of its own orders and will not overturn that interpretation unless [the reviewing court is] convinced that it amounts to an abuse of discretion."). Given the limited information available to the Bankruptcy Court on August 20, 2007, the potentially damaging impact a denial of the distribution could have had on futures markets, and the explicit language, both in the August 20, 2007 Order itself and the bankruptcy judge's in court statements that the transfer remained subject to challenge under applicable law, I regard the Bankruptcy Court's actions in this case as eminently reasonable. More to the point, the Court's interpretation of its own order does not even approximate an abuse of discretion.

FOURTH CONCLUSION OF LAW: The August 21, 2007 transfer of the Citadel proceeds was not authorized under the Bankruptcy Code or by the Bankruptcy Court.

2. Whether Defendant was the initial transferee or the entity for whose benefit such transfer was made

[10] The final showing the Trustee must make to avoid the post-petition transfer is that Defendant was "the initial transferee of such transfer or the entity for whose benefit such transfer was made." 11 U.S.C. § 550(a)(1). The Bankruptcy Code does not define the term "initial transferee." Absent statutory guidance, the Seventh Circuit has developed a "dominion and control" test to determine initial transferee status. *Bonded Fin. Servs., Inc. v. European Am. Bank,* 838 F.2d 890, 893 (7th Cir.1988). Under this test, a party is considered an initial transferee only if it has "dominion over the money or other asset, the right to put the money to one's own purpose." *Id.* If a party is the initial recipient of funds, but does not exercise dominion and control over them, the party is not an initial transferee. *See, e.g., In re Joy Recovery Tech. Corp.,* 286 B.R. 54, 80 (Bankr.N.D.Ill.2002).

[11] The Trustee argues that Defendant qualifies as an initial transferee because, although the post-petition transfer was made to a denominated segregated account for Defendant's customers, that account held some $75 million in funds over and above the amounts required to be segregated for the benefit of Defendant's customers. Because CFTC regulations allow FCMs to "draw upon such [excess] ***882** segregated funds to its own order, to the extent of its actual interest therein," 17 C.F.R. § 1.23, the Trustee asserts that Defendant's initial custody of the Citadel proceeds satisfies the "dominion and control" test.

Defendant raises two counterarguments. First, Defendant argues that it functioned as a mere conduit between its customers and the futures markets, and cites to a number of cases in which stock brokers acting in like capacity were found not to be initial transferees. *See, e.g., In re Toy King Dist., Inc.,* 256 B.R. 1, 145 (Bankr.M.D.Fla.2000) (listing cases in which courts have found securities and investment brokers to be mere conduits and not initial transferees); *In re Dominion Corp.,* 199 B.R. 410, 415 (9th Cir. BAP 1996) (stock broker was a mere "conduit, not a transferee"); *In re Blinder, Robinson & Co., Inc.,* 162 B.R. 555, 562 (D.Colo.1994) (stock broker exercised insufficient dominion over shareholders' funds to qualify as initial transferee).

The difficulty with this argument is that none of the stock broker cases involve the transfer of funds into customer accounts that contained excess segregated funds both before and after the challenged transfer. That distinction is critical to this case because, since 1997, the CFTC has treated segregated customer property as entirely fungible. *See* Corcoran Rep. at ¶¶ 88, 132. This means that an FCM meets its CEA segregation obligations by maintaining a minimum segregated account balance equal to or greater than the amount of its total customer obligations, not by keeping specific property in segregation. *See* Securities Representing Investment of Customer Funds Held in Segregated Accounts by Futures Commission Merchants, 62 F.R. 42398–01 (August 7, 1997); Financial and Segregation Interpretation 7–1, Comm. Fut. L. Rep.

(July 23, 2008); Corcoran Rep. at ¶ 132 ("[Since September 1997], from the CFTC's perspective, what was critical to segregation calculations was ... whether the *full amount* of required customer segregated assets were maintained in cash and/or securities at any given point in time.") (emphasis added).

I interpret the 1997 amendments to Rule 1.23 and 1.25 to mean that, because Defendant had sufficient excess funds in segregation to meets all of its customer obligations, it was not required to segregate the incoming proceeds of the Citadel sale, but instead was immediately free to use the proceeds to its own purposes. *See* 62 F.R. 42398, 42398 (eliminating the requirement that proceeds from the sale of segregated securities be redeposited into a segregated account); Financial and Segregation Interpretation 7–1 ("The amended rules permit an FCM to ... sell permissible securities that are in a segregated account and directly deposit the proceeds from such sale into a nonsegregated account ... Any such transfer of securities to, or deposit of proceeds into, nonsegregated account can only be made if the remaining funds in segregated accounts are sufficient to cover the FCM's obligations to its commodity customers."). And although Defendant chose to have the Citadel proceeds deposited into a segregated account, after the funds hit Defendant was free to move those funds (or, more accurately, the same amount of funds) out of segregation to use for its own purposes. CFTC Rule 1.23. Based on the above, I find that Defendant exercised "dominion and control" over the Citadel proceeds at all times that the proceeds were in its customer segregated account. To find otherwise would require me to interpret the CEA's segregation requirement in a manner that is at odds with the agency charged with enforcing it.

***883 [12]** Second, Defendant argues that regardless of its rights over the funds, it did not actually exercise dominion and control over the Citadel proceeds because it kept them in a segregated customer account at all times. This argument fails. The court in *Bonded Financial* stated that the dominion and control test turns on whether a party has "*the right* to put the money to [its] own purposes;" *Bonded Financial,* 838 F.2d at 893 (emphasis added). There is no language in the opinion to suggest that a party must actually exercise that right before it can be considered an initial transferee. Courts have interpreted *Bonded Financial* accordingly. *See, e.g., CLC Creditor's Grantor Trust v. Howard Sav. Bank (In re Commercial Loan Corp.),* 396 B.R. 730, 743 n. 8 (Bankr.N.D.Ill.2008) ("Under *Bonded,* however, the relevant question is whether the recipient had 'the *right* to put the money to use for its own purposes' ... not whether the recipient actually exercised that right") (emphasis in original) (quoting *Bonded Financial,* 838 F.2d at 893; citing *Universal Serv. Admin. Co. v. Post–Confirmation Comm. Of Unsecured Creditors (In re Incomnet, Inc.),* 463 F.3d 1064, 1070 (9th Cir.2006)); *see also Geltzer v. D'Antona (In re The Cassandra Group),* 312 B.R. 491, 496–97 (Bankr.S.D.N.Y.2004) (dominion and control analysis turns on whether party ever "had a legal right to put the payments to [its] own personal use ..."). It may very well be that "prudence and financially responsible business practice" militated against Defendant putting the Citadel proceeds to its own purposes, but best business practices do not alter the relevant legal landscape.

[13] I also conclude that Defendant is the "entity for whose benefit [the] transfer was made." 11 U.S.C. § 550(a)(1). This conclusion is based mostly on my finding that Defendant functioned as a *de facto* guarantor for all of its customer funds invested with Sentinel. *See Bonded Financial,* 838 F.2d at 894. Although Defendant points out that it contractually disclaimed liability for Sentinel-related losses, there is strong evidence in the record that 1) the disclaimer was not enforceable (*See, e.g.,* Corcoran Dep. At pp. 98–100 (explaining that an FCM cannot, by contract, shift investment losses to its customers)); CFTC Supp. Brief at p.6 n.7 ("[H]aving elected to invest customer funds through Sentinel and benefit from the expected earnings, [Defendant was] responsible for any losses resulting from [its] election"); and 2) even if it was enforceable, Defendant would have gone out of business had it tried to shift Sentinel-related losses to its customers. [23] Thus, for all intents and purposes, the August 21, 2007 post-petition transfer had the effect of relieving Defendant from an actual, quantifiable legal liability. *See In re McCook Metals, LLC,* 319 B.R. 570, 590 (Bankr.N.D.Ill.2005). [24]

***884 FIFTH CONCLUSION OF LAW:** Defendant was the initial transferee and the party for whose benefit the August 21, 2007 post-petition transfer was made under 11 U.S.C. § 550(a)(1).

JUDGMENT for the Trustee and against Defendant on Counts I and V. [25]

B. Count II—Avoidance of Preferential Transfer

The Trustee next seeks to avoid and recover the August 17, 2007, pre-petition transfer of $1,097,925 to FCStone as an unlawful preference pursuant to 11 U.S.C. § 547(b). To avoid the transfer the Trustee must demonstrate the August 17, 2007 transfer was 1) to or for the benefit of Defendant; 2) for or on account of an antecedent debt owed by the debtor before such transfer was made; 3) made while the debtor was insolvent; 4) made on or within 90 days before the date of the filing of the petition; and 5) enabled Defendant to receive more than it would have in Chapter 7 liquidation. 11 U.S.C. § 547(b). Based on my findings above, Defendant has made the necessary initial showing to avoid the August 17 transfer.

[14] The real dispute between the parties on Count II is whether the transfer is shielded from avoidance by Section 546(e)'s safe harbor provision, which provides:

> Notwithstanding 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.

11 U.S.C. § 546(e).

Defendant asserts that the August 17, 2007 transfer was both a settlement payment made to a commodity broker as well as a transfer made in connection with a securities contract, to wit, the Investment Advisory Agreement that governed the relationship between Sentinel and Defendant. The trustee argues that the August 17, 2007 transfer was not made "in connection with a securities contract" because the Investment Advisory Agreement does not, in and of itself, "contract for the purchase, sale, or loan of a security," 11 U.S.C. § 741(7). The trustee also contends that the August 17, 2007 transfer was not a "settlement payment" because it was not "made to complete [a] securities transaction." The relevant securities transaction, the Trustee argues, was between Sentinel and Citadel; the transfer merely constituted redemption of Group 7 and 9 customers' ***885** indirect beneficial interest in their respective portfolios (which happened to include proceeds from the Citadel sale).

I decline to address these specific arguments because, regardless of whether the distribution of the 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 of this case. There are two main bases for my finding. First, applying the safe harbor to shield Sentinel's distributions to its SEG 1 customers would create the very type of systemic market risks that Congress sought to prevent with its passage. Second, failing to apply the safe harbor in this case will not result in the unwinding of completed securities and commodities transactions that Congress sought to protect. Thus, applying the safe harbor here would produce a result "demonstrably at odds with the intentions of its drafters." *United States v. Ron Pair Enter.,* 489 U.S. at 242, 109 S.Ct. 1026.

[15] Congress enacted § 546(e)'s safe harbor as a means of "minimizing 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 1 (1982), 1982 U.S.C.C.A.N. 583, 583. The safe harbor functions as a firewall that insulates legitimate securities and commodities transactions from avoidance because of the potential destabilizing effects that unwinding such trades could have on the broader market. Section 546(e) reflects a clear policy choice by Congress to carve out an exception to the general principles of equity that underlie American bankruptcy law in order to protect the nation's financial systems. *See generally In re Resorts Intern., Inc.,* 181

F.3d 505, 515 (3d Cir.1999) ("[S]ection 546 [stands] at the intersection of two important national legislative policies on a collision course—the policies of bankruptcy and securities law.") (internal quotations omitted).

When Debtor sells a security to Buyer immediately prior to filing for bankruptcy, it is logical to shield that transaction from avoidance in order to prevent damaging ripple effects from spreading across the securities market. *See In re Enron Creditors Recovery Corp.,* 651 F.3d 329, 334 (2d Cir.2011) ("If a firm is required to repay amounts received in settled securities transactions, it could have insufficient capital or liquidity to meet its current securities trading obligations, placing other market participants and the securities markets themselves at risk.").

But a different set of ripple effects arise where Debtor is a financial institution that sells securities on behalf of third party customers, and § 546(e) is invoked not to shield the actual exchange between Debtor and Buyer but to uphold the manner in which Debtor distributes exchange proceeds to its customers. If Debtor distributes proceeds in an uneven and arbitrary manner (i.e. favoring certain customers over others with an equally forceful legal claim to the funds), extending § 546(e) safe harbors to uphold the distribution would destabilize the financial system by making it utterly unpredictable how losses will be apportioned in the event that an FCM or investment advisor goes bankrupt.

Consider the following hypothetical. If the safe harbor provisions applied to this case, then an insolvent investment advisor, in the eleventh hour prior to filing for bankruptcy, could drain its accounts to pay out all customers with names beginning with letters in the first half of the alphabet, while shifting all losses to customers with names in the latter half, and § 546(e) would render courts powerless to do anything about it. Could a Congress concerned with systemic market risks have ***886** intended the safe harbor to shield this type of arbitrary and destructive conduct simply because the distributions were made "in connection with a securities contract," or (less clear in this case) may be described as a "settlement payment"? I do not think so.

But the risks do not end with introducing uncertainty into the market and the investment determent this would cause. The problems laid out in the above scenario are compounded where, as here, *all of the customers are themselves financial institutions.* That a few of these customers could be forced to bear all losses, rather than their pro rata share, in the event of an FCM or investment advisor's bankruptcy raises the likelihood of institutional collapse and associated systemic fallout. Any systemic risks caused by future bankruptcies of investment advisers will likely be mitigated if losses are proportionately spread across the entire customer base, rather than arbitrarily foisted on a small group of financial institutions that may be unable to bear them.

Defendant warns of damaging market fallout that will occur if I allow the transfers to be avoided. I am unconvinced. First, the argument tends to lose its force where, as here, all claimants are financial institutions and can make the "ripple effect" argument with equal force. In fact, given that investment advisers have a much larger stake in the economy than FCMs, the ripple effects argument probably cuts against Defendant. [26] Second, I do not believe that the losses inflicted by a claw back of funds will spread beyond Defendant and some similarly situated enterprises. I agree with the CFTC that Defendant will be legally unable to seek redress from their customers—"having elected to invest customer funds through Sentinel and benefit from their expected earnings, the FCMs are responsible for any losses resulting from their election." CFTC *Amicus* Memorandum at 2 n.1 (*citing Craig v. Refco, Inc.,* 624 F.Supp. 944, 947 (N.D.Ill.1985)). Even if Defendant did have a viable cause of action against its customers, it is constrained from bringing suit by the practical consequences such action would have on Defendant's business.

Perhaps an even more important consideration in determining the applicability of § 546(e) to this case is whether failing to apply it will cause the type of unwinding of completed security transactions the safe harbor was designed to prevent. The answer is no. The relevant security transaction in this case was between Sentinel and Citadel; no securities were ever exchanged between Sentinel and FCStone. (*See* Figure 1 below). The safe harbor is very clearly designed to protect Citadel from having to return the securities it received from Sentinel, as those securities may be necessary to meet its current trading obligations. *See In re Enron Creditors Recovery Corp.,* 651 F.3d at 334. Allowing the Trustee to avoid the

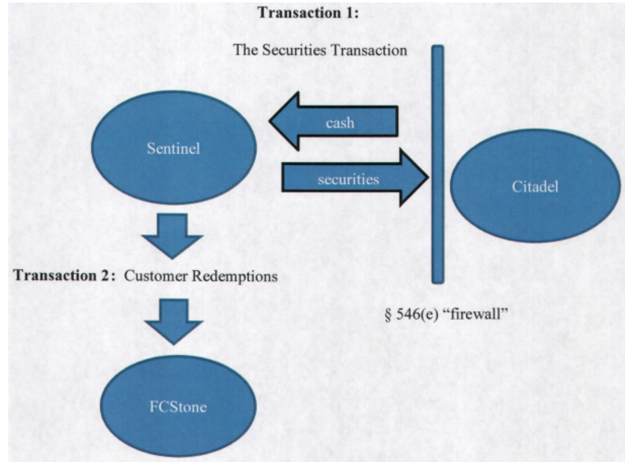
August 17, 2007 transfer would not affect Citadel in any way.

The legislative record is devoid of indication that Congress intended § 546(e) to govern how the debtor distributes proceeds from a completed securities transaction if that debtor happens to be trading on behalf of third parties. Defendant's argument that this secondary transaction between Sentinel and Defendant is subject ***887** to § 546(e) is further weakened when considered in the context of Sentinel's investment model. As described above, customer deposits and redemptions at Sentinel were not directly tied to the purchase or sale of securities —customer deposits were not necessary to settle security purchases, nor were customer redemptions necessary to settle security sales—and therefore did not affect the settlement chain that § 546(e) is designed to protect. *See Wieboldt Stores Inc. v. Schottenstein,* 131 B.R. 655, 664 (N.D.Ill.1991) ("Congress exempted settlement payments in the commodities (and later the securities) industry out of concern that the bankruptcy of one party in the clearance and settlement chain could spread to other parties in that chain."). So, assuming Sentinel's customer redemptions can be squeezed within the broadest literal interpretation of § 546(e)'s terms, from a practical standpoint it is clear that they were separate transactions unrelated to the completed trade between Citadel and Sentinel that is protected by the safe harbor. [27]

SIXTH CONCLUSION OF LAW: 11 U.S.C. § 546(e)'s safe harbor provisions do not apply to this case. Assuming that the Investment Advisor Agreement qualifies as a "securities contract," and/or the August 17, 2007 transfer qualifies as a "settlement payment" under a literal interpretation of 11 U.S.C. § 741, applying § 546(e) to exempt the August 17, 2007 transfer from avoidance would produce a result "demonstrably at odds with the intentions of its drafters." *Ron Pair Enter.,* 489 U.S. at 242, 109 S.Ct. 1026.

JUDGMENT for the Trustee and against Defendant on Count II.

Figure 1



*888 C. COUNT IV—UNJUST ENRICHMENT

[16] As an alternative to the avoidance claims, the Trustee seeks to recover funds transferred to Defendant under a theory of unjust enrichment. I find, as a matter of law, the unjust enrichment claim is preempted by the bankruptcy laws, regardless of on whose behalf the Trustee brings the claim. *See B.E.L.T., Inc. v. Wachovia Corp.,* 403 F.3d 474, 477 (7th Cir.2005) ("Calling the receipt of a preference 'unjust enrichment' does not change matters; a preference by any other name is still a preference and cannot be recovered outside of bankruptcy.").

SEVENTH CONCLUSION OF LAW: The Trustee's unjust enrichment claim is preempted by the Bankruptcy Code.

JUDGMENT for the Defendant and against the Trustee on Count IV.

*889 IV. CONCLUSION

This is an extraordinary case for a number of reasons. It involves unprecedented violations of federal segregation rules and enormous losses of customer funds. Never before has a firm with dual registration as an FCM and an investment advisor filed for bankruptcy, raising difficult questions over the competing rights of two groups of trust claimants assigned special protection in bankruptcy under federal law. In fact, this court is unable to find past cases of any kind involving such a clash between two federal trusts.

Yes, the facts are extraordinary, but at the end of the day it is a bankruptcy case. And if there is one prevailing principle that underpins American bankruptcy laws, it is that "equality is equity." *Cunningham,* 265 U.S. at 13, 44 S.Ct. 424. This is the starting principle in cases where investors' assets are commingled and recoverable property in bankruptcy is insufficient to fully repay those investors. Until Congress determines otherwise, it remains the starting principle even when the commingled funds are protected under competing federal trusts.

The pro rata distribution model that stems from *Cunningham* is particularly appropriate for this case because a pro rata interest in Sentinel's commingled pool of securities and cash is precisely what Defendant, and all other Sentinel customers, owned. Divvying up pro rata shares on the group level (i.e. what happened to be left in each customer portfolio when Sentinel filed for bankruptcy), as Defendant urges, however, is illogical from a tracing standpoint, because the securities in a given folder are not the converted form of the group customers' original trust property. More importantly, dividing pro rata interests by group would be grossly inequitable, because the allocation of customer securities at the time of Sentinel's bankruptcy filing was the product of Sentinel's "baseless and purely arbitrary" decisions as to which customer securities to 1) liquefy during the summer of 2007 to pay down the BONY loan; and 2) which securities to stake as collateral for the BONY loan in the eleventh hour. *Michigan Boiler,* 171 B.R. at 573.

That pure happenstance governed which Sentinel customers received payouts and which customers bore disproportionate losses is most dramatically highlighted by the collateral swap that took place between July 30 and 31, 2007. If Sentinel had kept the securities allocated to SEG 1 customers in the FC1 account rather than replace them with securities allocated to SEG 3 customers in the SLM account, I imagine the very same parties with the very same claims would be before the court, the only difference being which side of the "v" the parties stood in the case caption. If that were so, I would apply the same principles to ensure that SEG 1 customers did not bear an unfair share of Sentinel's losses.

The most apt description I have heard of Sentinel's collapse and last minute distributions of customer funds came at trial when a witness likened it to a game of musical chairs—whichever customers' funds happened to be in segregation when the music stopped received redemptions; those whose funds were not in segregation received nothing. 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. With no legal requirement to do so, I refuse to give such arbitrary and inequitable conduct the imprimatur of this Court.

Based on my findings of fact and seven conclusions of law, I find in favor of the ***890** Trustee and against Defendant on Counts I, II, III, and V; and in favor of Defendant and against the Trustee on Count IV. It is HEREBY ORDERED that Defendant return $15,576,964.00, the full amount it received in proceeds from the Citadel sale, to the Sentinel Liquidation Trust to be distributed pro rata in accordance with the Fourth Amended Chapter 11 Plan of Liquidation.

All Citations

485 B.R. 854, Bankr. L. Rep. P 82,411

Footnotes

1 Both parties moved for summary judgment on Counts I–IV before trial. I considered the motions but ultimately decided to take them with the case. This opinion addresses all issues raised at summary judgment and trial.

2 **To the extent that any findings of fact may be deemed conclusions of law, and vice versa, they should be considered as such; the labels used herein are not controlling. *See* 9 Wright & Miller, Federal Practice & Procedure, § 2579 (3d ed. 2008).**

3 This group consisted of a single customer, Lakeshore Asset Management Ltd. In July 2007, this Court, in an unrelated proceeding, ordered Sentinel to invest all Lakeshore funds under its management in Rule 1.25 compliant investments only.

4 A repo is a form of short-term borrowing for dealers in government securities in which a party purchases a security and then immediately loans it to a dealer in exchange for cash equal to the value of the security, less a "haircut," with an agreement to repurchase the security at a given date for the amount loaned plus interest. The "haircut" is the difference between a security's market value and the amount of the repo loan. Lending parties in repo transactions require haircuts

as a cushion against possible decline in the market value of the loaned security. A "reverse repo" is a transaction in which a party borrows a security from a dealer in exchange for cash collateral. Sentinel also engaged in reverse repo transactions as part of its leveraged trading strategy.

5 "Tracing" is a right afforded to trust beneficiaries to follow and identify converted or commingled trust property in order to recover such property. *See generally* Restatement Second, Trusts, § 202 (Following trust property into its product); Restatement, Restitution, §§ 202 to 215. It is based on a fundamental principle of English common law that a change in the form of that which is owned does not change who owns it. Bogert's Trust and Trustees, § 921. Generally, a trust is terminated once the trust property ceases to exist. Restatement Third, Trusts, § 2. Thus, when trust property has been converted or commingled, it is necessary for a beneficiary seeking to recover his property to demonstrate that the trust still exist by, identifying the trust res.

6 Since Begier involved only pre-petition transfers, the AIA's voluntary payment of its trust-fund tax obligations met this requirement.

7 The CFTC, as *Amicus Curiae,* initially raised the first argument (and hinted at the second) in its Supplemental Memorandum (CFTC Supp. Mem at 9–10, 11 n.8). Defendant, apparently realizing it could no longer ignore the IAA trust as it did in its summary judgment filings, adopted (rather reticently) the arguments at trial.

8 Both the SEC and the CFTC have the gratitude of the Court for their candid and insightful *Amicus Curiae* briefings.

9 Sentinel's bankruptcy is not a commodity-broker liquidation, and thus the commodity-broker liquidation rules do not apply. The rules are relevant to this case only insofar as they evince Congressional purpose to elevate commodity customer claims over customers protected under the IAA.

10 *See* Corcoran Dep. (150.21–151.4).

11 This would be unsurprising given Sentinel's unique regulatory status as both an FCM and an investment advisor.

12 I note that the Trustee could very well have brought in its own veteran SEC regulator to make arguments as to why such a so-called "super priority" would be damaging to securities markets. That it did not, I think, is more out of recognition that such policy arguments are not relevant to my Section 541 determination than an indication that equally compelling arguments cannot be made from the other side. Whatever arguments may or may not exist they are for Congress to weigh, which perhaps this litigation will prompt it to do.

13 In this case it might be argued that whatever collision there is between the CFTC rules and the SEC rules should be resolved in favor of applying the SEC rules because Sentinel functioned as an investment advisor and was an FCM in name only. This would be an equally misguided resolution, and the Trustee does not offer it. Sentinel submitted itself to CFTC control. As a licensee it came under the jurisdiction of the CFTC and bound itself to obey the rules and regulations of the Commission even if it never worked as a futures commission merchant. Practically speaking, allowing the SEC rules to trump would not change the outcome of this case—SEG 1 and SEG 3 customers would still be similarly situated, since SEG 1 customers were also protected under the IAA. I raise the point simply to illustrate the competing policy arguments raised as a result of Sentinel's dual registration as an FCM and an investment advisor.

14 The so-called " 'rule of Clayton's Case," extracted from *Clayton's Case,* [1816] Ch. 1 Merivale, 572.

15 Defendant argues that *Cunningham* is inapplicable to this case because Sentinel was not running a Ponzi scheme. That is incorrect. While it is true that Sentinel was not technically a Ponzi scheme, *Cunningham* is about the rights of similarly situated claimants to insufficient commingled funds, not the nature of the fraud that led to the commingling. *See Michigan Boiler,* 171 B.R. at 576. Ponzi schemes may provide the most straightforward context for *Cunningham' s* application, but its equitable principles are not so limited.

16 Defendant asserts, without explaining, that *Michigan Boiler* is inapposite because it involved a statutory trust created by state law, whereas the CEA trust is created by federal law. True enough, but for purposes of this case that is a distinction without a difference. The common law of trusts is no more binding on state legislatures than it is on Congress. The pertinent question for determining tracing requirements is whether a statutory trust of any kind has been created that alters common law tracing requirements. *Cf. Begier,* 496 U.S. at 62 n. 4, 110 S.Ct. 2258.

17 Defendant correctly points out that most cases in which courts have declined to trace trust property in order to avoid disproportionate losses to similarly situated claimants have occurred in the context of equitable receivership, not bankruptcy. Those courts were therefore not bound by Section 541's "property of the estate" definition. But, as the Seventh Circuit recently noted, "[t]he goal in both securities-fraud receiverships and liquidation bankruptcy is identical—the fair distribution of the liquidated assets." *Wealth Management,* 628 F.3d at 334. Where tracing would produce an outcome clearly at odds with this goal, a strong case can be made that courts should not allow it, Section 541 notwithstanding. *See U.S. v. Ron Pair Enterprises, Inc.,* 489 U.S. 235, 242, 109 S.Ct. 1026, 103 L.Ed.2d 290 (1989) ("[I]n the rare cases in which the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters ... the

intention of the drafters, rather than the strict language controls."); *but see* *Bonded Financial Services, Inc. v. European American Bank,* 838 F.2d 890, 894 (7th Cir.1988) (expressing general doubt about "the propriety of judges' declining to enforce statutes that produce inequitable results," and stating "[b]ankruptcy statutes are not special cases."). This case does not squarely present the issue because, as explained below, Defendant cannot trace. Because I believe it is a question better left for Congress, I do not decide the issue.

18 Similar, but not the same—unlike PACA beneficiaries, "Congress expected that the IRS would have to show *some* connection between the § 7501 trust and the assets sought to be applied to a debtor's trust-fund tax obligations." *Begier,* 496 U.S. at 66–67, 110 S.Ct. 2258.

19 The CFTC points to *Old Republic Nat'l Title Ins. Co. v. Tyler (In re Dameron),* 155 F.3d 718 (4th Cir.1998), as a case in which tracing fictions were employed to allocate an insufficient pool of commingled funds among multiple trust claimants. *Old Republic* is distinguishable because the claimants in that case did not have contemporaneous claims. The very small deficit in the commingled account in *Dameron* was created when only a single claimant had funds in the account. Thus the withdrawals that created the deficit necessarily depleted the funds of that single claimant. This case, by contrast, involves a commingled account to and from which dozens of customers made contemporaneous deposits and withdrawals over a period of several years. On top of that, and unlike *Dameron,* the cash deposits in this case were converted into indirect ownership interests in a commingled securities pool, which adds another layer of fiction in purporting to link customer redemptions to original deposits.

20 I do not say this to disparage the work of Ms. McCloskey, who is an accountant not an attorney. As such, she should not be expected to understand arcane common law tracing rules. Her work, like the work of all the experts in this case, was of value for my understanding of the facts.

21 This is why Defendant's attempt to demonstrate that the securities sold to Citadel were generally kept in segregation has very little meaning—the custodial location of a security at any given time was not related to the source of funds used to purchase that security.

22 Defendant argued at trial that SEG 3 customers should bear heavier losses than SEG 1 customers because of the riskier nature of SEG 3 investment portfolios. This is a misleading argument for two reasons. First, the vast majority of SEG 3 funds were held in the Group 10 portfolio, which, like all SEG 1 portfolios, was Rule 1.25 compliant. Second, the SEG 3 prime portfolio customers were stuck holding highly illiquid CDOs as a result of Sentinel's reckless leveraged trading strategy which it hid from its customers—hardly the type of risk for which Prime Portfolio customers contracted.

23 There was extensive testimony to this effect at trial from Corcoran, William Dunaway, and Professor Jerry Markham.

24 Defendant argues, incorrectly, that the Trustee must establish that Sentinel actually intended to benefit FCStone by making the transfer of the assets. In *McCook,* the Bankruptcy Court stated, "[f]ollowing ... *Bonded Financial* ..., it appears that transfer beneficiary status depends on three aspects of the "benefit": (1) it must actually have been received by the beneficiary; (2) it must be quantifiable; and (3) it must be accessible to the beneficiary." 319 B.R. at 590. The court went on to consider whether demonstrating "the transferor's intent to convey a benefit is sufficient in itself" to constitute an actual benefit received (the court held it was not sufficient). *Id.* at 590–91. The *McCook* court did not hold that the transferor's intent to benefit the transferee was a separate element that must be proven to establish beneficiary status, nor has any other court in this circuit as far as I can tell.

25 **Long after the approval of the Fourth Amended Plan, Defendant argues that the SEG 1 reserve is underfunded by approximately $32 million, which, according to Defendant, more than offsets any disproportionate distribution it received from the Citadel sale. To the extent that this is an actual claim by Defendant, it is disallowed by § 502(d). To the extent that it is simply a new argument that Defendant wants me to weigh in determining an equitable outcome, it comes too late and is barred by collateral estoppel. *See Grede v. Bank of New York Mellon Corp.,* 598 F.3d 899, 902 (7th Cir.2010).**

26 Arguments about the uniquely fragile nature of the futures market also tend to break down in this case. As Professor Markham explained at trial, many of the SEG 3 customers faced margin calls similar to the SEG 1 customers. Hedge funds, for example, are also active in the futures market—their failure could have the exact same consequences as an FCM's failure.

27 The Southern District of New York has come down differently on this issue in two recent cases involving the Ponzi scheme perpetrated by Bernard Madoff. *See Picard v. Katz,* 462 B.R. 447 (S.D.N.Y.2011); *Picard v. Greiff et al.,* No. 11 Civ. 3775, 2012 WL 1505349 (S.D.N.Y. Apr. 30, 2012). Madoff Securities operated an investment advisory unit that purported to trade securities on behalf of customers. In fact, it made no such trades—the unit was operated as a pure Ponzi scheme. As with the instant case, the Trustee of the Madoff Securities estate sought to avoid certain pre-petition payouts to customers. The *Picard* Court found that § 546(e) "precludes the Trustee from bringing any action to recover from any of

Madoff's customers any of the monies paid by Madoff Securities to those customers except in the case of actual fraud." *Katz,* 462 B.R. at 452. The *Picard* decisions were based largely on an "extremely broad" interpretation of § 546(e)'s "settlement payment" provision given by the Second Circuit in *Enron Creditors,* 651 F.3d at 335. There, the Second Circuit considered whether an issuer's early redemption of commercial paper met § 741(e)'s definition of "settlement payment." The *Enron* Court examined the *type* of financial instruments whose trade qualifies as a securities transaction subject to § 546(e)—it did not deal with the distribution of proceeds from that transaction to third party customers. *Id.* at 335. I agree with the Second Circuit that Congress intended § 546(e) to reach a broad scope of financial instruments exchanged in Transaction 1 (see Figure 1 below). I do not see, however, how this relatively uncontroversial holding allows for extending § 546(e) *beyond* the securities transaction to subsequent, indirectly related cash transactions to customers.

EXHIBIT B

In the

United States Court of Appeals

For the Seventh Circuit

Nos. 13-1232 and 13-1278

FREDERICK J. GREDE, not individually but as Liquidation Trustee of the Sentinel Liquidation Trust, Assignee of certain claims,

Plaintiff-Appellee, Cross-Appellant,

v.

FCSTONE, LLC,

Defendant-Appellant, Cross-Appellee.

Appeals from the United States District Court for the Northern District of Illinois, Eastern Division.
No. 09 C 136 — **James B. Zagel**, *Judge.*

ARGUED DECEMBER 10, 2013 — DECIDED MARCH 19, 2014

Before MANION, ROVNER, and HAMILTON, *Circuit Judges.*

HAMILTON, *Circuit Judge.* Sentinel Management Group, Inc., was an investment management firm that filed for Chapter 11 bankruptcy protection on August 17, 2007. Sentinel was caught in the midst of the credit crunch that heralded the beginning of the financial crisis of 2008–09. The crunch Sentinel faced was much worse because, it is now clear, Sentinel managers invaded for their own use the assets that Sentinel was legally required to hold in trust for its customers.

These appeals focus on two transfers of assets. In the days and even the hours just before the bankruptcy filing, Sentinel shifted assets around to increase dramatically the assets available to pay one group of its customers at the expense of another group. Then, on the first business day after the bankruptcy filing, Sentinel obtained the permission of the bankruptcy court to have its bank distribute more than $300 million from Sentinel accounts to the favored group of customers. As a result of these pre-petition and post-petition transfers, the customers in the favored pool have recovered a good portion of their assets from Sentinel, while those in the disfavored pool are likely to receive much less. For the benefit of the disfavored pool of customers, Sentinel's trustee in bankruptcy has sought to avoid both transfers under 11 U.S.C. §§ 547 and 549. Both transfers benefitted defendant FCStone, LLC, one of the customers in the favored pool, and both transfers to FCStone have been litigated as a test case. After a trial, the district court allowed the trustee to avoid both transfers. FCStone has appealed.

This case seems to be unprecedented, or at least unusual, in one important respect. Sentinel's managers violated federal commodities and securities law by invading not just one but two statutory trusts for customer assets, one under the Commodity Exchange Act and the other under the Investment Advisors Act. Those federal statutes, their accompanying regulations, and the two federal agencies charged with enforcing them were not enough to stop Sentinel managers from removing securities from customer trust accounts and using them for their own gain. (Federal criminal charges are pending against two senior executives of Sentinel.) Two groups of customers (not to mention the rest of Sentinel's creditors) have been wronged, large amounts of money are at stake, and there are insufficient funds in the estate to make Sentinel's customers whole. Under these circumstances, there are no easy answers, and the courts face hard choices in applying bankruptcy law to the wreckage and the survivors.

The district court resolved the conflict between the two groups of wronged customers in an equitable way. The court "avoided" (a technical term meaning set aside) both the pre-petition and post-petition transfers so as to share the available assets as fairly as possible between the two groups who are similarly situated, apart from Sentinel's choices to favor one group over the other. *Grede v. FCStone, LLC*, 485 B.R. 854 (N.D. Ill. 2013). As we explain below, however, our review persuades us that there are insurmountable legal obstacles to the avoidance relief ordered by the district court. We therefore reverse as to both transfers.

With respect to the pre-petition transfer, the bankruptcy code provides for avoidance (sometimes also called a "clawback") of so-called preferential transfers made by an insolvent debtor in the 90 days before filing a bankruptcy petition. 11 U.S.C. § 547(b). The code has a broad exception from avoidance or clawback, however, for payments made to settle securities transactions. See 11 U.S.C. § 546(e). In this case, Sentinel's pre-petition transfer fell within the securities exception in § 546(e) and therefore may not be avoided.

The post-petition transfer of $300 million was authorized by the bankruptcy court. That authorization means that the post-petition transfer cannot be avoided under the express terms of 11 U.S.C. § 549. Although we do not reach all of the parties' arguments under § 549, in an effort to provide guidance to the district court for future related cases, we briefly discuss at the end of this opinion whether the post-petition transfer involved property of the bankruptcy estate.

I. *Factual Background*

The details of Sentinel's illegal practices and eventual collapse have been described well in the district court's findings in this case, *Grede v. FCStone, LLC*, 485 B.R. 854 (N.D. Ill. 2013), and by our court in a related case, *In re Sentinel Mgmt. Grp., Inc.*, 728 F.3d 660 (7th Cir. 2013), so we set out only the facts most relevant to these appeals.

Sentinel was an investment management firm that specialized in short-term cash management. Its customers included hedge funds, individuals, financial institutions, and futures commission merchants, known in the business as FCMs. Sentinel promised to invest its customers' cash in safe securities that would nevertheless yield good returns with high liquidity. Under the terms of Sentinel's investment agreement, a customer would deposit cash with Sentinel, which then used the cash to purchase securities that satisfied the requirements of the customer's investment portfolio. Customers did not acquire rights to specific securities under the contract, but rather received a *pro rata* share of the value of the securities in their investment pool. Sentinel prepared daily statements for customers that indicated which securities were in their respective pools and the customers' proportional shares of the securities' value.

Sentinel classified all customers into segments depending on the type of customer and the regulations that applied to that customer. Sentinel then divided each segment into groups based on the type of investment portfolio each customer had selected. In all, Sentinel had three segments divided into eleven groups. For our purposes, we focus on two segments: Segment 1, which consisted of FCMs' customers' funds, and Segment 3, which contained funds belonging to hedge funds, other public and private funds, individual investors, and FCMs investing their own "house" funds. FCStone's funds were in Segment 1.

Both Segment 1 and Segment 3 accounts were subject to federal regulations requiring Sentinel to hold its customers' funds in segregation, meaning separate from the funds of other customers and Sentinel's own assets. Customer funds could not be used, for example, as collateral for Sentinel's own borrowing. The FCMs in Segment 1 were protected by the Commodity Exchange Act and related CFTC regulations, while Segment 3 customers were protected by the Investment Advisors Act and related SEC regulations. Both sets of regulations created statutory trusts requiring Sentinel to hold customers' property in trust and to treat it as belonging to those customers rather than to Sentinel. See 7 U.S.C. § 6d(a)–(b) (statutory trust under the CEA); 17 C.F.R. § 275.206 (statutory trust under the IAA).

Unfortunately for Sentinel's customers, their investment agreements with Sentinel and the federal regulations bore little relation to what Sentinel actually did with their money. Rather than investing each segment's cash in securities for the segment, Sentinel lumped all available cash together without regard to its source and used it to purchase a wide array of securities, including many risky securities that did not comply with customers' investment portfolio guidelines. Risky securities were used in "repo" transactions or assigned to a house securities pool.[1] At the end of each day, Sentinel would assign securities to groups from its general pool of securities and would issue misleading customer statements listing the securities that were supposedly held in the customer's group account. Sentinel's "house" securities bought in part with customers' money did not appear on customer statements.

Sentinel also allocated a misleading sort of "interest income" to its customers on a daily basis. Under the terms of their agreements with Sentinel, customers were entitled to a *pro rata* share of the interest accrued by securities in their respective pools. However, Sentinel instead would calculate the interest earned by *all* securities, including those belonging to other Segments and the house pool. Sentinel would then guesstimate the yield its customers expected to receive on their group's securities portfolio, add a little extra so that the rate of return seemed highly competitive, and report the customer's *pro rata* share of that amount, minus fees, on the customer's statement.

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[1] A "repo" transaction is like a short-term secured loan. One party sells a security to another for cash with a simultaneous agreement to repurchase the security at a later time for a slightly higher cash price. The difference in price is equivalent to interest. Sentinel engaged in repo transactions in both directions.

Sentinel funded its securities purchases using not only the customer cash in the segment accounts but also cash from repo transactions and money loaned to it by the Bank of New York (BONY), the bank where Sentinel housed the majority of its client accounts. BONY required Sentinel to move securities into a lienable account to serve as collateral for the loan. If Sentinel were to move Segment 1 or Segment 3 customer assets into a lienable account, meaning that BONY had a lien on those customer assets to secure its loans to Sentinel, then Sentinel would be violating the trust requirements of federal laws meant to protect Segment 1 and Segment 3 customers from precisely such a risk.

Originally, the BONY loan was meant to provide overnight liquidity. As Sentinel expanded its leveraged trading operations, though, it used the BONY loan to cover the fees those trades required. Sentinel's BONY loan ballooned, growing from around $55 million in 2004 to an average of $369 million in the summer of 2007. As the loan grew, Sentinel began using securities that were assigned to customers as collateral for its own borrowing, moving them out of their segregated accounts and into the lienable account overnight. This meant that securities that were supposed to be held in trust for customers were instead being used for Sentinel's financial gain and were subject to attachment by BONY, a flagrant violation of both SEC and CFTC requirements.

Sentinel's illegal behavior left customer accounts in both Segment 1 and Segment 3 chronically underfunded, but customers were none the wiser. The securities that were serving as collateral for the BONY loan continued to appear on customer statements as if they were being held in segregated accounts for their benefit even though Sentinel was routinely removing them from those accounts.

The music came to a crashing halt in the summer of 2007 as the subprime mortgage industry collapsed and credit markets tightened. Many of Sentinel's repo counter-parties began returning the high-risk, illiquid physical securities that Sentinel had loaned to them. They demanded cash in exchange. Sentinel did not have the cash on hand to pay them and was unable to sell the returned securities. It was also unable to sell its own similar house securities to raise cash. So Sentinel borrowed even more from BONY, putting at risk even more of the supposedly segregated customer assets.

BONY soon notified Sentinel that it would no longer accept physical securities as collateral. It began pressuring Sentinel to pay down its gigantic loan balance. In response, Sentinel moved $166 million worth of still-valuable corporate securities out of Segment 1, where they were held in trust, to a lienable account as collateral for the BONY loan, again violating federal segregation requirements and exposing Segment 1 customer assets to the risk of attachment by BONY. Sentinel also sold a large number of Segment 1 and Segment 3 securities to pay down the loan, again treating customer securities as if they belonged to Sentinel itself and using them for its own financial gain. On August 16, 2007, BONY asked Sentinel to repay its loan in full immediately. The following day, BONY told Sentinel that due to the failure to repay the loan, it would begin liquidating the loan's collateral in a few days. Sentinel filed for bankruptcy protection that same day.[2]

Sentinel took several actions as it approached bankruptcy that dramatically improved the situation of the Segment 1 customers and worsened that of the Segment 3 customers. On July 30 and 31, 2007, Sentinel returned $264 million worth of securities to Segment 1 from a lienable account where they had been placed in violation of segregation requirements. Sentinel then moved $290 million worth of securities from the Segment 3 trust into the same lienable account. This virtually emptied the Segment 3 trust and once again violated federal securities laws. Then, even after informing its customers on August 13 that it would no longer honor requests for redemption, Sentinel nevertheless paid out full and partial redemptions to some Segment 1 customers. Sentinel also distributed cash to two Segment 1 groups that constituted the full value of those accounts. Finally, on Friday, August 17, mere hours before filing for bankruptcy, Sentinel distributed $22.5 million in cash to two additional Segment 1 groups, one of which included FCStone. FCStone received $1.1 million in that distribution, which is the pre-petition transfer at issue in these appeals.

After filing for bankruptcy protection, Sentinel again acted to protect the Segment 1 customers at the expense of its other

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[2] Federal criminal charges have been filed against Sentinel's former president and CEO Eric A. Bloom and former senior vice president Charles K. Mosley in the Northern District of Illinois. See case No. 1:12-CR-00409. So far, Mosley has pled guilty to two counts of investment advisor fraud. Bloom's jury trial began on February 25, 2014 and had not ended as of March 17, 2014.

customers and creditors. On Thursday, August 16, Sentinel had sold a portfolio of Segment 1 securities to a company called Citadel and deposited the proceeds of more than $300 million in a Segment 1 cash account. Sentinel filed for bankruptcy the next day, on Friday, August 17.

On Monday, August 20, while still controlled by insiders, Sentinel filed an emergency motion with the bankruptcy court seeking an order allowing BONY to distribute the Citadel sale proceeds to the Segment 1 customers. The SEC, CFTC, and at least one Segment 3 customer appeared at an emergency bankruptcy court hearing. They expressed concerns that Sentinel might have been commingling funds and securities (which was in fact the case), and that there was reason to suspect that Segment 3 securities had been sold to Citadel. After hearing from all who were present (including Sentinel, Citadel, BONY, and some Segment 1 customers), the bankruptcy court issued an order on August 20, 2007 allowing BONY to release the funds. BONY did so on August 21. FCStone received nearly $14.5 million in that distribution, which is the post-petition transfer at issue here.[3]

The bankruptcy court later appointed Frederick Grede as trustee of the Sentinel bankruptcy estate. The trustee filed

[3] The trustee asserts that the money that was released by BONY was not from the Citadel sale, but rather came from a Segment 3 cash account. If this is correct, then Sentinel's solicitousness for the Segment 1 customers over the Segment 3 customers after its bankruptcy filing was even more dramatic. Because we hold that the bankruptcy judge authorized the transfer, however, it does not matter who is correct, so we adhere to the district court's findings of fact.

adversary proceedings in the bankruptcy court seeking to avoid Sentinel's pre- and post-petition transfers to FCStone and others. The district court withdrew the reference to the bankruptcy court because it found the proceedings raised significant and unresolved issues of non-bankruptcy law. *Grede v. Fortis Clearing Americas LLC*, No. 09-C-138, 2009 WL 3518159, at *3–4 (N.D. Ill. Oct. 28, 2009). The current case against FCStone was selected as a test case to resolve common issues among the trustee's adversary proceedings against other FCMs who received pre-petition and post-petition transfers. (We do not discuss the other FCMs further.) The trustee sought to avoid Sentinel's pre-petition transfer to FCStone under 11 U.S.C. § 547, and Sentinel's post-petition transfer to FCStone under 11 U.S.C. § 549. The trustee also alleged unjust enrichment.

The district court held that the trustee could avoid the pre- and post-petition transfers. *Grede*, 485 B.R. 854. The court examined the post-petition transfer first, focusing on whether the transfer involved property of the estate and was authorized by the bankruptcy court, see 11 U.S.C. § 549, and whether FCStone was an initial transferee or beneficiary of the transfer as required by 11 U.S.C. § 550(a)(1) to avoid a transfer. In the court's view, the post-petition transfer involved property of the estate. The court found that both the Segment 1 and Segment 3 customers were protected by statutory trusts and that the two trusts stood on equal footing. Because there were thus two equal trusts competing for an insufficient pool of assets, the court applied *Cunningham v. Brown*, 265 U.S. 1 (1924), and concluded that the Segment 1 customers would need to trace their assets to specific bankruptcy estate assets to be able to claim rights to trust property. If just one trust had been involved, the district court would have applied tracing conventions to preserve the trust, but the court found tracing conventions to be inappropriate in this case because of the existence of two competing trusts. See *Grede*, 485 B.R. at 874–78 (discussing tracing conventions). The court then found that FCStone was unable to trace its assets, which meant that its trust failed and the transferred assets were property of the estate, making their transfer subject to avoidance.

The district court also concluded that the bankruptcy court did not authorize the post-petition transfer of the Citadel sale proceeds within the meaning of 11 U.S.C. § 549(a) and that FCStone was an "initial transferee" and beneficiary under 11 U.S.C. § 550(a)(1). The district court therefore concluded that the trustee could avoid the post-petition transfer to FCStone. 485 B.R. at 884.

Turning to the pre-petition transfer, the court held that the transfer was not a "settlement payment" and was not made "in connection with a securities contract" within the meaning of 11 U.S.C. § 546(e)'s safe harbor provision for such payments that insulates them from most preference claims. The court concluded that the trustee could therefore avoid the pre-petition transfer as well. 485 B.R. at 887. Finally, the court held that the trustee's unjust enrichment claim was preempted by bankruptcy law. *Id.* at 888.

FCStone appeals the rulings avoiding both the pre- and post-petition transfers. It contends that the transfers did not involve property of the estate, that the pre-petition transfer fell within § 546(e)'s safe harbor, that FCStone was neither an initial transferee nor a beneficiary of either transfer, and that the post-petition transfer was authorized by the bankruptcy court. The trustee cross-appeals seeking prejudgment interest. He also argues for reinstatement of the unjust enrichment claim in the event that we reverse on the avoidance claims. We review the district court's findings of fact for clear error, but review both legal questions and mixed questions of law and fact *de novo*. *Mungo v. Taylor*, 355 F.3d 969, 974 (7th Cir. 2004).

II. *Analysis*

These appeals present many questions, but we find that just two are decisive. First, we conclude that the trustee cannot avoid the pre-petition transfer because 11 U.S.C. § 546(e)'s safe harbor provision applies. Second, we conclude that the bankruptcy court authorized the post-petition transfer, meaning that 11 U.S.C. § 549 bars the avoidance or clawback of that transfer.

A. *The Pre-Petition Transfer*

In general, a bankruptcy trustee can avoid a transfer that (1) was made to or for the benefit of a creditor, (2) was for or on account of an antecedent debt, (3) was made while the debtor was insolvent, (4) was made on or within 90 days before the date of the filing of the petition, and (5) allowed the creditor to receive more than it otherwise would have through the bankruptcy. 11 U.S.C. § 547(b); *Warsco v. Preferred Technical Group*, 258 F.3d 557, 564 (7th Cir. 2001). This general provision is designed to prevent a debtor approaching bankruptcy from choosing on its own to favor some creditors at the expense of others in ways that are not consistent with the priorities and preferences of bankruptcy law. *Id.* at 564.

The trustee's power to avoid transfers made on or within 90 days before a bankruptcy filing means that many financial transactions are not really final until those 90 days have passed. In securities and financial markets, however, such uncertainty can have especially high costs. In 11 U.S.C. § 546(e), Congress enacted a special provision exempting many payments in securities transactions from this power:

> Notwithstanding 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.

(Emphasis added.)

The purpose of this safe harbor was "to ensure that honest investors will not be liable if it turns out that a leveraged buyout (LBO) or other standard business transaction technically rendered a firm insolvent." *Peterson v. Somers Dublin Ltd.*, 729 F.3d 741, 748 (7th Cir. 2013); see also Peter S. Kim, Navigating the Safe Harbors: Two Bright Line Rules to Assist Courts in Applying the Stockbroker Defense and the Good Faith Defense, 2008 Colum. Bus. L. Rev. 657, 663–64. Otherwise, one firm's bankruptcy could cause a domino effect as its clients could similarly default on their obligations, which in turn would trigger further bankruptcies, and so on. By preventing one large bankruptcy from rippling through the securities industry in this way, the § 546(e) safe harbor protects the market from systemic risk and allows parties in the securities industry to enter into transactions with greater confidence.

We agree with FCStone that Sentinel's pre-petition transfer fell within § 546(e)'s safe harbor. The district court's findings of fact show that the transfer to FCStone was a "settlement payment" and was made "in connection with a securities contract" within the meaning of § 546(e).

Section 546(e) states that the trustee may not avoid a pre-petition transfer made to a commodity broker that is either a "settlement payment, as defined in section 101 or 741 of this title," or "in connection with a securities contract, as defined in section 741(7)," except under 11 U.S.C. § 548(a)(1)(A). The parties agree that FCStone is a commodity broker and that the transfer occurred before the commencement of the bankruptcy case. The only disputed issues are whether the transfer was a "settlement payment" or was made "in connection with a securities contract" as those terms are defined in the statute. If the answer to either question is yes, the safe harbor applies and the pre-petition transfer may not be avoided. The answer to both questions is yes.

The statute defines a settlement payment in a broad if rather circular manner as "a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade." 11 U.S.C. § 741(8). We have held that swapping shares of a security for money (as happens in a customer redemption) is a settlement payment within the meaning of § 546(e). See *Peterson*, 729 F.3d at 749. Here, Sentinel's customers did not have rights to specific securities, but they were entitled to *pro rata* shares of the value of the securities in their groups' portfolios. That meant that Sentinel could finance customer redemptions by selling securities from their group's portfolio or by paying them with cash it had on hand. Regardless of how Sentinel chose to fund customer redemptions, the redemptions were meant to settle, at least partially, the customers' securities accounts with Sentinel. The pre-petition transfer to FCStone thus qualified as a "settlement payment" under § 546(e).

The pre-petition transfer was also made "in connection with a securities contract," which is an independent basis for applying the safe harbor of § 546(e). Section 741(7) defines "securities contract" very broadly, including but not limited to "a contract for the purchase, sale, or loan of a security." Although Sentinel's investors like FCStone did not have rights to specific securities under their investment agreements, the agreements did authorize (and expect) Sentinel to purchase and sell securities as it saw fit for the benefit of its customers as long as it complied with the portfolio's investment guidelines. The fact that the Segment 1 customers were entitled to cash rather than to the securities themselves does not change the fact that these customers' investment agreements were contracts for the purchase and sale of securities. Additionally, although Sentinel could and did partially redeem FCStone's account without selling securities from the Segment 1 portfolio, the redemption still served in part to satisfy Sentinel's obligations to FCStone under the investment agreement. So the pre-petition transfer to FCStone in partial redemption of its account was made "in connection with" the investment agreement, and therefore "in connection with a securities contract" within the meaning of § 546(e).

The district court came to different conclusions based not on the text of § 546(e) but on policy grounds, concluding that Congress could not have intended the safe harbor provisions to apply to the circumstances of this case. *Grede*, 485 B.R. at 885–86. The court distinguished between an insolvent debtor selling a security to a buyer just before going bankrupt and an insolvent debtor distributing the proceeds of the sale of a customer's security. In the district court's view, shielding the transaction between debtor and buyer serves § 546(e)'s purpose of preventing destructive ripple effects in the case of a bankruptcy, whereas shielding the debtor's distribution of sale proceeds to customers would destabilize the financial system because it would be impossible to predict who would receive money in the event of a bankruptcy. Because the court did not think Congress could have intended this result, at least under the circumstances shown here, it held that § 546(e) did not protect Sentinel's pre-petition transfer to FCStone from avoidance.

We understand the district court's powerful and equitable purpose, but its reasoning runs directly contrary to the broad language of § 546(e). The text of § 546(e) does not include an exception for preferential transfers, although it does make an exception for actual fraud. See 11 U.S.C. § 546(e), citing 11 U.S.C. § 548(a)(1)(A) (trustee's power to avoid fraudulent transfers). We have explained that "[t]he presence of an exception for actual fraud makes sense only if § 546(e) applies as far as its language goes." *Peterson*, 729 F.3d at 749. Its broad language reaches this case, and there has been no claim of actual fraud in the challenged pre-petition transfer.

As important as the statutory text is, we hope we are not understood as applying a wooden textualism to the issue. We also do not see any persuasive reason to depart from the deliberately broad text of § 546(e). We are not persuaded that Congress could not have intended to protect even pre-petition transfers like the one in this case. Congress enacted § 546(e) to prevent a large bankruptcy from triggering a wave of bankruptcies among securities businesses. Section 546(e) applies only to the securities sector of the economy, where large amounts of money must change hands very quickly to settle transactions. Those dealing in securities have an interest in knowing that a deal, once completed, is indeed final so that they need not routinely hold reserves to cover the possibility of unwinding the deal if a counter-party files for bankruptcy in the next 90 days. Also, even a short term lack of liquidity can prove fatal to a commodity broker or other securities business.

By enacting § 546(e), Congress chose finality over equity for most pre-petition transfers in the securities industry—*i.e.*, those not involving actual fraud. In other words, § 546(e) reflects a policy judgment by Congress that allowing some otherwise avoidable pre-petition transfers in the securities industry to stand would probably be a lesser evil than the uncertainty and potential lack of liquidity that would be caused by putting every recipient of settlement payments in the past 90 days at risk of having its transactions unwound in bankruptcy court. The Supreme Court recently reminded us that Congress has balanced many of the difficult choices that must be made in bankruptcy cases, and that courts may not decline to follow those policy choices on equitable grounds, however powerful they may be in a particular case. *Law v. Siegel*, 571 U.S. —, —, 134 S. Ct. —, —, 2014 WL 813702, at *8 (2014). Given the broad statutory language and Congress' evident and understandable policy choice, we hold that Sentinel's pre-petition transfer to FCStone fell within § 546(e)'s safe harbor and that the trustee cannot avoid the pre-petition transfer under 11 U.S.C. § 547.[4]

B. *The Post-Petition Transfer*

A bankruptcy trustee can avoid a transfer of property of the estate that occurs after the commencement of the case if it was not authorized under the bankruptcy code or by the bankruptcy court. 11 U.S.C. § 549. FCStone contends that the post-petition transfer of $300 million from one of Sentinel's BONY

[4] FCStone argues that the pre-petition claim was not actually part of the trial in the district court so that the court's decision deciding that claim violated its due process rights. The record shows that the pre-petition transfer claim and § 546(e) issues were fully briefed at summary judgment, and that the district court declined to rule on the summary judgment motion until after trial. We think the parties had ample reason to understand that the district court considered the claim ripe for ruling, so we reject FCStone's due process argument.

accounts to Segment 1 customers, including FCStone, was authorized and did not involve property of the estate.[5]

As discussed above, on the first business day after the bankruptcy petition was filed, Sentinel asked the bankruptcy court for an emergency order allowing BONY to disburse funds to Segment 1 customers, including FCStone. Sentinel claimed that the funds belonged to the Segment 1 customers and were not property of the estate because they were the proceeds of the sale of Segment 1 securities to Citadel. The SEC cautioned, and the CFTC conceded, that there was evidence that Sentinel had commingled Segment 1 and Segment 3 funds and that Sentinel had sold Segment 3 securities to Citadel. The SEC opposed the order on that basis. Despite these concerns, the bankruptcy judge approved the transfer, which was carried out very quickly.

A trustee may not avoid a transfer of property of the estate under 11 U.S.C. § 549 if the transfer was authorized by the

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[5] FCStone also argues that it was neither an initial transferee nor a beneficiary under 11 U.S.C. § 550(a)(1), and that the trustee therefore cannot avoid the transfer. Because we hold that 11 U.S.C. § 549 bars avoidance of the transfer, we do not resolve FCStone's arguments under § 550(a)(1). However, we believe it is evident that FCStone was either an initial transferee or a beneficiary, as FCStone's own inconsistent arguments show. To argue that it was not an initial transferee, FCStone claims that it was a mere conduit for the Citadel money, which belonged to its customers and not to FCStone. But then, to argue that it was not a beneficiary of the transfer, FCStone asserts that it was under no obligation to pay those customers in the event of a shortfall. FCStone cannot have it both ways. We need not decide which position is correct, but FCStone was necessarily either an initial transferee or a beneficiary under § 550(a)(1).

bankruptcy court. Over a year after the order had been approved and acted upon, the trustee moved the court to "clarify" the order and to declare that it had not actually authorized the transfer under § 549 to clear the way for the avoidance action. By that time, the consequences of the post-petition transfer were better understood. The trustee's motion to clarify asserted that the disbursed property turned out to have been property of the estate after all, and he asked the court to clarify that the order did not affect the trustee's right to avoid the post-petition transfer. In ruling on the motion to clarify, the bankruptcy court knew that its emergency order was a barrier to a more equitable distribution of Sentinel's property. After full briefing and oral argument, the bankruptcy court held that its order had not authorized the transfer within the meaning of § 549 and thus did not prevent avoidance of the post-petition transfer.

The trustee argues and the district court held that although the bankruptcy court allowed BONY to disburse the funds to Sentinel's customers, including FCStone, the bankruptcy court did not authorize the transfer within the meaning of 11 U.S.C. § 549. See *Grede*, 485 B.R. at 881. In the trustee's view, to authorize the transfer under § 549, the bankruptcy court needed to decide whether the property belonged to the estate, which the court did not do. The trustee also argues that the order explicitly reserved the debtor's right to avoid the transfers.

We conclude that the post-petition transfer was clearly authorized by the bankruptcy court. That court's later "clarification" of its order ran contrary to the plain language of its order. We also are not persuaded that the bankruptcy court order actually authorizing the transfer somehow managed not to authorize the transfer within the meaning of 11 U.S.C. § 549. It was an abuse of discretion for the bankruptcy court to have reached that conclusion as part of its clarification.

For starters, we do not think that the bankruptcy court must first decide that the property at issue belongs to the estate in order to authorize the transfer within the meaning of § 549. The section states that "the trustee may avoid a transfer of property of the estate … that is not authorized under this title or by the court." This merely requires that, before an earlier transfer can be avoided, the court must find that it was "a transfer of property of the estate." It does not require that a court authorizing a transfer decide at that time that the transfer involves property of the estate.

For instance, if a bankruptcy trustee wishes to disburse funds that do *not* belong to the estate, nothing prevents it from asking the bankruptcy court, out of an abundance of caution, to issue a comfort order authorizing the disbursement of admittedly non-estate funds. It cannot be the case that requesting the court's authorization would somehow subject that transfer to additional scrutiny (and potential clawback) that would not apply if the trustee had simply disbursed the funds to their owners, as he would have been perfectly entitled to do. See *In re Kmart Corp.*, 2006 WL 952042, *7 (Bankr. N.D. Ill. April 11, 2006) (§ 549 protects all transfers "under court orders, whether erroneously entered or not, that are not subsequently reversed;" as long as the authorization order remains in effect, § 549 protects distributees from collateral attack).

Whether the property belonged to the estate or not, in the absence of reversal, the authorization order ended any discussion about its original ownership, and the disputed property cannot later be clawed back by the trustee. See *Vogel v. Russell Transfer, Inc.*, 852 F.3d 797, 800–01 (4th Cir. 1988) (rejecting trustee's argument that bankruptcy court authorization of a post-petition transfer was meaningless because transfer did not involve property of the estate; if no estate property was involved, then § 549 does not apply at all, meaning post-petition clawback is unavailable). Whether the transfer was authorized for purposes of § 549 did not depend on whether the bankruptcy court made a concurrent finding about whether the property was property of the estate.

The text of the order did not reserve the trustee's right to avoid the transfer. Such a reservation would be illogical if the order authorized the transfer under § 549, because § 549 allows the trustee to avoid transfers only if they have not been authorized by the court. Reserving the trustee's right to avoid the (authorized) transfer would thus suggest that, however illogical it may seem, the order authorized the transfer without authorizing it under the bankruptcy code. Since the order refers to the distribution as being "authorized" by the order, that argument is difficult to make. If the trustee were correct that the order reserved his right to avoid the transfer, it would go a long way towards establishing this seemingly illogical proposition.

Unfortunately for the trustee and the interests he represents, however, the order did not preserve such a right to avoid the transfer. In negotiations about the order, the parties agreed to reserve a five percent "holdback" to cover any unanticipated claims that might arise. The order then stated that it was "without prejudice to all rights, defenses, claim [sic] and/or causes of action, if any, of the Debtor or any such third parties (including Citadel) against any Distributee, with respect to the Holdback and/or with respect to any claim for priority under Section 761–767, or other applicable law." (Sections 761–767 of the bankruptcy code deal with the liquidation of a commodity broker; no argument has been made that the avoidance claim is based on any of those sections.) The trustee contends that the comma before "or other applicable law" means that the sentence protected the debtor's rights against distributees (1) with respect to the five percent holdback contemplated in the order, (2) with respect to claims for priority under 11 U.S.C. §§ 761–767, or (3) with respect to other applicable law. Under that reading, the order reserved all of the debtor's legal rights against distributees, allowing the debtor to avoid the post-petition transfer.

The trustee's reading is not correct. The placement of "with respect to" twice in the sentence divided the sentence into two parts: (1) the holdback, and (2) claims for priority under sections 761–767 or other applicable law. The use of "and/or" between the holdback claims and the priority claims, but not between priority claims under sections 761–767 and "other applicable law," also indicates that "other applicable law" modifies only the types of priority claims that can be brought. It follows that the sentence should be read to protect the debtor's rights against distributees (1) with respect to the five percent holdback contemplated in the order, and (2) with respect to claims for priority under 11 U.S.C. §§ 761–767 or other applicable law. The reservation of a five percent holdback signaled quite clearly that the rest of the distribution was not subject to avoidance. If it had been, then the holdback would not have been needed. The text of the order did not preserve the trustee's ability to avoid the funds under 11 U.S.C. § 549.

The trustee contends that we should interpret the order in light of the transcript of the hearing leading to the order authorizing the transfer. In general, there should be no need to go beyond the text of a court order unless its meaning is unclear. *Mendez v. Republic Bank*, 725 F.3d 651, 663 (7th Cir. 2013); cf. *Oneida Tribe of Indians of Wisconsin v. Wisconsin*, 951 F.2d 757, 760–61 (7th Cir. 1991) (we look beyond the text of a statute only if it is inconclusive or clearly contravenes express congressional intent). Relying on the hearing transcript rather than the text of the resulting court order to decide what the order meant can raise serious problems. See *Mendez*, 725 F.3d at 663. Parties and non-parties alike should be able to rely on the text of a court order where the text is clear, rather than having to dig through the docket and record to determine the order's true meaning. See *id.* Especially where, as here, the issues were urgent and the stakes were high (including, in this case, the potential collapse of a dozen FCMs and wide ripple effects), parties and non-parties should be able to act in reliance on the order itself, without waiting for a transcript or inquiring further.

In this case, FCStone and other parties needed BONY to release the money within hours of the order being issued so that they could in turn pay their obligations to their own customers. Requiring FCStone to pore through the court record before deciding whether the transfer was authorized and whether it could transfer the money on to its own customers without risk of having to return the money to Sentinel would have effectively nullified the emergency order. The amounts were large enough that if FCStone could not transfer the money to meet its obligations to its customers, it would have been insolvent itself. So, finding the text of the order unambiguous, we do not base our decision on the transcript of the hearing where the order was approved.[6]

The trustee also argues that we should defer to the bankruptcy court's later interpretation of its order. The district court deferred to the bankruptcy court's later interpretation of the order, citing *In re Resource Tech. Co.*, 624 F.3d 376, 386 (7th Cir. 2010), which in turn cited *In re Airadigm Communications, Inc.*, 547 F.3d 763, 768 (7th Cir. 2008), for the broad proposition that we will leave the interpretation of a bankruptcy court's order to that court's discretion. At the same time, we have raised concerns about such deference to an issuing court's interpretation, especially when the issue affects reliance interests and the interests of non-parties, rather than just issues such as case management. See *In re Trans Union Corp. Privacy Litigation*, 741 F.3d 811, 816 (7th Cir. 2014). "Litigants as well as third parties must be able to rely on the clear meaning of court orders setting out their substantive rights and obligations, and

[6] We have examined the hearing transcript at the parties' request. It would not change our interpretation of the bankruptcy court's order. As discussed above, the court was acting under extreme time pressure and may not have fully appreciated the legal consequences of authorizing the transfer. Nevertheless, the transcript shows quite clearly that the bankruptcy court authorized the transfer, notwithstanding its later regrets. Consideration of the transcript would not change our interpretation of the order's plain text.

appellate courts should interpret those orders in the same manner." *Id.* These concerns are particularly acute in a situation like the bankruptcy court's order authorizing payments to non-parties.

Too much deference to a bankruptcy court's much-later interpretation would undermine the ability of parties and non-parties to rely on a court order and creates the risk that interpretation of an order becomes a means to rewrite it after unintended consequences have given rise to regrets. When the order here was issued, the parties acted in reliance on its text. That means that the FCMs like FCStone passed the BONY money along to their customers in satisfaction of their trades and accounts, and both the FCMs and their customers were entitled to assume the money was unencumbered. That allowed the FCMs to settle their transactions and to stay afloat rather than filing for bankruptcy protection themselves back in 2007.

If we were to conclude now that the authorized transfer was not authorized after all, FCStone would face the resulting liquidity crunch now. The losses would fall not on its clients and creditors of 2007 but on its later clients and creditors, meaning that losses would fall quite differently than they would have in 2007. In other words, the bankruptcy court's later interpretation of its order would change the allocation of the loss stemming from Sentinel's bankruptcy, shifting it away from one group of FCStone customers and onto another. FCStone, the other FCMs, their customers, and all other affected parties have strong reliance interests in not allowing the bankruptcy court or the trustee to rewrite history in this way.[7]

The situation might be different if the bankruptcy court had clarified its order before parties and others had relied on the order's plain meaning to their detriment. However, deferring to the bankruptcy court's clarification made so long after the fact, when the money has already been disbursed to the FCMs and distributed to their customers, would upset the strong and reasonable reliance interests of those parties.

In this case, the text of the original order was sufficiently clear to find that the bankruptcy court's clarification, to the effect that the authorized transfer was not actually authorized for purposes of § 549, was an abuse of discretion. We would reach the same result if the appropriate standard of review is *de novo*.

We conclude, then, that the bankruptcy court authorized the post-petition transfer within the meaning of 11 U.S.C. § 549. The trustee therefore cannot avoid the transfer. We doubt whether a bankruptcy court can *ever* authorize a transfer without authorizing it under § 549, but that's a larger puzzle we leave for another day. If such a thing is possible, it did not occur in this case. We thus do not decide whether the other elements of § 549 are satisfied, including whether the funds at

[7] The reliance interests here are not purely speculative. Several parties at the hearing on the trustee's motion to clarify said that they had relied on the order's plain meaning, which in their view did not require clarification. They also stated that at the time the order was issued on August 20, 2007, they understood the court to have decided that the funds at issue were not property of the estate and thus not subject to avoidance by the trustee.

issue were, in fact, property of the estate. (The property-of-the-estate question is also academic in this case because Sentinel's approved bankruptcy plan treats all customers as part of a single class of unsecured creditors, and the time to appeal it has passed. That means that FCStone and the other Segment 1 and Segment 3 customers will be treated as unsecured creditors whether they can establish their trusts or not.) Because the case before us is a test case, though, we will say a few words about that question in an effort to provide guidance to the district court in future related cases.

Both the Segment 1 and Segment 3 funds were subject to statutory trusts. Segment 1 was protected by the Commodity Exchange Act and related CFTC regulations, while Segment 3 was protected by the Investment Advisors Act and related SEC regulations. We agree with the district court that there is no legal basis for placing one trust ahead of the other, despite FCStone and the CFTC's attempts to argue otherwise. See *Grede*, 485 B.R. at 871–72. This bankruptcy therefore presented two equal pools of statutory trust claimants battling over an insufficient pool of commingled funds. The district court found the situation analogous to that in *Cunningham v. Brown*, 265 U.S. 1 (1924), where common law trusts were battling over the insufficient commingled assets of Charles Ponzi, who gave his name to so many later Ponzi schemes. FCStone, however, argues that the proper analogy is to *Begier v. I.R.S.*, 496 U.S. 53 (1990), where the IRS benefitted from a statutory floating trust for tax payments it was owed by the debtor. (A floating trust is a trust in an abstract dollar amount rather than a trust in specific property. *Begier*, 496 U.S. at 62.)

Between these two options, we think the district court had the better answer and that *Cunningham* and its progeny provide useful insight for resolving the competing trust claims in this case. (We do not think that *Begier* applies here because it involved a floating trust.) That would suggest that the *Cunningham* requirement that claimants trace their assets to establish their trusts (without the benefit of tracing conventions) would apply here as well. See *Cunningham*, 265 U.S. at 11. FCStone rightly notes, though, that *Cunningham* did not involve statutory trusts, and we too find the difference significant. Where Congress has acted to establish a trust for certain customers to strengthen their confidence in capital markets, the trust may be more robust than one imposed by a court's equitable powers. The congressional protection indicates a national interest in protecting those customers. In short, we agree with the district court's discussion of this problem. See *Grede*, 485 B.R. at 874–78.

A new rule may be in order for competing statutory trust claimants that splits the difference between the harsh consequences of failing to trace under *Cunningham*, and the lax tracing requirements under *Begier*. One such rule might be to require trust claimants to trace without the benefit of tracing conventions, but to place trust claimants who fail to trace in a class ahead of at least unsecured creditors, giving them priority in bankruptcy proceedings. Again, we are not required to resolve the issue today, both because we reverse on other grounds and because the Sentinel bankruptcy plan (which treats all creditors as a single class of unsecured creditors) has been approved and the time to appeal it has run out.

C. *The Trustee's Cross-Appeal*

The trustee cross-appealed for reinstatement of his unjust enrichment claim if we reversed the district court, and for pre-judgment interest. We agree with the district court that the trustee's unjust enrichment claim is preempted by federal bankruptcy law. To allow an unjust enrichment claim in this context would allow the trustee or a creditor to make an end run around the bankruptcy code's allocation of assets and losses, frustrating the administration of the bankruptcy estate under federal bankruptcy law. See *Contemporary Industries Corp. v. Frost*, 564 F.3d 981, 988 (8th Cir. 2009); *Pertuso v. Ford Motor Credit Co.*, 233 F.3d 417, 426 (6th Cir. 2000). We therefore will not reinstate the trustee's unjust enrichment claim. We also do not award the trustee pre-judgment interest because he is not the prevailing party. See, *e.g.*, *In re Oil Spill by the Amoco Cadiz Off Coast of France on Mar. 16, 1978*, 954 F.2d 1279, 1331 (7th Cir. 1992).

The judgment of the district court is REVERSED and the case is remanded to the district court for further proceedings consistent with this opinion.

EXHIBIT C

KeyCite Red Flag - Severe Negative Treatment
Affirmed in Part, Reversed in Part and Remanded by Grede v. FCStone, LLC, 7th Cir.(Ill.), August 14, 2017

556 B.R. 357
United States District Court,
N.D. Illinois, Eastern Division.

Frederick J. GREDE, not individually but as Liquidation Trustee of the Sentinel Liquidation Trust, Plaintiff,
v.
FC STONE, LLC, Defendant.

No. 09 C 136
|
Signed 03/28/2016

Synopsis
Background: Liquidation trustee appointed under debtor's confirmed Chapter 11 plan brought adversary proceeding to avoid certain pre-petition and post-petition transfers effected by debtor, a registered investment adviser and futures commission merchant (FCM). Reference was withdrawn from bankruptcy court on basis that proceedings raised significant and unresolved issues of non-bankruptcy law. The United States District Court for the Northern District of Illinois, James B. Zagel, J., 485 B.R. 854, granted judgment in part for trustee. Debtor appealed. The Court of Appeals, 746 F.3d 244, affirmed in part and reversed and remanded in part. On remand, bench trial was held.

Holdings: The District Court, James B. Zagel, J., held that:

[1] post-petition transfer that had been authorized by bankruptcy court could not be avoided, and

[2] funds that debtor had been holding in particular account, including certain reserve funds, were property of estate for customers and unsecured creditors to share pro rata.

Ordered accordingly.

West Headnotes (2)

[1] **Bankruptcy**
Post-petition transactions

Post-petition transfer that had been authorized by bankruptcy court could not be avoided. 11 U.S.C.A. § 549.

Cases that cite this headnote

[2] **Bankruptcy**
Property held by debtor as trustee, agent, or bailee

Commingled funds that debtor investment management firm had been holding in particular account, including certain reserve funds, without reliable accounting records were property of estate for customers and unsecured creditors to share pro rata, and thus recipient of preferential post-petition transfer could not receive any additional distributions until there was equal recovery among customers and unsecured creditors.

Cases that cite this headnote

Attorneys and Law Firms

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MEMORANDUM OPINION AND ORDER

James B. Zagel, United States District Judge

The instant adversary proceeding was chosen as a "test case" to resolve common legal issues among the Trustee's actions in the bankruptcy proceedings of Sentinel Management Group, Inc. ("Sentinel"). In this five-count action, the Trustee seeks to avoid or reduce the transfer of approximately $15.6 million to Defendant FC Stone, LLC ("FC Stone") by alleging: 1) avoidance and recovery of post-petition transfers (11 U.S.C. §§ 549(a) and 550); 2) avoidance and recovery of preferential transfers (11 U.S.C. §§ 547(b) and 550); 3) declaratory judgment that cash and securities held by Sentinel in allegedly segregated bank accounts is property of the Debtor's estate; 4) unjust enrichment; and 5) disallowance or reduction of claims (11 U.S.C. § 502(d)).

After I held a bench trial in October 2012, I entered judgment in favor of the Trustee on Counts I, II, III, and V, and in favor of Defendant on Count IV on January 4, 2013. *See Grede v. FC Stone, LLC*, 485 B.R. 854 (N.D.Ill.2013). On appeal, the Seventh Circuit reversed my judgment in the Trustee's favor on Counts I and II, reaffirmed my judgment on Count IV in *FC Stone's* favor, and remanded the case "for further proceedings consistent with this opinion." *See Grede v. FC Stone, LLC*, 746 F.3d 244, 254, 258–60 (7th Cir.2014).

BACKGROUND

I incorporate the facts from my earlier opinion, *FC Stone*, 485 B.R. at 859–67, and I assume the reader's familiarity with the facts as set forth therein. I also excerpt ***359** and adopt the Seventh Circuit's summary of the facts below: [1]

> Sentinel was an investment management firm that specialized in short-term cash management. Its customers included hedge funds, individuals, financial institutions, and futures commission merchants, known in the business as FCMs. Sentinel promised to invest its customers' cash in safe securities that would nevertheless yield good returns with high liquidity. Under the terms of Sentinel's investment agreement, a customer would deposit cash with Sentinel, which then used the cash to purchase securities that satisfied the requirements of the customer's investment portfolio. Customers did not acquire rights to specific securities under the contract, but rather received a *pro rata* share of the value of the securities in their investment pool. Sentinel prepared daily statements for customers that indicated which securities were in their respective pools and the customers' proportional shares of the securities' value.
>
> Sentinel classified all customers into segments depending on the type of customer and the regulations that applied to that customer. Sentinel then divided each segment into groups based on the type of investment portfolio each customer had selected. In all, Sentinel had three segments divided into eleven groups. For our purposes, we focus on two segments: Segment 1, which consisted of FCMs' customers' funds, and Segment 3, which contained funds belonging to hedge funds, other public and private funds, individual investors, and FCMs investing their own "house" funds. FC Stone's funds were in Segment 1.
>
> Both Segment 1 and Segment 3 accounts were subject to federal regulations requiring Sentinel to hold its customers' funds in segregation, meaning separate from the funds of other customers and Sentinel's own assets. Customer funds could not be used, for example, as collateral for Sentinel's own borrowing. The FCMs in Segment 1 were protected by the Commodity Exchange Act and related CFTC regulations, while Segment 3 customers were protected by the Investment Advisors Act and related SEC regulations. Both sets of regulations created statutory trusts requiring Sentinel to hold customers' property in trust and to treat it as belonging to those customers rather than to Sentinel. See 7 U.S.C. § 6d(a)-(b) (statutory trust under the CEA); 17 C.F.R. § 275.206 (statutory trust under the IAA).
>
> Unfortunately for Sentinel's customers, their investment agreements with Sentinel and the federal regulations bore little relation to what Sentinel actually did with their money. Rather than investing each segment's cash in securities for the segment, Sentinel lumped all available cash together without regard to its source and used it to purchase a wide array of securities, including many risky securities that did not comply with customers' investment portfolio guidelines. Risky securities were used in "repo" transactions or assigned to a house securities pool. At the end of each day, Sentinel would assign securities to groups from its general pool of securities and would issue misleading customer statements listing the securities that were supposedly held in the customer's group account. Sentinel's "house" securities ***360** bought in part with customers' money did not appear on customer statements.

Sentinel also allocated a misleading sort of "interest income" to its customers on a daily basis. Under the terms of their agreements with Sentinel, customers were entitled to a *pro rata* share of the interest accrued by securities in their respective pools. However, Sentinel instead would calculate the interest earned by *all* securities, including those belonging to other Segments and the house pool. Sentinel would then guesstimate the yield its customers expected to receive on their group's securities portfolio, add a little extra so that the rate of return seemed highly competitive, and report the customer's *pro rata* share of that amount, minus fees, on the customer's statement.

Sentinel funded its securities purchases using not only the customer cash in the segment accounts but also cash from repo transactions and money loaned to it by the Bank of New York (BONY), the bank where Sentinel housed the majority of its client accounts. BONY required Sentinel to move securities into a lienable account to serve as collateral for the loan. If Sentinel were to move Segment 1 or Segment 3 customer assets into a lienable account, meaning that BONY had a lien on those customer assets to secure its loans to Sentinel, then Sentinel would be violating the trust requirements of federal laws meant to protect Segment 1 and Segment 3 customers from precisely such a risk.

Originally, the BONY loan was meant to provide overnight liquidity. As Sentinel expanded its leveraged trading operations, though, it used the BONY loan to cover the fees those trades required. Sentinel's BONY loan ballooned, growing from around $55 million in 2004 to an average of $369 million in the summer of 2007. As the loan grew, Sentinel began using securities that were assigned to customers as collateral for its own borrowing, moving them out of their segregated accounts and into the lienable account overnight. This meant that securities that were supposed to be held in trust for customers were instead being used for Sentinel's financial gain and were subject to attachment by BONY, a flagrant violation of both SEC and CFTC requirements.

Sentinel's illegal behavior left customer accounts in both Segment 1 and Segment 3 chronically underfunded, but customers were none the wiser. The securities that were serving as collateral for the BONY loan continued to appear on customer statements as if they were being held in segregated accounts for their benefit even though Sentinel was routinely removing them from those accounts.

The music came to a crashing halt in the summer of 2007 as the subprime mortgage industry collapsed and credit markets tightened. Many of Sentinel's repo counter-parties began returning the high-risk, illiquid physical securities that Sentinel had loaned to them. They demanded cash in exchange. Sentinel did not have the cash on hand to pay them and was unable to sell the returned securities. It was also unable to sell its own similar house securities to raise cash. So Sentinel borrowed even more from BONY, putting at risk even more of the supposedly segregated customer assets.

BONY soon notified Sentinel that it would no longer accept physical securities as collateral. It began pressuring Sentinel to pay down its gigantic loan balance. In response, Sentinel moved $166 million worth of still-valuable corporate securities out of Segment 1, where they were held in trust, to a ***361** lienable account as collateral for the BONY loan, again violating federal segregation requirements and exposing Segment 1 customer assets to the risk of attachment by BONY. Sentinel also sold a large number of Segment 1 and Segment 3 securities to pay down the loan, again treating customer securities as if they belonged to Sentinel itself and using them for its own financial gain. On August 16, 2007, BONY asked Sentinel to repay its loan in full immediately. The following day, BONY told Sentinel that due to the failure to repay the loan, it would begin liquidating the loan's collateral in a few days. Sentinel filed for bankruptcy protection that same day.

Sentinel took several actions as it approached bankruptcy that dramatically improved the situation of the Segment 1 customers and worsened that of the Segment 3 customers. On July 30 and 31, 2007, Sentinel returned $264 million worth of securities to Segment 1 from a lienable account where they had been placed in violation of segregation requirements. Sentinel then moved $290 million worth of securities from the Segment 3 trust into the same lienable account. This virtually emptied the Segment 3 trust and once again violated federal securities laws. Then, even after informing its customers on August 13 that it would no longer honor requests for redemption, Sentinel nevertheless paid out full and partial redemptions to some Segment 1 customers. Sentinel also distributed cash to two Segment 1 groups that constituted the full value of those accounts. Finally, on Friday, August 17, mere hours before filing for bankruptcy, Sentinel distributed $22.5 million in cash to two additional Segment 1 groups, one of which included FC Stone. FC Stone received $1.1 million in that distribution, which is the pre-petition transfer at issue in these appeals.

After filing for bankruptcy protection, Sentinel again acted to protect the Segment 1 customers at the expense of its other customers and creditors. On Thursday, August 16, Sentinel had sold a portfolio of Segment 1 securities to a company called Citadel and deposited the proceeds of more than $300 million in a Segment 1 cash account. Sentinel filed for bankruptcy the next day, on Friday, August 17.

On Monday, August 20, while still controlled by insiders, Sentinel filed an emergency motion with the bankruptcy court seeking an order allowing BONY to distribute the Citadel sale proceeds to the Segment 1 customers. The SEC, CFTC, and at least one Segment 3 customer appeared at an emergency bankruptcy court hearing. They expressed concerns that Sentinel might have been commingling funds and securities (which was in fact the case), and that there was reason to suspect that Segment 3 securities had been sold to Citadel. After hearing from all who were present (including Sentinel, Citadel, BONY, and some Segment 1 customers), the bankruptcy court issued an order on August 20, 2007 allowing BONY to release the funds. BONY did so on August 21. FC Stone received nearly $14.5 million in that distribution, which is the post-petition transfer at issue here.

The bankruptcy court later appointed Frederick Grede as trustee of the Sentinel bankruptcy estate. The trustee filed adversary proceedings in the bankruptcy court seeking to avoid Sentinel's pre-and post-petition transfers to FC Stone and others. The district court withdrew the reference to the bankruptcy court because it found the proceedings raised significant and unresolved issues of non-bankruptcy law. ***362** *Grede v. Fortis Clearing Americas LLC*, No. 09–C–138, 2009 WL 3518159, at *3–4 (N.D.Ill. Oct. 28, 2009).

FC Stone, 746 F.3d at 247–50.

DISCUSSION

In light of the Seventh Circuit's decision, the Trustee acknowledges that the Court should enter judgment in FC Stone's favor on Count II (preferential transfer) and Count IV (unjust enrichment). Counts I, III, and V remain in dispute.

I. Count I: Avoidance and Recovery of Post-Petition Transfers

[1] In Count I, the Trustee sues FC Stone under 11 U.S.C. § 549 to recover $14,479,039 that Sentinel paid to FC Stone on August 21, 2007 (the "Post-Petition Transfer"), just four days after Sentinel filed for bankruptcy. To prevail on a § 549 claim, the Trustee must prove that (1) the funds FC Stone received were property of the bankruptcy estate and (2) the Bankruptcy Court did not authorize the Post-Petition Transfer. 11 U.S.C. § 549(a). In my original decision, I found that the Trustee had successfully proven both of these elements.

On appeal, the Seventh Circuit did not make any formal ruling with respect to my decision that the funds Sentinel paid to FC Stone on August 21, 2007 were property of Sentinel's bankruptcy estate, but instead reversed my judgment with respect to the second element, holding that the Bankruptcy Court's August 20, 2007 Order authorized Sentinel's post-petition transfer to FC Stone. *Grede*, 746 F.3d at 254–58. The Seventh Circuit could not have made its holding any more clear:

> The post-petition transfer of $300 million [which includes the amounts transferred to all SEG 1 Defendants] was authorized by the Bankruptcy Court. That authorization means that the Post-Petition Transfer cannot be avoided under the express terms of 11 U.S.C. § 549.

FC Stone, 746 F.3d at 247. For good measure, the Seventh Circuit reiterated its holding eight pages later, explaining, "we conclude that the post-petition transfer was clearly authorized by the Bankruptcy Court." *Id.* at 255. And if that were not enough, the Seventh Circuit re-emphasized its holding yet again just three pages after that, stating "we conclude then, that the Bankruptcy Court authorized the post-petition transfer within the meaning of 11 U.S.C. § 549." *Id.* at 258.

Regardless, the Trustee now argues that the Bankruptcy Court did not authorize the Post-Petition Transfer because the Bankruptcy Court "clarified" its judgment authorizing the Post-Petition Transfer one year later in an October 28, 2008 Order, and this subsequent order is entitled to collateral estoppel effect.

The problem with the Trustee's argument, however, is that the Seventh Circuit already considered the Bankruptcy Court's October 28, 2008 Order and held that it was an abuse of discretion, stripping it of any force and effect.

> We conclude that the post-petition transfer was clearly authorized by the bankruptcy court. That Court's later "clarification" of its order ran contrary to the plain language of its order. We also are not persuaded that the Bankruptcy Court order actually authorizing the transfer somehow managed not to authorize the transfer within the meaning of 11 U.S.C. § 549. It was an abuse of discretion for the Bankruptcy Court to have reached that conclusion as part of its clarification.

FC Stone, 746 F.3d at 255.

The Trustee's collateral estoppel argument depends on the assumption that the October 28, 2008 Order is a viable and valid order. Yet, the Seventh Circuit, in great detail, already held that this order was a legal nullity and an abuse of discretion. ***363** Because the Bankruptcy Court authorized it, therefore, the Post-Petition Transfer cannot be avoided under 11 U.S.C. § 549, and I am entering judgment on Count I in favor of FC Stone.

II. Count III: Declaratory Judgment

[2] I previously entered judgment in favor of the Trustee and against FC Stone on Count III, concluding that the funds Sentinel was holding in the SEG 1 account on the day it filed for bankruptcy were property of the estate. 485 B.R. at 890. My previous decision on Count III was not overruled, and FC Stone's arguments for changing it now are unconvincing. I am therefore once again entering judgment on Count III in favor of the Trustee and concluding that the funds Sentinel was holding in the SEG 1 account, including certain reserve funds which are described below, are property of the estate.

The Seventh Circuit did not formally rule on Count III because it reversed my decisions on Counts I and II on other grounds and reasoned that, as a result of these other rulings, a decision on Count III had no bearing on the case:

> The property-of-the-estate question is also academic in this case because Sentinel's approved bankruptcy plan treats all customers as part of a single class of unsecured creditors, and the time to appeal it has passed. That means that FC Stone and the other Segment 1 and Segment 3 customers will be treated as unsecured creditors whether they can establish trusts or not.

FC Stone, 746 F.3d at 258. However, this is only 99% correct. Although the property-of-the-estate question no longer plays an active role in Counts I and II, it is not purely academic because the Plan created certain reserve funds whose allocation depends, at least in part, on a determination of whether the funds are considered property of the estate.

Specifically, the Plan describes three "Reserves" designed to hold putative trust funds that are disputed in the Adversary Proceedings brought by the Trustee—including these proceedings. Plan Section 7.20(a) states:

> (i) *SEG 1 Property Of The Estate Reserve*. On the Effective Date, the Liquidation Trustee shall establish a reserve equal to the amount of all funds held in any bank account denominates as a SEG 1 account, multiplied by a fraction, the numerator of which is the amount of Citadel Beneficiary Class 3 Customer Claims attributable to SEG 1 accounts (the principal amount of such claims calculated consistent with Section 4.4 of this Plan) which voted against the Plan and/or lodged objections thereto, and the denominator of which is the total aggregate amount of Class 3 Customer Claims attributable to SEG 1 accounts.

(ii) *SEG 2 Property Of The Estate Reserve*. On the Effective Date, the Liquidation Trustee shall establish a reserve equal to the amount of all funds held in any bank account denominated as a SEG 2 accounts, multiplied by a fraction, the numerator of which is the amount of Citadel Beneficiary Class 3 Customer Claims attributable to SEG 3 accounts (the principal amount of such claims calculated consistent with Section 4.4 of this Plan) which voted against the Plan and/or lodged objections thereto, and the denominator of which is the total aggregate amount of Class 3 Customer Claims attributable to SEG 2 accounts.

(iii) *SEG 3/4 Property Of The Estate Reserve*. With respect to each distribution that is made to Holders of Class 3 Claims, the Liquidation Trustee shall hold back and create a reserve equal to the distribution that Holders of Citadel Beneficiary Class 3 Customer Claims attributable to SEG 3 or SEG 4 accounts (the principal amount of such claims calculated ***364** consistent with Section 4.4 of this Plan) which voted against the Plan and/or lodged objections thereto, would have received had the portion of its Class 3 Customer Claims attributable to a SEG 3 or SEG 4 account been Allowed and received a distribution.

In addition, Section 7.20(b) of the Plan provides that when the Trustee makes a distribution of assets other than "Customer Property" (*e.g.*, litigation recoveries) to SEG 3 customers or other unsecured creditors, the Trustee must reserve for the amount that any SEG 1 customer would be entitled to receive as a claimant pending a determination of whether the August 21, 2007 distributions were transfers of property of Sentinel's estate. As of September 30, 2014, the Trustee has reserved $3,684,606 in this "Section 7.20(b) Reserve."

The Plan expressly provides for what happens if property in the Reserves is found to be property of the estate. Section 7.20(c)(ii) of the Plan provides:

> In the event the Court determines that the Citadel Sale Distributions were distributions of property of the estate, the Claims of Citadel-Beneficiary Customers shall be entitled to the treatment and distributions set forth in Sections 4.4 and 4.5 of the Plan, without modification.

If I determine that the Reserves are property of the estate, therefore, the Plan mandates that customers and unsecured creditors share pro rata in distributions of property of the estate (including the Reserves) and the SEG 1 customers cannot receive any distributions until everyone else receives an equal recovery, *i.e.*, approximately 70% of their claims. Plan §§ 4.4, 4.5 and 7.20(c)(ii).

In its most persuasive arguments, FC Stone focuses on the commingling that occurred between the SEG 1 and SEG 3 customer accounts. With regards to the Reserves specifically, FC Stone argues that the SEG 3 customers approved the Plan and therefore waived their trust claims under the Plan while FC Stone voted against the Plan and therefore preserved its trust claim. Under this reasoning, FC Stone argues that the dispute over the Reserves is a battle between a statutory trust claimant and a pool of unsecured creditors, and FC Stone's trust claim should be given priority even if FC Stone cannot trace its assets.

FC Stone's reasoning would be more persuasive if Sentinel had not engaged in so much commingling, if its commingling had been limited to the SEG 1 and SEG 3 accounts, and if its claim did not preclude another equally valid statutory trust claimant from receiving any of the funds.

The amount of commingling that occurred in this case—combined with Sentinel's complete failure to keep reliable accounting records—makes Sentinel's bankruptcy unlike any other. Although the commingling that occurred between the SEG 1 and SEG 3 accounts may have been the most egregious commingling in this case, Sentinel also commingled other funds with the SEG 1 account when it used SEG 1 securities in an unauthorized repo transaction.

Repo markets serve as the pawnshops of the financial world. Repurchase, or "repo," agreements resemble loans in many ways, but a repo transaction is different than a loan. In a repo transaction, a borrower—here, Sentinel—actually sells its assets to a lender with the agreement that the borrower can buy back the assets at an agreed-upon price at some point in the future, which is also agreed upon beforehand. The money that changes hands is effectively a loan, and the assets that are "repo-ed" essentially serve as the collateral for the loan.

A repo transaction is different than a secured transaction, however, because the effective lender of the money—here, ***365** BONY—actually owns the assets during the transaction. Unlike the type of assets that could be pawned through a pawnshop, the assets involved in a repo transaction—and this isn't always true, but it is here—can actually produce cash in the form of daily interest accretions. As these assets accrete interest, the owner of the assets at the time of accretion—BONY—receives the benefit.

An understanding of the repo markets is essential to the property-of-the-estate issue because Sentinel's decision to use SEG 1 securities in its repo transactions with BONY and then lie about it on its accounting statements means that Sentinel was not only commingling SEG 1 property with SEG 3 property, but it was also commingling SEG 1 property with other funds that it had in its possession. For obvious reasons, Sentinel did not tell its customers that it was violating both SEC and CFTC requirements by doing this. In an effort to keep its customers ignorant but happy, Sentinel paid out interest to the SEG 1 customers as if Sentinel still owned and possessed the SEG 1 securities. But Sentinel didn't. Rather, Sentinel "guesstimated" the yield SEG 1 customers expected to receive on their securities portfolio and then added a little extra before paying out these amounts to the SEG 1 customers. Where did this money come from? Not from the securities themselves, because BONY received any interest that the securities earned until Sentinel repurchased them. The money that was paid to SEG 1 customers as "guesstimated" interest payments, therefore, came from Sentinel's own funds and the funds of its other customers.

I previously cited *Cunningham v. Brown*, 265 U.S. 1, 44 S.Ct. 424, 68 L.Ed. 873 (1924) for the proposition that common law tracing rules in the context of bankruptcy "require a trust beneficiary to identify particular trust property to exempt it from the estate." Although the Seventh Circuit said that it generally agreed with my discussion of and my answer to the problem, it described some concern with my use of *Cunningham* in rendering these trust assets property of Sentinel's estate. As the Seventh Circuit noted, *Cunningham* did not deal with statutory trusts, and this difference is significant:

> Where Congress has acted to establish a trust for certain customers to strengthen their confidence in capital markets, the trust may be more robust than one imposed by the court's equitable powers. The Congressional protection indicates a national interest in protecting these customers.

FC Stone, 746 F.3d at 259. The Seventh Circuit then proposed a new rule for competing statutory trust claimants: "require trust claimants to trace without the benefit of tracing conventions, but [ ] place trust claimants who fail to trace in a class ahead of at least unsecured creditors, giving them priority in bankruptcy proceedings." *Id.*

The Seventh Circuit's proposed rule is a reasonable one, but it is not fully compatible with the facts of this case, which are messy. I cannot apply this rule to the SEG 1 customers and SEG 3 customers here—both of whom agreed to be treated as general unsecured creditors under the Plan—without creating absurd results.

As I discussed in my previous opinion, equity prevents me from favoring one statutory trust claim over another. Tracing is difficult here, if not impossible, because Sentinel's commingling prior to its bankruptcy filing was so appalling, not only between the SEG 1 and SEG 3 accounts but also between the SEG 1 account and Sentinel's other accounts. Even if the SEG 1 customers preserved their rights to assert a trust claim with respect to the Reserves and the SEG 3 customers waived their rights to do so, therefore, equity ***366** would not allow me to determine that the funds in the SEG 1 account when Sentinel filed its bankruptcy petition was property of the SEG 1 customers only. Without tracing, such a determination would be unjustifiably unfair to Sentinel's other unsecured creditors and, more importantly, the SEG 3 customers who had an equally valid statutory trust claim.

The dispute raised in Count III is therefore not a dispute between two statutory trust claimants, nor is it a dispute between statutory trust claimants and a pool of unsecured creditors. It is more complicated. After sitting through a bench trial, I can only conclude that the funds held in the SEG 1 account, including the Reserves, are property of the estate and should be distributed according to Sections 4.4, 4.5 and 7.20(c)(ii) of the Plan.

Even if the Reserves were determined not to be property of the estate, however, such a determination would have no effect on their allocation under the Plan. Section 7.20(c)(i) of the Plan provides:

> In the event the Court determines that the property in any of the Property Of The Estate Reserves is not property of the estate, Sections 4.4 and 4.5 of the Plan shall be deemed modified to provide that Customer Property shall be distributed to the rightful owners of such property *or to the Estate*, as determined by the Court.

Under Section 7.20(c)(i) of the Plan, therefore, I have discretion to distribute the Reserves to the estate even if the Reserves are found not to be property of the estate, and I would use my discretion to do exactly that for the reasons discussed in this opinion and my previous one.

I am therefore entering Count III in favor of the Trustee. Under the Plan, customers and unsecured creditors alike share pro rata in distributions of property of the estate (including the Reserves), and FC Stone cannot receive any additional distributions until everyone else receives an equal recovery. Plan §§ 4.4, 4.5, and 7.20(c).

III. Count V: Disallowance or Reduction of Claims

Section 502(d) of the Bankruptcy Code provides for the disallowance of the claims of an entity that receives an avoidable transfer from the debtor's estate and does not return such transfer to the estate. *See* 11 U.S.C. § 502(d). Because the Seventh Circuit already held that FC Stone did not receive any avoidable transfers from Sentinel's estate, I am entering judgment on Count V in favor of FC Stone.

CONCLUSION

In light of the Seventh Circuit's decision, I am entering judgment in FC Stone's favor on Counts I, II, IV, and V, and I am entering judgment in the Trustee's favor on Count III.

All Citations

556 B.R. 357

Footnotes

1 I have removed the Seventh Circuit's footnotes to eliminate any confusion with my own citations and observations.

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EXHIBIT D

In the

United States Court of Appeals

For the Seventh Circuit

No. 16-1896 & 16-1916

FREDERICK J. GREDE, not individually but as Liquidation Trustee of the Sentinel Liquidation Trust,

Plaintiff-Appellant / Cross-Appellee,

v.

FCSTONE, LLC,

Defendant-Appellee / Cross-Appellant.

Appeals from the United States District Court for the Northern District of Illinois, Eastern Division.
No. 09 C 136 — **James B. Zagel**, *Judge*.

ARGUED JUNE 7, 2017 — DECIDED AUGUST 14, 2017

Before RIPPLE, ROVNER, and HAMILTON, *Circuit Judges*.

HAMILTON, *Circuit Judge*. The 2007 bankruptcy of Sentinel Management Group, Inc. has echoed through the courts for ten years now. This is our fifth appeal dealing with Sentinel. In a pair of cases decided in 2013 and 2016, we addressed the priority of a claim against the bankruptcy estate by the Bank of New York, Sentinel's largest (but no longer secured) creditor. *In re Sentinel Management Group, Inc.*, 728 F.3d 660 (7th Cir.

2013); *Grede v. Bank of New York Mellon Corp.* (*In re Sentinel Management Group, Inc.*), 809 F.3d 958 (7th Cir. 2016). Earlier this year, we affirmed the convictions and sentence of Sentinel's former president and CEO, who was prosecuted for wire fraud and investment adviser fraud. *United States v. Bloom*, 846 F.3d 243 (7th Cir. 2017).

In *Grede v. FCStone, LLC*, 746 F.3d 244 (7th Cir. 2014) (*FCStone I*), the direct predecessor to this appeal, we considered among other issues a distribution of $297 million to a group of Sentinel customers a few days after Sentinel filed for bankruptcy protection in August 2007. Following a bench trial, the district court had allowed the trustee in bankruptcy to avoid this post-petition transfer under 11 U.S.C. § 549. We reversed, holding that relief under § 549 was unavailable to the trustee because the bankruptcy court had authorized the transfer. We rejected the trustee's reliance on an October 2008 "clarification" through which the bankruptcy judge indicated that he had not intended to foreclose a § 549 avoidance action. Later statements by the judge about his subjective intentions could not, we concluded, defeat the plain language of the order authorizing the transfer. We remanded for further proceedings, which led to these new appeals.

Despite our holding in *FCStone I* that "the bankruptcy court authorized the post-petition transfer" and that the trustee "therefore cannot avoid the transfer," 746 F.3d at 258, the trustee argued on remand that the bankruptcy judge's October 2008 "clarification" was entitled to preclusive effect. Since FCStone did not appeal that "clarification" when it was made, the trustee argued, FCStone should be bound by it and collaterally estopped from arguing that the post-petition transfer was authorized. The district court rejected the trustee's argument on this point, and we affirm on two independent grounds. First, pursuant to the mandate rule and the law-of-the-case doctrine, the collateral estoppel theory was unavailable to the trustee on remand. Second, even if the theory were available despite our unambiguous holding in *FCStone I*, the bankruptcy judge's "clarification" was not the sort of final ruling that could be entitled to preclusive effect.

On cross-appeal, FCStone raises an issue that lingered in the background but was not squarely presented during the previous appeal. The question concerns the proper distribution of nearly $25 million held in reserve under the confirmed bankruptcy plan. FCStone argues that these funds are trust property belonging to it and other creditors in its customer class who are protected by statutory trusts under the Commodity Exchange Act. The district court disagreed, treating the funds instead as property of the bankruptcy estate subject to pro rata distribution among all Sentinel customers and other unsecured creditors. On this cross-appeal, we reverse. Under the Bankruptcy Code, property held by the debtor in trust for others is by definition not property of the bankruptcy estate. Pursuant to the confirmed bankruptcy plan, FCStone and similarly situated customers preserved their right to recover their trust property. These creditors are entitled to the benefit of reasonable tracing conventions. Moreover, FCStone introduced essentially unrebutted evidence at trial showing that it can trace a portion of the reserve funds back to its investment. FCStone is entitled to recover its proportionate share of the reserve funds. The reserve funds should be distributed pro rata among FCStone and other members of its customer class.

I. *Factual Overview and Procedural History*

A. *Sentinel's Collapse*

We review the most salient facts of the case, drawing from the district court's findings after the earlier bench trial. More complete discussions of Sentinel's downfall and the criminal misconduct of senior executives are included in the district court's earlier opinion, *Grede v. FCStone, LLC*, 485 B.R. 854, 859–67 (N.D. Ill. 2013), and in our opinions in *Bloom*, 846 F.3d at 246–50, and *FCStone I*, 746 F.3d at 247–51.

In brief, Sentinel managed investments for futures commission merchants (FCMs) like FCStone, as well as for other classes of investors. FCMs act as financial intermediaries between investors and futures markets. They are regulated under the Commodity Exchange Act. Sentinel itself was an FCM and so was regulated under the Act.

Sentinel organized its customers in different tranches known as segments or "SEGs." Within each SEG, customers were further divided into investment groups based on their risk appetites and financial goals. As relevant to this appeal, FCM customer assets were held in SEG 1, with FCStone's customer assets placed in Group 7. SEG 3 contained assets belonging to hedge funds and other sophisticated investors, as well as FCM proprietary or "house" funds.

When customers invested funds with Sentinel, those funds were exchanged for securities and interest-bearing cash through a process that Sentinel called "allocation." Customers did not own securities outright but instead held indirect pro rata interests in the securities allocated to their group portfolios, as determined by their level of investment.

Both the SEG 1 and SEG 3 customers were entitled to special protections under federal law. FCM customers who invested their own clients' funds in SEG 1 were protected by the Commodity Exchange Act and regulations promulgated by the Commodity Futures Trading Commission (CFTC). SEG 1 and SEG 3 customers alike were protected by the Investment Advisers Act of 1940 and regulations promulgated by the Securities and Exchange Commission (SEC). Both regulatory regimes required Sentinel to hold customer funds in segregation, i.e., separate from funds belonging to other customer classes and separate from Sentinel's own or "house" funds. Both regimes also created statutory trusts in the customers' favor to protect their property from Sentinel and its other creditors.

Sentinel, unfortunately, did not honor the statutory trusts and comply with the segregation rules under the Commodity Exchange Act and the Investment Advisers Act. Instead, as the district court found, Sentinel routinely used hundreds of millions of dollars in securities it had allocated to customers as collateral to support Sentinel's own borrowing to pursue its leveraged trading strategy for its own benefit. It moved those securities out of segregation and into a lienable account at the Bank of New York, its main lender, putting customer property at risk for Sentinel's benefit. As Sentinel's leveraged trading increased, its outstanding debt ballooned, and it drew more and more on its customers' assets to support its borrowing habit.

During the summer of 2007, Sentinel's investment scheme collapsed. As credit markets tightened and liquidity dried up on Wall Street (this was the beginning of what would become the financial crisis of the late 2000s), the market value of many

Sentinel assets dropped. Sentinel's trading partners began making demands that forced it to borrow more heavily and in turn to provide more collateral—which it did by using customers' property as collateral. In late June and July 2007, Sentinel moved $250 million worth of securities allocated to SEG 1 to the lienable Bank of New York account. Then, in late July, Sentinel swapped these securities with securities allocated to SEG 3 customers, resulting in a "massive shift of loss exposure" from SEG 1 to SEG 3. See *Grede*, 485 B.R. at 866.

That final manipulation proved fateful for SEG 3 customers in the looming bankruptcy. Sentinel's wheeling and dealing had bought it some time, but in the end the firm could not keep up with redemption requests and demands from the Bank of New York. On Monday, August 13, 2007, Sentinel advised its customers that it was halting all redemptions (i.e., payments to them from their accounts). On Thursday, August 16, Sentinel sold a large portfolio of securities then allocated to SEG 1 to a firm called Citadel, depositing the proceeds in a SEG 1 cash account at the Bank of New York. The next day, Sentinel filed for Chapter 11 bankruptcy protection.

B. *Chapter 11 Proceedings*

1. *Early Litigation*

On Monday, August 20, 2007, the first business day after it filed for bankruptcy, Sentinel (still under the control of its insiders) filed an emergency motion in the bankruptcy court seeking an order approving payment of the Citadel sale proceeds to SEG 1 customers. After emergency hearings, the bankruptcy court issued an order authorizing the Bank of New York to disburse the funds, less an approximately five percent holdback. The bank did so, and the SEG 1 customers received $297 million in what the parties describe as the "post-petition transfer," with FCStone receiving a little shy of $15 million.

Frederick Grede was appointed as Chapter 11 trustee. The bankruptcy court approved his appointment on August 29, 2007, within the fourteen-day window for appealing the order authorizing the post-petition transfer. See Fed. R. Bankr. P. 8002. The trustee did not appeal. A year later, however, he filed a "Motion to Clarify or in the Alternative to Vacate or Modify the Court's August 20, 2007 Order." In essence, the trustee argued that he should be permitted to bring avoidance actions against FCStone and the other SEG 1 customers who received, in the trustee's view, a disproportionate payout through the post-petition transfer.

A group of SEG 1 customers including FCStone opposed the trustee's motion. At the conclusion of a hearing on the motion, the bankruptcy judge declined to vacate or modify the prior order. The judge said, however, that he was clarifying the order in that he "did not decide on August 20 and … am not deciding today whether or not any of the proceeds that were the subject of that order are property of the estate … or whether … they were trust funds." The judge said that in his August 20 order, he "did not intend to foreclose the trustee or any party from any avoidance action whatsoever."

2. *FCStone I*

The bankruptcy court entered an order confirming the Fourth Amended Chapter 11 Plan of Liquidation in late 2008. (We discuss several provisions of the confirmed Chapter 11 plan in Part II-B.) Around that same time, the trustee commenced adversary actions against FCStone and other SEG 1 customers who had received distributions from the Citadel security sale back in August 2007. The trustee sought to avoid the post-petition transfers and to recover the Citadel sale proceeds (Count I), and he requested a declaration that funds held in reserve are property of the bankruptcy estate (Count III).[1] The district court withdrew the reference to the bankruptcy court, see 28 U.S.C. § 157(d), and presided over the case against FCStone as a test case.

Following a bench trial, the district court ruled in favor of the trustee on Counts I and III. *Grede*, 485 B.R. at 889–90. The court concluded that the Citadel sale proceeds should be treated as property of the bankruptcy estate. *Id.* at 880. The court reasoned that (1) both SEG 1 and SEG 3 customers were protected by statutory trusts; (2) because the two classes of customers were similarly situated and because there were insufficient funds to satisfy all their claims, tracing fictions or conventions were inappropriate; and (3) FCStone and other SEG 1 customers could not trace the Citadel sale proceeds back to their original investments given Sentinel's commingling and misappropriation of customer assets that should have been segregated in trust for the customers. *Id.* at 873, 878, 880. The district court added that, for purposes of 11 U.S.C. § 549, and in light of the bankruptcy court's 2008 "clarification," the 2007 post-petition transfer had not been "authorized" by the bankruptcy court. *Id.* at 881.

[1] The trustee also sought to avoid a pre-petition transfer (Count II) and to recover on a theory of unjust enrichment (Count IV). Those claims are no longer at issue. The trustee also brought a disallowance claim under 11 U.S.C. § 502(d), but that claim turns on the outcome of Count I and requires no separate consideration in this appeal.

We reversed in *FCStone I*, 746 F.3d at 260. We explained that the bankruptcy court's after-the-fact "clarification" of its subjective intentions concerning the post-petition authorization order ran contrary to the plain language of the order and amounted to an abuse of discretion. *Id.* at 255. "Whether the property belonged to the estate or not," we reasoned, "in the absence of reversal, the authorization order ended any discussion about its original ownership, and the disputed property cannot later be clawed back by the trustee." *Id.*

Because the parties had focused on the post-petition transfer, we did not specifically address the status of the funds held in reserve.[2] For that matter, we declined to decide "whether the funds at issue were, in fact, property of the estate," *id.* at 258, though we agreed with the district court that there was

[2] In the prior appeal, FCStone's opening brief noted in passing the five percent holdback from the post-petition transfer, and it cited reservation-of-rights language appearing in the transfer authorization order. FCStone also devoted a few sentences to the reserves created under the confirmed Chapter 11 plan, but it did not discuss the composition of those reserves or explain why a favorable ruling on the post-petition transfer issue would not necessarily resolve the parties' disagreement over the allocation of the reserve funds. The trustee barely acknowledged the five percent holdback, and he made no mention of the reserves. While the parties chide us more or less gently for assuming that our resolution of the post-petition transfer issue also resolved the trustee's declaratory judgment request in Count III, we believe the onus was on the parties to identify clearly each source of disputed funds and the arguments relevant to the disposition of those funds. E.g., *Montgomery v. Amoco Oil Co.*, 804 F.2d 1000, 1004 n.8 (7th Cir. 1986) (issue raised in a "two-sentence reference in the statement of facts" and through a citation to a statute was "hardly properly presented"); *Prudential Ins. Co. of America v. Sipula*, 776 F.2d 157, 161 n.1 (7th Cir. 1985) (litigant who attempted to incorporate by reference into his appellate brief arguments he had raised in the district court assumed the risk that appellate court might overlook issues not clearly presented).

no generally applicable legal basis for placing one statutory trust ahead of another. We tentatively approved the district court's requirement that would-be trust claimants (such as FCStone) must actually trace their investment property to the disputed funds. *Id.* at 259. We remanded for further proceedings.

3. *The Decisions on Remand*

On remand, the trustee moved for judgment on Counts I and III, while FCStone sought judgment on Count I and summary judgment on Count III. With respect to Count I, the trustee argued that FCStone should be collaterally estopped from asserting that the post-petition transfer was authorized. In the trustee's view, the bankruptcy judge's October 2008 "clarification" was entitled to preclusive effect. The district judge disagreed, writing that our decision in *FCStone I*—holding that the "clarification" was an abuse of discretion—stripped that ruling of "any force and effect." *Grede v. FC Stone, LLC*, 556 B.R. 357, 362 (N.D. Ill. 2016). The court entered judgment for FCStone on Count I. The trustee appeals that decision.

The district judge then considered the status of the disputed reserves. The judge reiterated his view that equity prevented him from "favoring one statutory trust claim over another" and that actual tracing is difficult if not impossible given Sentinel's egregious pattern of commingling. *Id.* at 365. The judge concluded that the reserve funds should be treated as property of the estate, subject to pro rata distribution according to the confirmed Chapter 11 plan. *Id.* at 366. The court entered judgment for the trustee on Count III. FCStone cross-appeals that decision.

II. *Analysis*

A. *The Trustee's Appeal — Collateral Estoppel*

On the issue of collateral estoppel (also known as issue preclusion) presented by the trustee's appeal, no facts are disputed, so we review *de novo* the district court's decision on this question of law. *Adams v. Adams*, 738 F.3d 861, 864 (7th Cir. 2013); *Bernstein v. Bankert*, 733 F.3d 190, 225 (7th Cir. 2013).

1. *Mandate Rule and Law of the Case*

The trustee's collateral estoppel argument is straightforward, if improbable. In the trustee's view, FCStone's failure to appeal the bankruptcy court's oral "clarification" of its prior written order means that FCStone should be bound by that "clarification" rather than being able to rely on the underlying order.

As a preliminary matter, we conclude that the collateral estoppel argument was not even available to the trustee on remand following our decision in *FCStone I*. We did not specifically address collateral estoppel in our prior opinion because the trustee did not raise the issue, even though he had presented it earlier to the district court as an alternative argument in support of his § 549 avoidance action. But our broader discussion of the post-petition transfer left nothing to the imagination on this point. We said that the transfer was authorized and that it therefore "cannot be avoided under the express terms of 11 U.S.C. § 549." *FCStone I*, 746 F.3d at 247. We repeated that the transfer was "clearly authorized" and that, regardless whether the transferred property was part of the bankruptcy estate, "in the absence of reversal, the authorization order ended any discussion about its original ownership, and the disputed property cannot later be clawed back by the trustee." *Id.* at 255.

Given our unambiguous resolution of the dispute over the post-petition transfer, two closely related doctrines—the mandate rule and the law-of-the-case doctrine—should have precluded the trustee from resurrecting his collateral estoppel theory in the district court and getting a second bite at the § 549 apple. Compare *EEOC v. Sears, Roebuck & Co.*, 417 F.3d 789, 796 (7th Cir. 2005) ("In general, any issue conclusively decided by this Court on appeal may not be reconsidered by the district court on remand."), and *United States v. Polland*, 56 F.3d 776, 777 (7th Cir. 1995) ("The mandate rule requires a lower court to adhere to the commands of a higher court on remand."), with *United States v. Adams*, 746 F.3d 734, 744 (7th Cir. 2014) ("The law of the case doctrine is a corollary to the mandate rule and prohibits a lower court from reconsidering on remand an issue expressly *or impliedly* decided by a higher court absent certain circumstances.") (emphasis added) (citation omitted).

The trustee argues that, as appellee in *FCStone I*, he was "not required to advance every possible ground for affirmance." See *Door Systems, Inc. v. Pro-Line Door Systems, Inc.*, 83 F.3d 169, 174 (7th Cir. 1996); see also *Frank v. Walker*, 819 F.3d 384, 387 (7th Cir. 2016). That is true as a general principle, but it is difficult to understand why—when the legal weight of the bankruptcy judge's "clarification" was squarely at issue—the trustee did not cover his bases by arguing in the alternative that the ruling (even if erroneous) was entitled to preclusive effect. In any event, the general privilege of the appellee to renew on remand arguments preserved in the district court gives way to the mandate rule and the law of the case where the argument the appellee would raise is flatly incompatible with a prior mandate of this court.[3]

While we need not go so far as to say, as the district court did, that *FCStone I* rendered the bankruptcy judge's "clarification" a "legal nullity," *Grede*, 556 B.R. at 362, we conclude that the district court acted appropriately in declining to reach the merits of an argument that, if decided in the trustee's favor, would have eviscerated our prior holding.[4]

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[3] At oral argument, we asked the trustee whether any appellate court has ever applied collateral estoppel to revive a trial court ruling it had previously disapproved on the merits. The trustee cited *Federated Department Stores, Inc. v. Moitie*, 452 U.S. 394 (1981), but that case is readily distinguishable. In *Moitie*, two plaintiffs in a consolidated case declined to appeal the district court's dismissal of their claims, while other plaintiffs appealed and obtained relief in the Ninth Circuit after the Supreme Court decided a case raising similar issues. The non-appealing plaintiffs re-filed in state court; the defendants removed the actions, and the federal district court dismissed the claims on res judicata grounds. In a subsequent ruling, the Ninth Circuit held that the non-appealing plaintiffs could "benefit from a reversal" since their litigating position was "closely interwoven" with that of the appealing parties. *Id.* at 398 (citation omitted). The Supreme Court reversed that decision, declining to "countenance[] an exception to the finality of a party's failure to appeal merely because his rights are 'closely interwoven' with those of another party." *Id.* at 400. *Moitie* is not responsive to the question we asked at oral argument. It does not involve a situation in which an appellate court applied preclusive effect to a trial court ruling that the *same appellate court* previously rejected on its merits. *Moitie* also fails to support the trustee's position because, as discussed below, FCStone could not have appealed the bankruptcy judge's "clarification" even if it had wanted to.

[4] As a matter of appellate advocacy, it would ordinarily be prudent for an appellee who deliberately chooses not to argue alternative grounds for affirmance to alert the appellate court to the existence of those alternative grounds. The first time the trustee alerted us to his collateral estoppel

2. *Collateral Estoppel and the Requirement of Finality*

Even if the trustee could have pursued his collateral estoppel theory on remand without running afoul of our mandate in *FCStone I*, the theory would fail on the merits. A party is constrained by collateral estoppel as a matter of federal law only where four criteria are satisfied: "(1) the issue sought to be precluded must be the same as that involved in the prior litigation, (2) the issue must have been actually litigated, (3) the determination of the issue must have been essential to the final judgment, and (4) the party against whom estoppel is invoked must [have been] fully represented in the prior action." *Matrix IV, Inc. v. American Nat'l Bank & Trust Co. of Chicago*, 649 F.3d 539, 547 (7th Cir. 2011) (citation omitted).

The key criterion in this case is finality. Collateral estoppel does not attach to tentative orders. See *Loera v. United States*, 714 F.3d 1025, 1028 (7th Cir. 2013) ("The doctrine of collateral estoppel … teaches that a judge's ruling on an issue of law or fact in one proceeding binds in a subsequent proceeding the party against whom the judge had ruled, provided that the ruling could have been … challenged on appeal, or if not that at least it was *solid*, *reliable*, and *final* … .") (emphasis added); *Amcast Industrial Corp. v. Detrex Corp.*, 45 F.3d 155, 158 (7th Cir. 1995) ("[W]hether a judgment, not 'final' in the sense of 28 U.S.C. § 1291, ought nevertheless be considered 'final' in the sense of precluding further litigation of the same issue, turns upon such factors as the nature of the decision (i.e., that it was not avowedly tentative), the adequacy of the hearing, and the

theory was in his petition for rehearing following our decision in *FCStone I*. Even at that point, the trustee's theory was quite underdeveloped. He did not flesh out this theory until the remand proceedings.

opportunity for review."), quoting *Lummus Co. v. Commonwealth Oil Refining Co.*, 297 F.2d 80, 89 (2d Cir. 1961).

The trustee's collateral estoppel argument fails because the bankruptcy judge's oral "clarification" was not the kind of "solid, reliable, and final" order entitled to preclusive effect. See *Loera*, 714 F.3d at 1028. The judge was ambivalent about whether the post-petition transfer involved funds that should be characterized as property of the estate. He said that he "did not decide" the issue in 2007 and was "not deciding today" in October 2008. By contrast, as we held in *FCStone I*, the August 2007 order itself unambiguously authorized the post-petition transfer and "ended any discussion about … original ownership." 746 F.3d at 255–56. If any order was entitled to preclusive effect, it was the August 2007 order authorizing the post-petition transfer, not the bankruptcy judge's later comments about his subjective intentions.

The trustee points out that he brought his motion in the bankruptcy court under Federal Rule of Civil Procedure 60(b) and that the denial of Rule 60(b) relief is "appealable as a separate final order." See *Stone v. INS*, 514 U.S. 386, 401 (1995). In the trustee's view, FCStone should have appealed from the bankruptcy court's ruling on the Rule 60(b) motion, and its failure to do so should stop it from challenging the substance of that ruling. But Rule 60(b) does not authorize a judge to "clarify" the meaning of a prior order. The rule does authorize a judge to "relieve a party … from a final judgment, order, or proceeding" for good cause, and indeed the trustee asked the bankruptcy judge in the alternative to vacate or modify the August 2007 order. *But the judge denied the motion.* "For the record," he said, "I'm denying the Rule 60(b) motion. I am not going to vacate or modify my order. It stands. I don't think I made any mistake … ." In other words, though the trustee did indeed bring a Rule 60(b) motion, he *lost* his motion. The court took no firm action adverse to FCStone. It would have been extraordinary for FCStone to have tried to appeal a decision in its favor.

We acknowledge that the clarification aspect of the bankruptcy judge's oral ruling arguably was contrary to the position argued by FCStone, but the clarification had no actual effect at that time. It was at best a helpful signal for the avoidance claims the trustee then asserted against FCStone and other SEG 1 customers seeking actual return of the money. It was the district court's later decision on the avoidance claim against FCStone that would have moved money from one party to another (and that we reversed on a timely appeal in *FCStone I*).

The trustee cites no authority for the proposition that a "clarification" that, as we previously held, runs "contrary to the plain language" of the underlying order," *FCStone I*, 746 F.3d at 255, is itself an appealable final order. It is not even clear on what procedural basis the trustee brought his motion to clarify. See *Barton v. Uniserv Corp.*, No. 15 CV 4149, 2016 WL 4577033, at *3 (N.D. Ill. Aug. 30, 2016) (Federal Rules of Civil Procedure do not expressly authorize "motion for clarification"); *Lou v. Ma Laboratories, Inc.*, No. 12-cv-05409 WHA (NC), 2013 WL 1615785, at *1 (N.D. Cal. Apr. 15, 2013) (same); *United States v. Philip Morris USA, Inc.*, 793 F. Supp. 2d 164, 168 (D.D.C. 2011) (same).

While the trustee cites a handful of cases illustrating the breadth of potentially appealable orders, none involved a ruling as vague, open-ended, and inconclusive as the "clarification" here. E.g., *Matrix IV*, 649 F.3d at 549 (bankruptcy orders confirming asset sale, denying creditor's Rule 60(b) challenge to asset sale, and resolving lien priority after full trial, were final and appealable); *Tidwell v. Smith* (*In re Smith*), 582 F.3d 767, 776 (7th Cir. 2009) (bankruptcy order modifying discharge injunction was final and appealable); *Chase Manhattan Mortgage Corp. v. Moore*, 446 F.3d 725, 728 (7th Cir. 2006) (district court order entering summary judgment in bank's favor but failing to order foreclosure was nevertheless final and appealable by mortgagor); *In re UAL Corp.*, 411 F.3d 818, 822 (7th Cir. 2005) (bankruptcy order vacating authorization allowing airline to retain leases was final and appealable).

As a fallback, the trustee argues that "an order does not need to be final to be preclusive, provided it is sufficiently firm and not tentative and the parties were fully heard." That's not quite right. Finality is critical to the application of preclusion doctrines, though as we recognized in *Gilldorn Savings Ass'n v. Commerce Savings Ass'n*, 804 F.2d 390, 393 (7th Cir. 1986), "finality for collateral estoppel is not the same as that required to appeal under 28 U.S.C. § 1291." In *Gilldorn Savings*, however, we added that appealability is still an important factor in considering "whether a decision is 'final' for collateral estoppel purposes." *Id.* at 393, citing *Miller Brewing Co. v. Joseph Schlitz Brewing Co.*, 605 F.2d 990, 996 (7th Cir. 1979).

Even if FCStone's inability to appeal the oral "clarification" should not be treated as dispositive, nothing about that ruling was firm or definite. The ruling did not even make sense. As noted, the bankruptcy judge *denied* the trustee's Rule 60(b) motion, declared that the August 2007 order "stands," and then asserted that he was unprepared to decide the property-of-the-estate question.

We are sympathetic to the bankruptcy judge's situation back in August 2007. He faced extraordinary pressure to make a $300 million decision within a few hours. He was being told by numerous parties that failure to authorize the transfer would force many of the SEG 1 FCMs into bankruptcy themselves, with ripple effects throughout commodity markets and other financial markets. The judge said on the record that he "didn't have the foggiest idea what was going on in this very complicated case." Still, in October 2008, the judge could not undo his prior order (on which financial firms and investors with significant exposure had relied) simply because, in retrospect, the order had consequences he may not have fully appreciated at the time.

In essence, the trustee urges us to adopt a rule providing that a trial court's after-the-fact comments, however inconclusive, should be entitled to preclusive effect so as to supersede a prior binding order. That rule would be unrealistic, and we decline to adopt it. The rule would create new ambiguities that would set traps for parties who rely on court orders, and it would create both incentives and opportunities for their opponents to multiply litigation.

Not only was the bankruptcy court's October 2008 ruling unappealable by FCStone and other SEG 1 customers, it was indefinite and internally inconsistent, and it is entitled to no preclusive effect. Even if the trustee's collateral estoppel argument were not barred by the mandate rule and the law of the case, the argument would fail on its merits. We affirm Judge Zagel's decision rejecting the trustee's collateral attempt to revive his avoidance action against FCStone.

B. *FCStone's Cross-Appeal — The SEG 1 Reserve*

We now turn to FCStone's cross-appeal. In authorizing the post-petition transfer following the Citadel sale, the bankruptcy court required the Bank of New York to hold back $15.6 million (about five percent of the sale proceeds). That amount, along with $4.9 million in proceeds from a late-settling security and certain proceeds of subsequent liquidations, remained in reserve in a SEG 1 account at the bank. As of September 30, 2014, that SEG 1 reserve account had a balance of $24,551,622.

In Count III of his operative complaint, the trustee seeks a declaration as to the ownership of these funds. The trustee argues, and the district court concluded, that the funds should be treated as property of the estate that should be distributed pro rata among all Sentinel customers and other unsecured creditors (including the Bank of New York). *Grede*, 556 B.R. at 366. FCStone counters that the funds belong to it and other SEG 1 customers (the "SEG 1 Objectors") who opposed early drafts of the Chapter 11 plan that would have treated all customers uniformly as unsecured creditors. FCStone argues that the funds are protected by a statutory trust and that it would be improper to disburse that trust property to other claimants—particularly the Bank of New York, which as we previously determined was on "inquiry notice of Sentinel's fraud." *In re Sentinel Management Group, Inc.*, 809 F.3d at 964.

This issue arose on cross-motions for judgment and summary judgment following a bench trial and subsequent remand. We review for clear error the district judge's factual findings, but we review *de novo* his legal conclusions. *Muhammad-Ali v. Final Call, Inc.*, 832 F.3d 755, 760 (7th Cir. 2016). We hold that the funds in the SEG 1 reserve account are trust property belonging to FCStone and other SEG 1 Objectors. These claimants preserved their statutory trust rights and are entitled to the benefit of tracing conventions. Although there are understandable reasons for wanting to treat SEG 3 customers similarly based on their similar statutory protections, we conclude that the SEG 3 customers surrendered those protections by agreeing to be treated as unsecured creditors under the confirmed Chapter 11 plan. Further, FCStone has shown that it can actually trace a portion of the reserve funds back to its initial investment, strengthening its claim to those funds. The district court's reasons for rejecting the tracing would also, we believe, undermine important statutory protections for FCM customers under the Commodity Exchange Act in any future FCM bankruptcies. We reverse the district court's judgment on Count III and remand for entry of judgment in FCStone's favor.

1. *Statutory Trusts and Tracing Conventions*

We begin with a simple statutory proposition. Under the Bankruptcy Code, property held in trust by the debtor for a third party is not property of the debtor's bankruptcy estate. See 11 U.S.C. § 541(d) ("Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest … becomes property of the estate … only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold."); *Begier v. IRS*, 496 U.S. 53, 59 (1990) ("Because the debtor does not own an equitable interest in property he holds in trust for another, that interest is not 'property of the estate.'"); *Marrs-Winn Co. v. Giberson Electric, Inc.* (*In re Marrs-Winn Co.*), 103 F.3d 584, 589 (7th Cir. 1996)

("From the plain language of the Code, one can easily conclude that the debtor's bankruptcy estate does not include property held in trust for another.").

Trust property does not lose its trust character simply because, as in this case, the debtor misappropriated it or commingled it with the debtor's own property. E.g., *Old Republic Nat'l Title Ins. Co. v. Tyler* (*In re Dameron*), 155 F.3d 718, 723–24 (4th Cir. 1998) ("courts have consistently rejected the notion that commingling of trust property, without more, is sufficient to defeat tracing"); *Connecticut General Life Ins. Co. v. Universal Ins. Co.*, 838 F.2d 612, 619 (1st Cir. 1988) ("mere comingling of the trust property with other property of the bankrupt corporation … does not defeat [trust beneficiary's] claim"); *Turley v. Mahan & Rowsey, Inc.* (*In re Mahan & Rowsey, Inc.*), 817 F.2d 682, 684 (10th Cir. 1987) (the "trust pursuit will even allow tracing of trust funds into a commingled mass"); accord, *Universitas Education, LLC v. Nova Group, Inc.*, Nos. 11 Civ. 1590(LTS)(HBP) & 11 Civ. 8726(LTS)(HBP), 2013 WL 6123104, at *12 (S.D.N.Y. Nov. 20, 2013); *Appalachian Oil Co. v. Kentucky Lottery Corp.* (*In re Appalachian Oil Co.*), Bankr. No. 09-50259, 2012 WL 1067731, at *7 (Bankr. E.D. Tenn. Mar. 23, 2012); *Hanley v. Notinger* (*In re Charlie's Quality Carpentry, LLC*), No. 02-11983-JMD, 2003 WL 22056647, at *5 (Bankr. D.N.H. Aug. 25, 2003); *Carlson Orchards, Inc. v. Linsey* (*In re Linsey*), 296 B.R. 582, 586 (Bankr. D. Mass. 2003).

The trustee correctly acknowledges that FCStone and the other SEG 1 customers were the beneficiaries of a statutory trust. Under the Commodity Exchange Act, it is "unlawful for any person to be a futures commission merchant unless … such person shall … treat and deal with all … property received by such person to margin, guarantee, or secure the trades or contracts of any customer of such person, or accruing to such customer as the result of such trades or contracts, as *belonging to such customer*." 7 U.S.C. § 6d(a) (emphasis added); see also 17 C.F.R. § 1.20(f)(3) ("No person … that has received futures customer funds for deposit in a segregated account … may hold, dispose of, or use any such funds as belonging to any person other than the futures customers of the futures commission merchant which deposited such funds."); *Marchese v. Shearson Hayden Stone, Inc.*, 822 F.2d 876, 878 (9th Cir. 1987) ("The legislative history of the Act makes it clear that [§ 6d] establishes a specific statutory trust … and this fact has long been recognized.").

There are powerful policy reasons for according robust protection to investors whose trust property is covered by the Commodity Exchange Act. The CFTC, the regulator responsible for enforcing the Act (and amicus in earlier proceedings), explained:

> The ability of participants in futures markets to rely on the protections provided by section 6d when an FCM becomes insolvent is critical to the functioning of these markets. … In futures transactions there is no equivalent of federal deposit insurance for bank depositors or the Securities Investor Protection Corporation Fund to protect securities investors … . Instead, the requirements of section 6d are the principal legal protection for commodity customer funds against wrongdoing or insolvency by FCMs and their depositories. … Participants in the futures market rely on this protection … and customers' ability to rely on this protection when an FCM

> faces insolvency contributes to the stability of markets in times of stress.

Supplemental *Amicus Curiae* Memorandum of CFTC at 7–8, *Grede v. FCStone, LLC*, 485 B.R. 854 (N.D. Ill. 2013) (No. 09 C 136, Dkt. Entry 87), reprinted in FCStone App. at 839–40.

The Futures Industry Association, Inc., a trade organization and amicus curiae in the current appeals, has made a similar point, describing the district court's decision on remand as opening the door for "non-futures claimants in future FCM bankruptcies to litigate rights to futures margin account property, creating perilous delay and rendering unpredictable the return of futures customers' assets." Brief of *Amicus Curiae*, Futures Industry Ass'n, at 19.

The statutory trust assures futures customers that their funds will be protected from an FCM's general creditors and other customer classes. The trust also assures futures customers that, in the event of an FCM failure, "funds and property can be immediately transferred to the segregated customer accounts of solvent FCMs to … support the ongoing obligations of open trades" and thus can prevent the bankruptcy of a single FCM from starting a domino effect that overwhelms other firms and the larger market. *Id.* at 20. Cf. *In re JPMorgan Chase Bank, NA*, Comm. Fut. L. Rep. (CCH) ¶ 32,156, 2012 WL 1143791, at *5 (C.F.T.C. 2012) ("Without immediate access to customer funds, the FCM is hindered in its ability to satisfy margin requirements. In times where there is a market disruption, any impediment or restriction upon the ability to immediately withdraw funds 'could magnify the impact of any market disruption and cause additional repercussions.'") (citation omitted). We agree that the Commodity Exchange Act and Bankruptcy Code should be interpreted and applied with these concerns in mind.

Though the trustee concedes that the SEG 1 customers were entitled to statutory trust protection, he argues that (1) the SEG 3 customers were likewise the beneficiaries of a statutory trust and (2) the two customer classes are similarly situated under the confirmed Chapter 11 plan. The trustee is correct as to the first point: the Investment Advisers Act, like the Commodity Exchange Act, creates a trust in favor of investors.[5] With respect, however, we believe the trustee is mistaken as to the second point, and that undermines his argument.

This issue concerning the parallel statutory trusts presents the most difficult equitable problem we have confronted in these protracted bankruptcy proceedings. It was understandably the focus of the district court's thinking. As we suggested in *FCStone I*, the default rule should be to treat customers protected by statutory trusts under the Commodity Exchange

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[5] See 17 C.F.R. § 275.206(4)–2(a) ("If you are an investment adviser … it is a fraudulent, deceptive, or manipulative act … for you to have custody of client funds or securities unless: (1) … A qualified custodian maintains those funds and securities: (i) In a separate account for each client under that client's name; or (ii) In accounts that contain only your clients' funds and securities, under your name as agent or trustee for the clients."). While this trust language appears in regulations promulgated by the SEC (whereas the Commodity Exchange Act trust is established by the Act's statutory language itself), we recognized in *FCStone I* that there is "no legal basis for placing one trust ahead of the other," 746 F.3d at 259; see also *Chrysler Corp. v. Brown*, 441 U.S. 281, 295 (1979) ("It has been established in a variety of contexts that properly promulgated, substantive agency regulations have the 'force and effect of law.'") (footnote omitted).

Act and those protected by statutory trusts under the Investment Advisers Act as similarly situated. In this case, the SEG 1 Objectors, including FCStone, steadfastly asserted their rights under the Commodity Exchange Act. The SEG 3 customers, however, agreed to be treated as unsecured creditors without any carve-out or exception for any statutory trust claim that they might otherwise have brought.

That agreement has consequences that we cannot overlook. See *Ernst & Young LLP v. Baker O'Neal Holdings, Inc.*, 304 F.3d 753, 755 (7th Cir. 2002) ("A confirmed plan of reorganization is in effect a contract between the parties and the terms of the plan describe their rights and obligations."), citing *In re Chicago, Milwaukee, St. Paul & Pacific R.R. Co.*, 891 F.2d 159, 161 (7th Cir. 1989); see also 11 U.S.C. § 1141(a) ("[T]he provisions of a confirmed plan bind … any creditor … whether or not the claim or interest of such creditor … is impaired under the plan and whether or not such creditor … has accepted the plan."); *In re Harvey*, 213 F.3d 318, 321 (7th Cir. 2000) ("[A] confirmed plan acts more or less like a court-approved contract or consent decree that binds both the debtor and all the creditors.").[6]

The plan's language confirms that the SEG 1 Objectors and SEG 3 customers are situated differently *under the plan itself*.

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[6] To the extent we suggested in dicta in *FCStone I* that the two customer classes are similarly situated, that dictum is not controlling here. We made clear that we were not deciding the property-of-the-estate issue in our earlier opinion. We decided only that the post-petition transfer was authorized by the bankruptcy court. While we believe our prior dictum is correct as a general proposition, our earlier decision did not require us to scrutinize the provisions of the confirmed Chapter 11 plan that, we hold in this cross-appeal, treat the SEG 1 Objectors differently from the SEG 3 customers.

Under Section 4.4(a), customer claimants are entitled to distributions as set forth in Section 4.5(a). That section in turn provides that customer claimants and unsecured creditors are entitled to pro rata distributions of "Cash and Cash proceeds of all Property, including Customer Property, not allocated for payment of Allowed Claims in other Classes." Section 7.20(a) then creates an exception: "Pending a determination by the Court whether the assets held in the SEG 1 Property Of The Estate Reserve … are property of the Estate, the Trustee shall continue to maintain the Property of the Estate Reserve[]." Section 7.20(a)(i) prescribes the "Seg 1 Property Of The Estate Reserve" as follows:

> On the Effective Date, the Liquidation Trustee shall establish a reserve equal to the amount of all funds held in any bank account denominated as a SEG 1 account, multiplied by a fraction, the numerator of which is the amount of Citadel Beneficiary … Customer Claims attributable to SEG 1 accounts … which voted against the Plan and/or lodged objections thereto, and the denominator of which is the total aggregate amount of … Customer Claims attributable to SEG 1 accounts.

As the trustee himself explained prior to plan confirmation, "the Plan Proponents have established reserves to address the Seg 1 Objectors' contention that certain funds are not property of the estate, *see* Plan § 7.20, and, as such, Customers will share *pro rata* with Holders of General Unsecured Claims only in property that the Court determines is property of the estate." There are no similar provisions for SEG 3 customers.

Section 7.20(c)(i) explains how the disputed funds should be disbursed if the court "determines that the property … is not property of the estate." In that event, "Sections 4.4 and 4.5 of the Plan shall be deemed modified to provide that Customer Property shall be distributed to the rightful owners of such property or to the Estate, as determined by the Court." Reading all these provisions together, as we must, we find that while the confirmed plan treats SEG 1 and SEG 3 customers by default as unsecured creditors, the SEG 1 Objectors alone preserved their right to recover trust property held in reserve, and the plan specifically contemplates that such property may be restored to those customers. SEG 3 customers simply did not preserve a comparable right.

The trustee argues that the final phrase of Section 7.20(c)(i)—"as determined by the Court"—authorizes the court (1) to find that the reserve funds are trust property belonging to the SEG 1 Objectors, yet nevertheless (2) to distribute the property pro rata to all customers and unsecured creditors. Though the text in a vacuum offers some support for the trustee's reading, that reading would lead to a nonsensical result. If the reserve funds belong to the SEG 1 Objectors, the court cannot simply disregard that fact and split the funds among differently situated creditors. For that matter, if the court were vested with such unfettered discretion, what would be the point of the extended adversarial proceedings that have already taken place?

We decline to interpret the confirmed Chapter 11 plan as authorizing an absurd outcome or inviting futile litigation. E.g., *BKCAP, LLC v. Captec Franchise Trust 2000-1*, 572 F.3d 353, 360 (7th Cir. 2009) (where literal application of text would "lead to absurd results" and "thwart the obvious intentions of its drafters," we cannot rely solely on plain language) (citations and internal quotation marks omitted). In context, the phrase "as determined by the Court" refers to the threshold determination whether property is correctly characterized as trust property or property of the estate. Only property of the estate could and should be distributed pro rata to creditors. Property belonging to others must be returned to them.

Since only the SEG 1 Objectors preserved their status as trust claimants with respect to the SEG 1 reserve funds, the problem of co-equal trust claimants addressed in *Cunningham v. Brown*, 265 U.S. 1 (1924), the key case on which the district court relied, is absent here. In its original opinion, the district court indicated that, if it were dealing with a single class of trust claimants, it would "apply every reasonable tracing fiction available to preserve the … trust." *Grede*, 485 B.R. at 878. The district court's original view is consistent with our dictum in *FCStone I*: we emphasized the "national interest" in protecting statutory trust claimants, and we suggested that, in a case involving competing trusts, claimants who cannot actually trace might still be entitled to priority over at least unsecured creditors. 746 F.3d at 259.

Because this case no longer involves competing trust claims by SEG 1 customers under the Commodity Exchange Act and SEG 3 customers under the Investment Advisers Act, we need not rely on our proposed rule of priority. Instead, to ensure that the goals underlying the Commodity Exchange Act are honored, we should accord FCStone and the other SEG 1 Objectors every reasonable opportunity to recover their trust property. If such a customer can trace its initial investment to funds remaining under the control of the Sentinel Liquidation Trust, that customer should be entitled to its proportionate share of those funds. And if the customer cannot actually trace, it should nevertheless be entitled to rely on reasonable tracing conventions (or "fictions"). Though a variety of tracing conventions might be helpful in a case like this, the CFTC proposed that "assets in the Sentinel Seg 1 accounts and portfolios at the time of the Sentinel bankruptcy must be considered to have been held in a trust under the [Act] independent of any requirement on the part of customers to trace particular assets." Supplemental *Amicus Curiae* Memorandum of CFTC at 7–8, *Grede v. FCStone, LLC*, 485 B.R. 854 (N.D. Ill. 2013) (No. 09 C 136, Dkt. Entry 87), reprinted in FCStone App. at 842. We agree with the CFTC's view, though that logic would have extended to customers protected by the Investment Advisers Act as well, at least if they had not agreed to relinquish any such rights.[7]

The securities Sentinel sold to Citadel in August 2007 were (with limited exceptions) segregated for the benefit of SEG 1 prior to the sale; the proceeds of that sale were deposited in segregation for SEG 1; and funds attributable to the five percent holdback and subsequent liquidations were likewise

[7] We recognize that, unlike SEG 1, SEG 3 customers did not have hundreds of millions of dollars in securities or proceeds in their segregated accounts when Sentinel filed for bankruptcy protection. As the last customer class Sentinel raided before going belly-up, SEG 3 was in an inherently weaker negotiating position than SEG 1. But by agreeing to a plan that treated them as unsecured creditors, SEG 3 customers gave up whatever trust claims they might otherwise have asserted. As a practical matter, these customers may ultimately recover less than some other creditor classes. We cannot cover their losses with funds rightfully belonging to SEG 1 customers.

kept in segregation. Pursuant to the tracing convention proposed by the CFTC and urged by the Futures Industry Association and FCStone, the funds should be disbursed pro rata among the SEG 1 Objectors.[8]

2. *Actual Tracing*

As set forth above, FCStone and other SEG 1 Objectors are entitled to the full benefit of reasonable tracing conventions to recover their trust property. But even apart from those conventions or presumptions, FCStone has shown an independent basis for its claim to a share of the SEG 1 reserves. It can actually trace its initial investment to the proceeds of the Citadel security sale (both those proceeds disbursed in the August 2007 post-petition transfer and those remaining in reserve). FCStone has done so through the essentially unrebutted report and testimony of its key expert, Frances McCloskey, a certified public accountant with extensive experience in forensic accounting. For this additional reason, FCStone is entitled to judgment on Count III of the trustee's operative complaint.

a. *Trial Testimony*

McCloskey testified at trial that she had traced (1) all cash and securities within all of Sentinel's records (not only those

[8] At oral argument, FCStone contended that beneficiaries of a statutory trust should enjoy an "irrebuttable" presumption of entitlement to assets held in a segregated account "no matter how they got there." We need not and do not endorse this view. Suppose, for example, that a segregated trust account were shown to contain at the time of a bankruptcy filing a balance exceeding its beneficiaries' contributions and earnings. In such a scenario, an irrebuttable presumption of entitlement obviously would be unjustified.

assets allocated to SEG 1) for 2007, the year Sentinel failed; (2) all customer deposits during that same year to the securities allocated on customers' statements; and (3) the allocation of all securities included in the Citadel sale back to their original dates of purchase (as early as 2004). She then explained how she accomplished this task. Securities are identified by Committee on Uniform Security Identification Procedures (CUSIP) numbers, which are similar to serial numbers. Using these CUSIP numbers, McCloskey was able to test and prove the accuracy of two different accounting ledgers that Sentinel maintained on a daily basis.

One of these two ledgers, the customer ledger, reflected all securities that had been allocated to a particular customer group. The securities allocated to—meaning owned by—a group would change to reflect the value of clients' cash deposits or redemptions. In other words, Sentinel "would exchange customer balances for an exact interest in the market value of a security." Sentinel frequently participated in repurchase or "repo" transactions, that is, transactions where "one party … sells a security to a counterparty … with an agreement to repurchase the security later with interest. " *Bloom*, 846 F.3d at 248. McCloskey found that the customer ledger never reflected "repo" transactions in which securities that Sentinel had loaned to counterparties. Nor did it include unallocated, house-owned securities.

Sentinel's accounting system also included a securities inventory, which, in contrast to the customer ledger, listed by CUSIP number *every* security controlled by Sentinel, including "repo" securities out on loan and Sentinel's own everexpanding pool of riskier securities not allocated to customers. The securities inventory contained no information relevant to customer transactions. According to McCloskey, however, the customer ledger accurately "reflected every customer and every group and each security's allocation or each customer's interest in a security."

McCloskey testified that she performed extensive testing to verify the accuracy of these ledgers and could trace, "to a reasonable degree of accounting certainty, the value that customers deposited at Sentinel, the balances that Sentinel held for their … benefit, and the securities that Sentinel held each day." She found no instances of missing, fictitious, or double-allocated securities. To the contrary, Sentinel's customer statements reflected to the penny the "economic exchange that occurred between the customers and Sentinel for an interest in a pool of securities valued at market for that day" and represented a "true economic transaction."

McCloskey acknowledged, of course, that Sentinel had improperly commingled and illegally pledged customer-owned securities as collateral for its own loan. Even so, McCloskey did not find, after validating the accounting for all of Sentinel's securities inventory for more than 200 business days, any misappropriation of customer assets apart from those segregation violations. Sentinel's misuse of customer assets, although illegal, did not impede McCloskey's ability to trace the assets. The assets still belonged to the respective customers despite having been placed, illegally and temporarily, at risk.

The securities Sentinel sold to Citadel, with few exceptions, had been out of segregation for no more than two brief periods—but long or short, those periods of unlawful conduct did not affect the tracing analysis. McCloskey explained that the potential risks associated with Sentinel's improper use of customer assets did not "have anything to do with what the customer accounting and customer records reflect in terms of the allocation of securities and the exchange of customer balances for interests [in] pools of securities."

For his part, the trustee argued that the customer records on which McCloskey relied should be disregarded in their entirety because Sentinel's segregation violations rendered its record-keeping "a complete fraud" that "can't be the starting point for a tracing analysis." The trustee grounded this assertion in expert testimony by James Feltman, also a CPA. Feltman conceded that Sentinel's customer ledger consistently matched the allocation of securities on customers' statements, but he rejected that data as meaningless because "billions of dollars of [house-owned] securities that are in Sentinel's inventory … don't show up on customer statements," and because Sentinel kept customers in the dark about the risk inherent in its improper pledging of customer assets to secure the Bank of New York loan. Feltman opined that tracing was inappropriate even for securities that had *never* been comingled or subject to a lien in the bank's favor because the securities Sentinel allocated to customer groups typically had been purchased years earlier. In Feltman's view, the allocation process was "arbitrary and didn't have real economic meaning."

McCloskey countered (without contradiction) that Feltman had analyzed only the omnibus custodial account records at the Bank of New York and the Sentinel securities inventory, which, McCloskey said, by their "very nature" are not designed to reflect balances or transactions on a customer-by-customer basis. She contended that Feltman had disregarded the "fundamental concept of book-entry customer accounting" and "look[ed] in the wrong place" by simply ignoring Sentinel's detailed customer ledgers. McCloskey added that Feltman's conclusions were "inaccurate and misleading" because he had focused on the risks from collateralizing client-owned securities, which had no bearing on the ownership of those securities. She opined that his "notion that the customer ledger is somehow fiction or it doesn't represent reality is just wrong," because it ignores the consistent accuracy of Sentinel's record-keeping.

b. *First District Court Opinion*

In its initial opinion, the district court concluded that, using the ledgers and data identified by McCloskey, "it is possible to identify: 1) the custodial location of every Sentinel security held at [the Bank of New York] for all relevant time periods; and 2) the indirect beneficial ownership interest in these securities that Sentinel assigned its customers." *Grede*, 485 B.R. at 864. Nonetheless, the court rejected McCloskey's testimony, calling "nonsensical" her claim to have traced "customers' indirect beneficial ownership in securities" and finding that "tracing is not possible in this case." *Id.* at 878–79 (citation omitted).

The district judge did not, as we read his decision, question McCloskey's credibility. He said explicitly that he did not "disparage the work of Ms. McCloskey, who is an accountant not an attorney" and therefore "should not be expected to understand arcane common law tracing rules." *Id.* at 879 n.20. The judge then explained why, in his view, tracing was not possible:

> But for tracing purposes the critical shortcoming of Ms. McCloskey's report is that it fails to adequately account for the fact that none of Sentinel's customers held specific ownership interests in securities. Rather, they owned pro rata portions of investment portfolios, which Sentinel was free to fill with any of the securities in its pool of assets so long as those securities met the portfolio's investment criteria. Further, these securities were generally purchased [originally] with commingled funds … . The upshot is that the securities held in a given customer group portfolio at any time were not necessarily—indeed, were most improbably—the converted form of the original trust property (i.e. cash deposits) of the customers within that group.

Id. at 879. The judge also asserted that the "fungible nature of cash alone makes it impossible to trace specific securities back to original customer deposits," and thus, "commingling aside, Sentinel's investment model makes tracing essentially impossible because, upon deposit, customer funds were immediately converted into an abstract ownership interest." *Id.* In other words, according to the district court, "Sentinel's pooled investment model renders tracing impracticable because there is no specific form of converted trust property to trace." *Id.* (emphasis omitted).

c. *Remand Proceedings*

After our remand in *FCStone I*, the parties resumed their battle over the reserves and submitted dueling motions for judgment and summary judgment. FCStone filed an affidavit from McCloskey addressing specifically the district court's reasons for rejecting her tracing analysis. She contended that the district court had misunderstood both tracing principles and "how securities markets actually function." The court, she asserted, had overlooked her testimony that customers' cash deposits were exchanged for an ownership interest in specific, identifiable securities held in Sentinel's inventory, which became the traceable trust res. She provided a detailed description of tracing methodology in financial services firms. McCloskey then explained why the fungible nature of cash does not defeat tracing. Customer funds were wired into segregated accounts, and these cash deposits were exchanged daily for ownership interests in CUSIP-identifiable securities, all verifiable through time stamps.

McCloskey also challenged the district court's conclusion that the use of a single clearing account impedes tracing. She clarified that the use of such an account is standard industry practice, pointing out that if the "use of a single clearing account precluded the ability to trace, FCMs and broker-dealers nationwide would not be able to account for or hold customer assets," a result "contrary to accounting principles and industry recordkeeping requirements." Finally, she explained how the use of pooled FCM customer securities accounts is standard industry practice and consistent with CFTC regulations.

The district court's remand opinion again rejected McCloskey's testimony. The court declared tracing "difficult here, if not impossible, because Sentinel's commingling prior to its bankruptcy filing was so appalling." *Grede*, 556 B.R. at 365. The court was particularly troubled by Sentinel's use of "SEG 1 securities in an unauthorized repo transaction," *id.* at 364, but did not otherwise give reasons for rejecting McCloskey's unrebutted analysis.

d. *Discussion*

We agree with FCStone that the district court's explanation for rejecting Frances McCloskey's tracing analysis is not sound and would have troubling implications for protection of FCM customers more broadly. McCloskey testified that "it was actually pretty easy" to follow the trail of assets given the accuracy of Sentinel's customer ledger. The trustee not only failed to rebut this analysis but conceded the consistency of the customer records during closing argument at trial.

Instead of pointing to evidence to rebut McCloskey's analysis, the trustee continues to argue that FCStone relied on "phony" records and a "fictional, arbitrary allocation process with no basis in reality." The trustee is arguing in essence that because Sentinel unlawfully used customer assets as collateral for its own borrowing, all of its records amount to nothing more than smoke and mirrors. The trustee also contends that Sentinel's customer ledgers are unreliable because they do not show securities owned by the house (which seems unsurprising to us since these are *customer* ledgers), and because customer statements did not disclose the risk to customers from Sentinel's use of their assets as collateral to support its own leveraged trading strategy. But the trustee cites no legal authority to show that these facts render Sentinel's internal records meaningless, and he cites no record evidence to show that McCloskey's tracing analysis was flawed. In our view, McCloskey's forensic analysis therefore remains unrebutted.

The trustee insists that tracing is "improper" because it is "merely fortuitous" that Sentinel, on the eve of bankruptcy, had swapped improperly collateralized SEG 1 securities for assets owned by SEG 3 clients. This argument, though central to the trustee's position and the district court's analysis, is a red herring. All parties to this case agree that Sentinel broke the law by using client assets as collateral for its Bank of New York loan. (Two of Sentinel's executives are serving prison sentences, after all.) But that fact does not mean that FCStone cannot prove what it owned. Sentinel *risked* customer assets by pledging them as collateral, but that misconduct did not affect McCloskey's ability to *trace* those assets. The fact that SEG 3 customers happened to be the last victims of Sentinel's machinations does not confer upon the district court broad equitable discretion to remedy their injury at the SEG 1 customers' expense.

The trustee also argues that the district judge found "that FCStone's tracing expert lacked credibility," but the judge said no such thing. Rather, the judge characterized McCloskey's work as valuable to an "understanding of the facts" and expressly avoided disparaging her work or her credibility. *Grede*, 485 B.R. at 879 n.20. The judge rejected McCloskey's conclusion that beneficial interests in pooled securities can be traced easily because, as "an accountant not an attorney," McCloskey "should not be expected to understand arcane common law tracing rules." *Id.* With respect, that assertion is mistaken: McCloskey is a forensic accountant, an expert in financial tracing. As an expert witness in this case, it was her task to break down complex accounting principles for the trier of fact. She did so, tracing customer assets through the pooled investment portfolios for each group of customers, just as FCMs and other financial institutions do routinely. The ability to do so is critical to the day-to-day operation of FCMs and commodity markets and to customer confidence that their property will be protected in the event of an FCM bankruptcy.

In urging us to affirm the district court's ruling on FCStone's cross-appeal, the trustee argues that mixed questions of law and fact not involving constitutional issues are generally reviewed for clear error, see *United States v. Frederick*, 182 F.3d 496, 499 (7th Cir. 1999), and that we accordingly owe substantial deference to the district court's findings. The trustee's explanation of the standard of review is consistent with the weight of authority. See, e.g., *Isby v. Brown*, 856 F.3d 508, 521 (7th Cir. 2017); *Muhammad-Ali*, 832 F.3d at 760; *Trovare Capital Group, LLC v. Simkins Industries, Inc.*, 794 F.3d 772, 778 (7th Cir. 2015); *Morisch v. United States*, 653 F.3d 522, 528 (7th Cir. 2011). But see *Mungo v. Taylor*, 355 F.3d 969, 974 (7th Cir. 2004) ("Both questions of law and mixed questions of law and fact … are reviewed *de novo*."); *FCStone I*, 746 F.3d at 251 (same); *In re Longview Aluminum, L.L.C.*, 657 F.3d 507, 509 (7th Cir. 2011) (same).

Our primary disagreement with the district judge's analysis on this tracing issue, however, concerns not his factual findings (most of these are undisputed) but rather his legal conclusions stemming from and relating to those findings. Those legal conclusions are subject to *de novo* review.

The district judge concluded that tracing is impossible because Sentinel's customers held only pro rata interests in a pooled investment portfolio (i.e., a share of the securities allocated to each investment group) rather than discrete interests in particular securities. Sentinel's investment model does not render tracing impossible. It is undisputed that pooling and allocation is standard industry practice, and CFTC regulations expressly permit FCM customer funds to be held and invested in this manner. See 17 C.F.R. §§ 1.20–1.23. The district court's grounds for rejecting McCloskey's tracing run contrary to the regulations that protect FCM customers' funds. If accepted more broadly, that view could disrupt the futures market by thwarting the ability of investors to trace assets held in a trust in which multiple beneficiaries maintain undivided interests. The likely result would be to undermine confidence of FCM customers that they would actually receive the promised statutory protection in a future FCM bankruptcy.

The district court also concluded that the fungible nature of cash renders tracing impossible, a contention the trustee defends by insisting that "because cash is fungible, FCStone is necessarily confusing actual tracing with tracing with the benefit of a fiction." That logic would hold, however, only if Sentinel maintained customer assets as one undifferentiated pool of cash—similar to the original Ponzi scheme discussed in *Cunningham*, 265 U.S. at 7–9. Instead, Sentinel exchanged customer deposits for a beneficial ownership interest in identifiable securities on a daily basis. The trustee makes much of the fact that securities allocated to customers often were purchased by Sentinel much earlier. But the fact that Sentinel used a buy-and-hold strategy for its securities is irrelevant. The process of converting cash deposits into identifiable securities was unaffected by whether Sentinel already owned the securities or purchased them on the open market in response to new customer deposits.

For similar reasons, the district court erred by concluding that Sentinel's use of a single clearing account impeded the ability to trace customer ownership of securities. McCloskey testified not only that use of a single clearing account is standard industry practice but also that if this practice impeded the ability to trace, "FCMs and broker-dealers nationwide would not be able to account for or hold customer assets," a result "contrary to accounting principles and industry recordkeeping requirements." The trustee did not address this problem on appeal.

The trustee has cited as supplemental authority our decision in *Bloom*, 846 F.3d 243, which was issued after the briefing in these appeals. See Fed. R. App. P. 28(j). He contends that our "detailed discussion of Sentinel's fraudulent operation supports the Trustee's position that FCStone failed to meet its burden of tracing its property to the reserve account because Sentinel's fraudulent conduct made tracing impossible without the benefit of tracing fictions." On the contrary, our discussion in *Bloom* undermines James Feltman's opinion that Sentinel's allocation of securities within its customer ledgers amounted to a fiction. Eric Bloom, Sentinel's former president and CEO, challenged the sufficiency of the evidence supporting his fraud conviction. The government had offered three theories of fraud, one of which was that Bloom had intentionally manipulated customer yield rates to inflate the returns to SEG 1 customers while attributing less interest to SEG 3 than those customers' securities actually earned. *Bloom*, 846 F.3d at 252. To prove its theory, the government had to show which securities were owned by each customer group on a given day and to compare the market interest earned by those securities with the amounts reflected on customer statements. Although the jury's guilty verdicts in *Bloom* do not establish that McCloskey's tracing analysis must be accepted, these verdicts do undercut the trustee's position that Sentinel's fraud rendered tracing impossible.

In short, the district court's rationale for rejecting McCloskey's detailed tracing analysis turned on flawed legal conclusions, not factual determinations, and the trustee failed to rebut FCStone's evidence of actual tracing. FCStone is therefore entitled to judgment on Count III, and FCStone and the other SEG 1 Objectors are entitled to share pro rata in the SEG 1 reserve.

C. *Disputed Claims Reserve*

Before we conclude, we address briefly the Section 7.20(b) "Disputed Claims Reserve," a separate reserve fund established under the confirmed Chapter 11 plan that contained about $3.7 million as of September 30, 2014. FCStone acknowledges the Disputed Claims Reserve in its appellate brief, but it does not discuss the reserve at length, and the trustee ignores the reserve completely.

The Disputed Claims Reserve consists of funds that "any Citadel-Beneficiary Customer Claim which voted against the Plan and/or lodged objections thereto[] would be entitled to receive" but for language in Section 4.5(a) that requires SEG 1 Citadel sale beneficiaries to wait on further distributions until other customers catch up to their level of recovery. The Disputed Claims Reserve was designed to capture the pro rata portions of litigation recoveries and similar distributions that SEG 1 Objectors would have received had the parties agreed up front that the Citadel sale proceeds were SEG 1 trust property (and therefore should not count against the SEG 1 Objectors' pro rata share in the property of the estate).

As discussed in Part II-B, however, we conclude that the SEG 1 reserve funds are trust property belonging to the SEG 1 Objectors both because these statutory trust claimants are entitled to the benefit of tracing conventions and because FCStone has shown that it is possible to trace portions of the reserve back to the customers' initial investment. Likewise, FCStone has shown that it is possible to trace the $297 million post-petition transfer to the Citadel security sale and further to trace the beneficial ownership of those securities all the way back to the dates they were first acquired by Sentinel. Those securities were overwhelmingly allocated to (and segregated for) SEG 1 customers as of the Citadel sale date.

The confirmed Chapter 11 plan accounted for the possibility that the courts might ultimately side with the SEG 1 Objectors on the property-of-the-estate dispute. In addition to Section 7.20(c)(i), which, as discussed above, modifies the plan's distribution provisions if a reviewing court determines that the SEG 1 reserve is not property of the estate, Section 7.20(c)(ii) provides:

> In the event the Court determines that the Citadel Sale Distributions did not constitute distributions of property of the estate, the Claims of Citadel-Beneficiary Customers shall, to the extent such Claims become Allowed Claims, be entitled to *pro rata* distributions with all other Holders of Allowed … Claims with respect to all Property other than Customer Property, without regard to … Plan provisions which provide that until all Holders of Allowed … Customer Claims that are NonCitadel-Beneficiary Customers shall have received a Percentage Recovery on account of such Claims equivalent to the applicable Citadel-Beneficiary Customer, such Citadel-Beneficiary Customer shall not be entitled to a distribution.

Section 7.11, which governs disputed claims reserves generally, similarly provides that "to the extent any … Disputed Claim becomes an Allowed Claim by Final Order, the relevant portion of the Cash held in the Disputed Claims Reserve therefor shall be distributed … to the Claim Holder in a manner consistent with distributions to similarly situated Allowed Claims." In light of these provisions and our conclusions about the post-petition transfer and the SEG 1 reserve funds, the Section 7.20(b) Disputed Claims Reserve should be liquidated and the funds disbursed to SEG 1 Objectors who would have received these funds but for the property-of-the-estate dispute.

For the reasons we have explained, we AFFIRM the district court's judgment as to Counts I and V of the trustee's operative Second Amended Complaint. We REVERSE with respect to Count III and REMAND with instructions to enter judgment for FCStone on that count and for further proceedings consistent with this opinion.

EXHIBIT E

United States Court of Appeals

For the Seventh Circuit
Chicago, Illinois 60604

October 2, 2017

Before

KENNETH F. RIPPLE, *Circuit Judge*

ILANA DIAMOND ROVNER, *Circuit Judge*

DAVID F. HAMILTON, *Circuit Judge*

Nos. 16-1896 & 16-1916

FREDERICK J. GREDE, not individually but as Liquidation Trustee of the Sentinel Liquidation Trust,
Plaintiff-Appellant/Cross-Appellee,

v.

FCSTONE, LLC,
Defendant-Appellee/Cross-Appellant.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.

No. 09 C 136

James B. Zagel,
Judge.

ORDER

On consideration of plaintiff Frederick J. Grede's petition for rehearing and rehearing en banc, filed on September 11, 2017, no judge in active service has requested a vote on the petition for rehearing en banc,* and all judges on the original panel have voted to deny the petition.

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* Judge Joel M. Flaum took no part in the consideration of the petition for rehearing and rehearing en banc.

Accordingly, the petition for rehearing and rehearing en banc filed by plaintiff Frederick J. Grede is DENIED.