No. 17-1086

IN THE
Supreme Court of the United States

FREDERICK J. GREDE, NOT INDIVIDUALLY BUT AS LIQUIDATION TRUSTEE OF THE SENTINEL LIQUIDATION TRUST,

Petitioner,

v.

FCSTONE, LLC,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

REPLY IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

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Stretching to evade the clear conflict between the Seventh Circuit's decision below and *Cunningham v. Brown*, 265 U.S. 1 (1924) and six other courts of appeals, FCStone opens its Opposition by chiding the Trustee for not discussing *Begier v. IRS*, 496 U.S. 53 (1990). (Opp.Br.1-2.) But the applicability of *Begier* is not the *ratio decidendi* for the decision below; the applicability of *Cunningham* is. The Seventh Circuit cites *Begier* only once, in a string cite, for the unremarkable proposition that if a creditor can prove the existence of a trust, Bankruptcy Code §541(d) removes the trust property from the bankruptcy estate. (Pet.App.23a.) But that question is entirely different from the question this case presents.

The question here is *not* whether trust property is bankruptcy estate property. *Begier* and §541(d) already establish that it is not. Instead, this case presents the question whether FCStone is entitled to establish a trust in the first place, given that there are multiple victims of Sentinel's fraud and insufficient funds to satisfy all of their trust claims. On this foundational question, the circuits are split. The Seventh Circuit holds that victims who choose to litigate or otherwise seek to elbow out their fellow creditors are to be preferred notwithstanding *Cunningham.* (Pet.App.27a-32a.) The Second, Fifth, Sixth, Ninth, Tenth, and Eleventh Circuits, consistent with *Cunningham*, reject that proposition and refuse to reward the creditor who is "successful in the race of diligence." *Cunningham*, 265 U.S. at 13; *see SEC v. Credit Bancorp, Ltd.*, 290 F.3d 80, 88-91 (2d Cir. 2002); *Hill v. Kinzler (In re Foster)*, 275

F.3d 924, 926-28 (10th Cir. 2001); *United States v. Real Property Located at 13328 and 13324 State Highway 75 N.*, 89 F.3d 551, 553-54 (9th Cir. 1996); *SEC v. Elliott*, 953 F.2d 1560, 1569-70 (11th Cir. 1992); *First Fed. of Mich. v. Barrow*, 878 F.2d 912, 915-17 (6th Cir. 1989); *Rosenberg v. Collins*, 624 F.2d 659, 662-64 (5th Cir. 1980).

FCStone also portrays the case as being fact-bound and therefore unworthy of this Court's review based upon the supposedly "case-specific fact" that some victims preserved their right to litigate (FCStone and other SEG1 creditors) while others failed to do so (SEG3 creditors). (Opp.Br.3.) But this "case-specific fact" is nothing more than the readily-repeatable conduct of FCStone and its fellow litigants challenging a trustee's efforts to have all fraud victims share equally in a fraudster's bankrupt estate. Indeed, almost eleven years after Sentinel filed for bankruptcy, after a trial, and two reversals in the Seventh Circuit, the Trustee finds himself on this Court's doorstep trying to enforce the principles of *Cunningham* and bring a fair recovery to *all* of Sentinel's victims. Worse yet, because the decision below richly rewards FCStone for embarking on its extended litigation efforts to thwart the Trustee, while severely penalizing Sentinel's other fraud victims for agreeing to share ratably and allowing the Trustee to bring about a fair distribution of what assets remained with Sentinel at its end, fraud victims in the Seventh Circuit, unlike those in six other circuits, now will have to litigate long and hard against trustees to avoid being penalized too.

Far from addressing a unique set of facts unlikely to recur, the decision below will, unless reversed, provide a powerful precedent mandating that all fraud victims must institute and pursue litigation against a trustee simply to preserve their rights to share ratably in commingled trust assets. The Seventh Circuit's unfortunate precedent will burden the courts with unnecessary litigation and put an end to the efficient administration of fraud cases in the Seventh Circuit, causing victims in that Circuit and that Circuit alone to wait longer for their recoveries and to receive far less as litigation costs erode what is distributed. Before this Court allows this to occur, it should review this case.

I. An Important Direct Conflict Exists On The First Question Presented.

A. The Seventh Circuit's Decision Is Not Distinguishable.

FCStone would distinguish the decision below from *Cunningham* and the decisions of the Second, Fifth, Sixth, Ninth, Tenth, and Eleventh Circuits in three ways. (Opp.Br.21-27.) None of these supposed distinctions erase the conflict or make this case inappropriate for addressing this circuit split.

First, FCStone contends there is no conflict because the other circuits do not cite *Begier* and those cases do not involve statutory trusts under 7 U.S.C. §6d(b) ("CEA"). (Opp.Br.22-23.) But *Begier* addresses circumstances very different from those present here. *Begier* holds only that if a debtor makes a voluntary payment of withholding taxes within 90 days of bankruptcy, the trustee cannot recover the payment under 11 U.S.C. §547(b) because of the government's unique trust claim. 496 U.S. at 67. *Begier* does not involve fraud or multiple fraud victims, some of whom are asserting trust claims over limited assets. *Id*. at 55-58. And *Begier* does not concern how a court (or trustee) should allocate funds equitably among creditors of the same priority class. It is *Cunningham*, not *Begier*, that speaks to that issue.

Consistent with *Begier's* marginal relevance here, the Seventh Circuit did not base its decision to break with *Cunningham* and the other circuits on *Begier*. Instead, it included *Begier* in a string cite supporting the statement that if a creditor establishes a trust, the trust property is not part of the bankruptcy estate. (Pet.App.23a.) In fact, *Cunningham* and the circuit decisions that create the conflict here recognize that very same point, though without citing *Begier*. The Tenth Circuit states: "[p]roperty subject to a trust is not property of the bankruptcy estate" citing *Cunningham*. *Foster*, 275 F.3d at 926 (citing 265 U.S. at 11); *see also Barrow*, 878 F.2d at 916; *Rosenberg*, 624 F.2d at 662. The issue this case presents is not the status of property once it is deemed to be trust property, but whether a litigious or recalcitrant fraud victim may establish its own trust when there are multiple fraud victims and insufficient funds to pay all. *Cunningham* and six circuits say no, holding all fraud victims should be treated equally and rejecting a rule that would reward those who choose to litigate for a preference. The Seventh Circuit says yes, creating a conflict only this Court can resolve.

The fact that FCStone asserts a statutory basis for its trust as opposed to a common-law basis is another distinction without a difference. The statutory basis for

FCStone's alleged trust neither explains nor justifies the Seventh Circuit's break with *Cunningham* because the text of §541(d), which carves trust property out of a bankruptcy estate, does not distinguish among the legal bases for a trust. (Pet.App.180a.) It excludes from the bankruptcy estate all trust property, "whether express, statutory or equitable constructive trusts." *Mid-Atlantic Supply, Inc. v. Three Rivers Aluminum Co.*, 790 F.2d 1121, 1125 (4th Cir. 1986).

Cunningham itself suggests no reason its rule would not apply in the case of victims within the same priority class who assert statutory rather than common-law trusts. In fact, the Second Circuit has applied *Cunningham* in a case where, as here, fraud victims asserted competing trust claims under the CEA and the Investment Advisors Act ("IAA"). *CFTC v. Walsh*, 712 F.3d 735, 740, 749-50 (2d Cir. 2013). Other courts also have applied *Cunningham* to statutory trusts. *See, e.g.*, *In re ML & Assocs., Inc.*, 301 B.R. 195, 200 (Bankr. N.D. Tex. 2003); *In re Mich. Boiler & Eng'g Co.*, 171 B.R. 565, 576 (Bankr. E.D. Mich. 1993). And that makes sense. The point of *Cunningham* is to recognize that defrauded creditors within the same priority class should receive distributions that reflect equity, not intransigence, speed, or litigation muscle.

Here, there is no doubt that the relevant creditors have the same priority. The Seventh Circuit held that FCStone's statutory-based trust claim gave it no preference over IAA-protected creditors, holding that there was "no *legal* basis for placing one trust ahead of the other." (Pet.App.27an.5(emphasis added).) The Seventh Circuit recognized that the policy reasons that make CEA-protected trusts important applied equally to IAA-protected trusts. Thus the Seventh Circuit's only basis for favoring FCStone over Sentinel's other creditors was the fact that FCStone was litigating for a preference while other creditors were not. This places the Seventh Circuit's decision squarely at odds with *Cunningham* and six other Circuits.[1]

Second, FCStone contends that because Sentinel's Plan preserved FCStone's right to litigate its trust status, FCStone should be preferred over those fraud victims who elected not to litigate. (Opp.Br.23-25.) The Seventh Circuit's (and FCStone's) focus on what remedies FCStone could pursue under the Plan misses the point. The pertinent question is whether Sentinel's victims were "similarly situated in relationship to the fraud, in relationship to the losses, in relationship to the fraudsters, and in relationship to the nature of their investments." *Walsh*, 712 F.3d at 750; *accord Foster*, 275 F.3d at 927-28; *Barrow*, 878 F.2d at 915-17; *Real Property Located at 13328 and 13324 State Highway 75 N.*, 89 F.3d at 553-54; *Rosenberg*, 624 F.2d at 662-64; *Credit Bancorp*, 290 F.3d at 88-91; *Elliott*, 953 F.2d at 1569-70. Here, all Sentinel customers, whether in SEG3 or SEG1 like FCStone, suffered the same harm when Sentinel misappropriated their funds (Pet.App.119a-

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[1] FCStone infers that Sentinel's IAA-protected creditors could recover from the Securities Investor Protection Corporation Fund (Opp.Br.23), but this fund did not protect Sentinel's customers because Sentinel was not a member. 15 U.S.C. §78ccc(2). Although it did not acknowledge the SEC's brief, the Seventh Circuit adopted the SEC's position that IAA and CEA-based trusts are co-equal. (Pet.App.25a-27a.)

24a), and all invested under identical customer agreements, (Pet.App.110a).

As *Cunningham* itself explained, victims of a fraud are "not to be divided into two classes, those who rescinded for fraud [*i.e.*, sued] and those who were relying on his contract to pay them [*i.e.*, remained unpaid at the time of bankruptcy]. They were all of one class...." 265 U.S. at 13. By holding that FCStone's decision to litigate elevated its claim above those that did not, the Seventh Circuit's decision contradicted *Cunningham* and the decisions of six courts of appeals.

FCStone suggests that this break from *Cunningham* is justified by the text of Sentinel's Plan. (Opp.Br.24-25.) But Sentinel's Plan did not grant FCStone a trust, only the opportunity to litigate for one, subject to the Trustee's complete reservation of all "defenses" to FCStone's trust claim. (Fourth Amended Chapter 11 Plan of Liquidation §6.4, *In re Sentinel Mgmt. Grp. Inc.*, 07-B-14987 (Bankr. N.D. Ill. Dec. 11, 2008), ECF1254.) The Plan also classified both SEG1 and SEG3 customer claims in the same class and the bankruptcy court approved that classification (over FCStone's objection). *In re Sentinel Mgmt. Grp., Inc.*, 398 B.R. 281, 298 (Bankr. N.D. Ill. 2008). Because 11 U.S.C. §1122(a)(1) and §1129(a)(1) require that all claims in the same class be "substantially similar," the bankruptcy court could not have confirmed Sentinel's Plan if confirmation elevated the priority of SEG1 claims over those of SEG3. In fact, the bankruptcy court found the opposite, holding that SEG1 and SEG3 claims were "similar in their legal nature, character, and effect. The SEG 1 and SEG 3 claims are simply unsecured claims.

Hence, these claims *share common legal rights against Sentinel's assets*." *Sentinel*, 398 B.R. at 298 (emphasis added). The confirmation of Sentinel's Plan, therefore, could not justify the Seventh Circuit's split from *Cunningham* and the decisions of six other circuits.

Third, it makes no difference that *Cunningham* was a "Ponzi" scheme and Sentinel committed a different type of fraud. (Opp.Br.26.) The Court based its rule in *Cunningham* on the fundamental principle that "equality is equity," not on the type of fraud the debtor committed. 265 U.S. at 13. The concept of equality applies with equal force under today's Bankruptcy Code. *Begier* holds: "[e]quality of distribution among creditors is a central policy of the Bankruptcy Code." 496 U.S. at 58; *see also Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, 138 S. Ct. 883, 887 (2018) (avoidance actions exist to "ensure equity in[] the distribution to creditors"). That "central policy" applies with equal force no matter the fraud's character, and indeed the type of fraud Sentinel committed played no role in the Seventh Circuit's decision to break from *Cunningham*. (Pet.App.31a-33a.) The district court also rejected this argument, noting that while "Ponzi schemes may provide the most straightforward context for *Cunningham's* application, [] its equitable principles are not so limited." (Pet.App.144an.15.) That Sentinel was not a "Ponzi" scheme is not a reason to deny this Petition.

B. The Conflict Is Not Moot.

FCStone argues that the Court should decline review because, even if this case presents a circuit split, an alternative ground exists for affirming—that

FCStone was able to trace—and so any conflict "is moot." (Opp.Br.27-30.) But this argument ignores that three circuits—the Second, Fifth, and Eleventh—have held that when *Cunningham's* rule applies, fraud victims may not assert a trust even if they can trace without fictions. *See Credit Bancorp*, 290 F.3d at 88-90; *United States v. Durham*, 86 F.3d 70, 72-73 (5th Cir. 1996); *Elliott*, 953 F.2d at 1569-70. Tacitly acknowledging that split, FCStone again attempts to distinguish the Seventh Circuit's decision from these conflicting decisions, again relying upon the irrelevant differences discussed above. (Opp.Br.27-28.)

FCStone makes two additional arguments. (*Id.*) *First*, FCStone notes that the decisions creating this split are federal receivership cases—which it contends differ from bankruptcy cases because bankruptcy courts may only distribute bankruptcy estate property. (Opp.Br.28.) But that is equally true in receivership cases—a receiver may only distribute property of the receivership entity. *Wuliger v. Mfrs. Life Ins. Co.*, 567 F.3d 787, 793, 795 (6th Cir. 2009). In both bankruptcy and federal receivership cases the operative question under *Cunningham* is exactly the same: whether the property is part of the estate *or* belongs to the creditor claiming a trust. *Compare Credit Bancorp*, 290 F.3d at 82 ("[t]he issue...is whether shares of stock...can be included in the receivership estate of the defrauding company for purposes of a *pro rata* distribution to the defrauded victims") *with Foster*, 275 F.3d at 926-27 (addressing whether a trust could be asserted because "[p]roperty subject to a trust is not property of the bankruptcy estate").

Second, FCStone contends that *Cunningham* settled the question whether fraud victims could trace (Opp.28-29), but the Court necessarily did not decide the issue of what it would do if a victim could trace because the defendant in *Cunningham* could not trace its property without using tracing fictions. 265 U.S. at 12-13. Three circuits that have confronted that issue directly have held no form of tracing is allowed. The Seventh and Tenth Circuits hold otherwise, creating a conflict and justifying review here.

C. The Question Presented Is Of Great Importance And Likely To Recur.

FCStone argues that this case is fact-bound making review inappropriate. (Opp.Br.30-31.) What makes this case "unique" according to FCStone is the "fact" that one group wanted to litigate and one group did not. The Seventh Circuit rewarded richly those who litigated and punished those who cooperated by deeming their cooperation waiver. Far from making this case unique, this decision establishes a powerful precedent in a key circuit holding that fraud victims must litigate against a trustee rather than cooperate or risk waiving their rights under *Cunningham*. The Seventh Circuit's unfortunate precedent—which applies across all fraud cases and is not limited to firms in Sentinel's business—will significantly delay distributions in future cases and reduce the amount distributed as unnecessary litigation consumes estate funds.

II. A Circuit Split Exists Over The Form Of Preemption The Seventh Circuit Applied To Bar Creditors' State-Law Claims.

The question the Trustee asks this Court to review is whether the "end run" theory of preemption is a valid basis on which to bar a trustee from bringing state-law claims. The Seventh and Ninth Circuits hold it is: Pet.App.102a; *Miles v. Okun,* 430 F.3d 1083 (9th Cir. 2005). The Third and Sixth Circuits hold it is not: *Rosenberg v. DVI Receivables XVII, LLC*, 835 F.3d 414 (3d Cir. 2016), *Mik. v. Fed. Home Loan Mortg. Corp.*, 743 F.3d 149 (6th Cir. 2014).

FCStone argues there is no circuit split because the Seventh Circuit actually applied "conflict" preemption. (Opp.Br.34-35.) It did not, as is evident from its ruling: "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." (Pet.App.102a (emphasis added).) If the Seventh Circuit had intended to invoke "conflict" preemption it would have said so.

Moreover, if the Seventh Circuit had invoked "conflict" preemption, it would have deepened a conflict over whether "conflict" preemption can bar a trustee from bringing state-law claims. The Sixth and Eighth Circuits answer yes: *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 988 (8th Cir. 2009) and *Pertuso v. Ford Motor Credit Co*., 233 F.3d 417, 426 (6th Cir. 2000). The Third, Ninth, and Tenth Circuits hold it cannot: *Davis v. Yageo Corp.*, 481 F.3d 661, 679-80 (9th Cir. 2007) (assigned state-law fiduciary breach claim); *Integrated Sols., Inc. v. Serv. Support Specialties, Inc.*, 124 F.3d 487, 492-93 (3d Cir. 1997) (state-law tort claims); and *Paul v. Monts*, 906 F.2d 1468, 1475-76 (10th Cir. 1990) (state-law contract claims).

FCStone also would narrow the question to state-law unjust enrichment claims rather than state-law claims more generally. (Opp.Br.32-39.) FCStone does not explain, however, why the strong presumption against preemption applies differently to unjust enrichment claims. (Opp.Br.37-38.) FCStone points to §546(e)'s legislative history, but it makes no mention of barring state-law claims and §546(e)'s text does not either. "If we apply faithfully the presumption against preemption, silence on the part of Congress should be the end of the analysis." *DVI*, 835 F.3d at 422.

FCStone's argument that the Court should deny the Petition because FCStone would prevail on the merits if the courts below had heard the claim is wishful thinking. (Opp.Br.40-41.) The only way to reach the merits is to grant certiorari, reverse, and remand. That is precisely the relief the Trustee requests.

Respectfully submitted,

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