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Can We Keep This Dirty Money: Ponzi Scheme Transfers and the Fouth Circuit's Vague but Workable Standard in re Derivium Capital, LLC

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Can We Keep This Dirty Money?: Ponzi Scheme Transfers and the Fourth Circuit's Vague but Workable Standard in *In re Derivium Capital, LLC*[*]

INTRODUCTION

The term "Ponzi scheme" derives from the notorious 1920s con artist, Charles Ponzi,[1] but its use has boomed since the recession began in 2008.[2] In recent years, Ponzi schemes have been commonly associated with Bernie Madoff, who robbed investors of nearly $50 billion.[3] While Madoff's fraudulent scheme was the largest in United States history,[4] Ponzi schemes have not disappeared and parties continue to bring notable Ponzi scheme cases in courts across the country.[5]

The start of the recession in 2008 forced the unraveling of a record number of Ponzi schemes.[6] When a Ponzi scheme is

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1. *See* Peter S. Kim, Note, *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, 673 n.68. Charles Ponzi operated a scheme that promised quick riches for investors, which collapsed when a Boston newspaper declared Ponzi to be insolvent, thus resulting in an investigation of Ponzi's business and the unraveling of his fraud. *See id.*; *see also* Cunningham v. Brown, 265 U.S. 1, 7–9 (1924) (detailing the collapse of Ponzi's fraudulent scheme).

2. *See* Gary D. Halbert, *Record Year for Ponzi Schemes*, INVESTOR INSIGHT (Jan. 19, 2010, 4:21 PM), http://www.investorsinsight.com/blogs/forecasts_trends/archive/2010/01/19/record-year-for-ponzi-schemes.aspx (explaining that almost 150 fraudulent schemes were uncovered in 2009, which was nearly four times the number of Ponzi schemes uncovered in 2008).

3. *See, e.g.*, Stephen Gandel, *Wall Street's Latest Downfall: Madoff Charged with Fraud*, TIME (Dec. 12, 2008), http://content.time.com/time/business/article/0,8599,1866154,00.html (describing the Madoff scandal as "a massive Ponzi scheme"); Jordan Maglich, *Madoff Ponzi Scheme, Five Years Later*, FORBES (Dec. 9, 2013, 10:30 AM), http://www.forbes.com/sites/jordanmaglich/2013/12/09/madoff-ponzi-scheme-five-years-later/ ("While Charles Ponzi's namesake scheme had given the fraud its name back in the 1920's, Madoff's arrest quickly transformed 'Ponzi scheme' into a household word.").

4. *See* DENIS COLLINS, *Case Study: Bernie Madoff's Ponzi Scheme*, *in* BUSINESS ETHICS: HOW TO DESIGN AND MANAGE ETHICAL ORGANIZATIONS 435, 435 (2011), *available at* http://dcollins.faculty.edgewood.edu/pdfdocuments/Madoff%20Case.pdf.

5. *See* Constance Parten, *After Madoff: Most Notable Ponzi Scams*, CNBC, http://www.cnbc.com/id/41722418 (last updated Apr. 18, 2011).

6. *See, e.g.*, *Busted Ponzi Schemes Quadrupled in 2009*, CBS NEWS (Dec. 28, 2009, 4:20 PM), http://www.cbsnews.com/news/busted-ponzi-schemes-quadrupled-in-2009/ (estimating that the recession unraveled nearly four times the number of scams in 2009

uncovered, it is likely to become the subject of various legal proceedings.[7] In addition to criminal and civil suits, the scheme's crash often results in the operating enterprise's bankruptcy, thus subjecting the entity to bankruptcy proceedings.[8] The primary purpose of these bankruptcy proceedings is to recover money to repay the bankrupt enterprise's creditors.[9] However, there are limitations to carrying out this goal. Notably, Congress created an exception to the transactions that can be returned to creditors, also known as avoidance, by enacting § 546(e) of the Bankruptcy Code ("Code"), the stockbroker safe harbor provision ("stockbroker defense").[10] Under § 546(e), "[a] trustee may not avoid a transfer that is a . . . settlement payment . . . made by or to (or for the benefit of) a . . . stockbroker."[11] Thus, § 546(e) immunizes transfers that qualify as "settlement payments" made from the debtor to a stockbroker, thereby preventing avoidance of those transfers and lessening the amount that can be repaid to creditors.[12] However, an exception to the exception exists: transactions made to a stockbroker that normally would receive protection under § 546(e) may be avoided and returned to creditors if the debtor in bankruptcy fraudulently transferred the money involved.[13]

Courts have reached incongruous results in applying § 546(e)'s stockbroker defense. The discord begins with defining the terms

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than 2008); Parten, *supra* note 5 ("In all, more than 150 Ponzi schemes collapsed in 2009, compared to about 40 in 2008 . . . .").

7. *See* R. ALEXANDER PILMER, RICHARD L. WYNNE & MARK T. CRAMER, KIRKLAND & ELLIS LLP, KIRKLAND ALERT: IN THE WAKE OF COLLAPSE: APPROACHES TO PONZI SCHEME LITIGATION 1–2 (Feb. 2009) [hereinafter KIRKLAND ALERT], *available at* http://www.kirkland.com/siteFiles/Publications/BFA6C410069121A85A79531FF51D5509.pdf. Defrauded investors are also likely to bring civil claims against the Ponzi scheme operators. *See id.*

8. *See id.*

9. *See* Menchise v. Akerman Senterfitt, 532 F.3d 1146, 1151 (11th Cir. 2008) ("The main purposes of bankruptcy law are to collect all of the assets and liabilities of an entity, to pay the creditors of the bankrupt to the fullest extent possible, and to give the debtor a fresh start.").

10. *See* Act of July 27, 1982, Pub. L. No. 97-222, § 4, 96 Stat. 235, 236 (1982) (codified as amended at 11 U.S.C. § 546(e) (2012)) (amending § 546 of title 11 by adding subsection (d), which prohibits a trustee from avoiding a transfer that is a margin payment or a settlement payment); Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 351(2), 98 Stat. 333, 358 (redesignating subsection 546(d) as subsection 546(e)).

11. 11 U.S.C. § 546(e) (2012).

12. *See id.*

13. *See id.* § 548(a)(1)(A) ("The trustee may avoid any transfer . . . incurred by the debtor . . . if the debtor voluntarily or involuntarily . . . made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud.").

contained in the statute.[14] Some courts have applied the safe harbor broadly while others limit its application to public market transactions only.[15] In a matter of first impression for the Fourth Circuit Court of Appeals, the court in *Grayson Consulting, Inc. v. Wachovia Securities, LLC (*In re *Derivium Capital LLC)*[16] expanded the application of the stockbroker defense to protect commissions, fees, and margin payments paid to a brokerage firm even though the underlying transfers were made in connection with an alleged Ponzi scheme.[17] In addition, the court held that the commission payments at issue must be reasonable and customary in the industry in order to qualify as "settlement payments."[18] No other appellate court has taken either approach.[19] As a result, the Fourth Circuit established a new standard in stockbroker defense law that not only allows commission payments to be shielded from avoidance under § 546(e), but also holds that these payments must be reasonable and customary in the industry.

This Recent Development proceeds in four parts. Part I begins with a background discussion of the Code's stockbroker safe harbor provision and then examines the varying approaches courts have taken in applying this exception to the avoidance power of trustees in bankruptcy proceedings. Part II focuses on the facts and holding of *Derivium Capital* and describes how the Fourth Circuit broadly applied the stockbroker defense in the context of an alleged Ponzi scheme. Part III discusses the Fourth Circuit's analysis in *Derivium Capital*, arguing that while the court's ruling to extend § 546(e) to include commissions shown to be reasonable and customary in the industry was vague, this shortcoming should be adequately rectified through subsequent case law. Part III also argues that the court

14. *See infra* Part I.A.

15. *See infra* Part I.B (describing differences in circuit courts' application of the defense). The Second, Third, Sixth, Eighth, and Tenth Circuits define "settlement payments" broadly to include both public and private market transactions, *see infra* notes 42–43 and accompanying text, while the Ninth Circuit and a few district courts take the "public market" approach, *see infra* notes 37–38 and accompanying text. The Eleventh Circuit has not specifically adopted a public market approach, but it has indicated its willingness to only apply § 546(e) to public market transactions by applying the stockbroker defense very narrowly. *See infra* note 37.

16. 716 F.3d 355 (4th Cir. 2013).

17. *See id.* at 364–65.

18. *See id.*

19. *See id.* at 363 n.6 ("It appears that there are no cases expressly addressing whether § 546(e) immunizes commissions."); Richard L. Costella & Kristen M. Siracusa, *Fraudulent Conveyance Law and the Stockbroker Defense*, 32 AM. BANKR. INST. J. 16, 64 (2013).

correctly declined to add an extra-statutory Ponzi scheme exception to the stockbroker defense because it would be unnecessary and would disrupt the balance between the goals of securities and bankruptcy law. Part IV provides insight into the possible implications of *Derivium Capital* and urges courts to use caution when applying a broad definition of "settlement payment" in order to provide consistency and clarity to an ambiguous and convoluted doctrine.

I. SAFE HARBOR PROVISIONS: THE STOCKBROKER DEFENSE

A. Background

Under the Code, an entity's filing for Chapter 7 bankruptcy triggers the liquidation process.[20] Upon an entity entering liquidation in bankruptcy, the U.S. Trustee or a creditor assigns a trustee to the entity,[21] and this trustee has certain powers and tasks.[22] One of the trustee's main responsibilities is to collect the debtor's assets, liquidate them, and distribute the proceeds among its creditors.[23] To carry out this task, the Code provides bankruptcy trustees the authority to "avoid" certain transfers and obligations the debtor made prior to the bankruptcy proceeding.[24] In doing so, the trustee can "claw back" certain assets to be returned to the debtor's creditors.[25]

However, the trustee's power to avoid transactions and return the assets to the debtor's creditors is not without limitation. Section 546(e) of the Code provides a crucial limitation that "the trustee may

20. *See* 11 U.S.C. §§ 701–784 (2012). *See generally Chapter 7: Liquidation Under the Bankruptcy Code*, U.S. COURTS, http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter7.aspx (last visited Mar. 25, 2014) (explaining the Chapter 7 liquidation process).

21. *See* §§ 701, 702.

22. *See id.* § 704; *see also* BLACK'S LAW DICTIONARY 1656 (9th ed. 2009) (defining a trustee in the bankruptcy context as "a person appointed by the U.S. Trustee or elected by creditors or appointed by a judge to administer the bankruptcy estate during a bankruptcy case," whose duties include "collecting and reducing to cash the assets of the estate" and "investigating the debtor's financial affairs"); Samuel P. Rothschild, Note, *Bad Guys in Bankruptcy: Excluding Ponzi Schemes from the Stockbroker Safe Harbor*, 112 COLUM. L. REV. 1376, 1379–80 (2012) (discussing a trustee's powers in a bankruptcy proceeding).

23. *See* § 704.

24. *Id.* § 544.

25. Rothschild, *supra* note 22, at 1380. For an in-depth discussion of the term "claw back" as it relates to Ponzi schemes, see generally Miriam A. Cherry & Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 94 MINN. L. REV. 368 (2009).

not avoid a transfer that is a . . . settlement payment . . . made by or to . . . a stockbroker."[26] In other words, the trustee does not have the power to claw back a payment the debtor made to a stockbroker or if the debtor itself is a stockbroker.[27] Thus, the stockbroker defense becomes an exemption from the avoidance provision of the Code, thereby limiting the power of the bankruptcy trustee to return assets to creditors.[28]

By enacting this safe harbor provision for stockbrokers, Congress aimed to prevent the insolvency of one financial institution from spreading to other institutions and threatening the collapse of the financial market.[29] That is, Congress did not want a major bankruptcy of one firm to have a "domino effect" and negatively affect the financial industry as whole.[30] Ultimately, this safe harbor provision exists as a tool to promote stability within the financial market.[31]

Even though the stockbroker defense appears to be straightforward, courts have struggled to apply the defense consistently. This difficulty begins with the definition of "settlement payment" as used in § 546(e). The Code defines "settlement payment" as "a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade."[32] Unfortunately, this definition is circular in nature—it defines "settlement payment" only

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26. § 546(e). "Stockbroker" is defined as one who is "engaged in the business of effecting transactions in securities." *Id.* § 101(53A)(B).

27. *See* Rothschild, *supra* note 22, at 1380.

28. *See id.*

29. *See* H.R. REP. NO. 97-420, at 2 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583, 583–84. The House Judiciary Committee summarized the purpose of the provision:

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

Id.

30. *See id.*

31. *See* Kim, *supra* note 1, at 663; *cf.* H.R. REP. NO. 109-31, at 3, 20, 131, 132 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 89, 105, 191, 192 (noting that one goal of the Bankruptcy Code is to reduce "systemic risk" in the marketplace).

32. 11 U.S.C. § 741(8) (2012).

by reference to other undefined "settlement payment[s]."[33] One court described the definition as "cryptic" because "[e]ssentially, it provides that a settlement payment is a settlement payment."[34] Thus, the definition gives courts little guidance about whether or not a specific transaction would qualify under the definition. Courts are therefore left to interpret the statute on their own and try to do so while maintaining Congress's goals in enacting this provision.[35]

B. How Courts Apply the Stockbroker Defense

Given that the Code provides a circular definition for the term "settlement payment," it is not surprising that courts have adopted divergent methods to interpreting the stockbroker defense in bankruptcy avoidance proceedings. When applying the stockbroker defense, courts usually focus on its legislative history or how "settlement payments" are understood in the context of the securities industry.[36] Regardless of the method employed, courts continuously disagree about how expansive the definition is itself.

In one camp, a minority of courts has applied a "public market" approach, which defines the term "settlement payment" narrowly.[37]

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33. *See id.*; *see also* Alfa, S.A.B. de C.V. v. Enron Creditors Recovery Corp. (*In re* Enron Creditors Recovery Corp.) (*Enron Creditors I*), 422 B.R. 423, 433–34 (S.D.N.Y. 2009), *aff'd*, Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V. (*Enron Creditors II*), 651 F.3d 329 (2d Cir. 2011) (recognizing the circularity of the definition).

34. Zahn v. Yucaipa Capital Fund, 218 B.R. 656, 675 (D.R.I. 1998).

35. *See, e.g.*, Official Comm. of Unsecured Creditors of Norstan Apparel Shops, Inc. v. Lattman (*In re* Norstan Apparel Shops, Inc.), 367 B.R. 68, 76–77 (Bankr. E.D.N.Y. 2007) (defining the term "settlement payment" in light of Congress's purpose in enacting § 546(e)).

36. *See Enron Creditors II*, 651 F.3d at 345–46 (pointing to the congressional goals of "preventing a 'race to the courthouse' and ensuring equality of distribution among creditors" and applying these goals in evaluating the lower court's decision); Kaiser Steel Corp. v. Charles Schwab & Co., 913 F.2d 846, 849 (10th Cir. 1990) (recognizing that its interpretation of " 'settlement payment' ... is consistent with the way 'settlement' is defined in the securities industry"); *Norstan Apparel Shops*, 367 B.R. at 76 ("[I]n the context of the legislative history of these provisions, the modifying phrase at the end of § 741(8) must be understood, at a minimum, to mean that in order to be encompassed in the statutory definition of 'settlement payment,' a transaction must involve the public securities markets."). Whether courts focus on legislative intent, context in the industry, or both does not appear to be contested extensively.

37. *See, e.g.*, Kipperman v. Circle Trust F.B.O. (*In re* Grafton Partners, L.P.), 321 B.R. 527, 538–40 (B.A.P. 9th Cir. 2005) ("[C]ommon elements in decisions finding that there is not a protected settlement payment are that the securities involved are not publicly traded and public markets are not utilized."); *Norstan Apparel Shops*, 367 B.R. at 76–77 (defining a "settlement payment" as "a transaction ... involv[ing] the public securities market"); Official Comm. of Unsecured Creditors v. Asea Brown Boveri, Inc. (*In re* Grand Eagle Cos.), 288 B.R. 484, 494 (Bankr. N.D. Ohio 2003) (refusing to expand the definition of "settlement payment" to include all payments "for the purchase and sale of privately held

These courts largely agree that the Code defines "settlement payment" broadly but refuse to extend its application outside of the public market.[38] That is, these courts generally require the transaction to involve the formal clearance and settlement process, and for the transfer to be of a publicly traded security in a public market.[39] This view implies that avoidance of a non-public transaction typically would not be of enough significance that it could disrupt the financial market.[40] In this view, the sole purpose behind § 546(e) is to stabilize the financial market; therefore, only transactions directly tied to this purpose—public market transactions—should be excluded.[41]

In contrast, most courts interpret the term "settlement payment" broadly.[42] These courts focus on the plain language of the Code to incorporate a variety of transactions into the definition.[43] The definition of "settlement payment" under § 741(8) concludes with the phrase "or any other similar payment commonly used in the securities

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stock [made] through a financial institution"). The Eleventh Circuit has narrowly applied § 546(e), but it did so by focusing on whether the transfer "was 'made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, or securities clearing agency' " rather than narrowly defining "settlement payments." Munford, Inc. v. Valuation Research Corp. (*In re* Munford, Inc.), 98 F.3d 604, 610 (11th Cir. 1996) (quoting 11 U.S.C. § 546(e) (1988)).

38. *See, e.g.*, *Grafton Partners*, 321 B.R. at 538–40 ("The transaction in question did not occur on a public market and did not involve the process of clearing trades. This places it within the pattern of cases that have concluded that a statutorily-protected 'settlement payment' is not present.").

39. *See* Robert G. Richardson, *Unsettled "Settlement Payments" in § 546(e)*, 27 AM. BANKR. INST. J. 12, 44 (2008) (citing Kapila v. Espirito Santo Bank (*In re* Bankest Capital Corp.), 374 B.R. 333 (Bankr. S.D. Fla. 2007); *Norstan Apparel Shops*, 367 B.R. 68).

40. *See id.* at 46.

41. *See id.*

42. For a commentary on this trend, see generally Christopher W. Frost, *The Continued Expansion of Section 546(e): Has the Safe Harbor Swallowed the Rule?*, 31 BANKR. L. LETTER NO. 10, at 1 (2011).

43. *See Enron Creditors II*, 651 F.3d 329, 334–35 (2d Cir. 2011) (applying the stockbroker defense to an issuer's early redemption of commercial paper); Brandt v. B.A. Capital Co. (*In re* Plassein Int'l Corp.), 590 F.3d 252, 257–59 (3d Cir. 2009) (extending its previous definition of settlement payments to include transactions in privately held securities); QSI Holdings, Inc. v. Alford (*In re* QSI Holdings, Inc.), 571 F.3d 545, 549–50 (6th Cir. 2009) ("[N]othing in the text of § 546(e) precludes its application to settlement payments involving privately held securities."); Contemporary Indus. Corp. v. Frost, 564 F.3d 981, 989 (8th Cir. 2009) (exempting payments exchanged for privately held stock as settlement payments within in the meaning of § 546(e)); Lowenschuss v. Resorts Int'l, Inc. (*In re* Resorts Int'l, Inc.), 181 F.3d 505, 514–15 (3d Cir. 1999) (noting the court's prior recognition "that the definition [of 'settlement payment'] is extremely broad"); Jonas v. Resolution Trust Corp. (*In re* Comark), 971 F.2d 322, 326 (9th Cir. 1992) ("We now join with the Third and Tenth Circuits and broadly define the term settlement payment."); Kaiser Steel Corp. v. Charles Schwab & Co., 913 F.2d 846, 848 (10th Cir. 1990) (interpreting the definition of a "settlement payment" to include a transfer of consideration in a leveraged buyout).

trade."[44] Under the broad view, this phrase acts as a "catchall" to include a wide range of transactions.[45] In construing the term broadly, courts do not differentiate between public and private securities; a transaction will be classified as a "settlement payment" as long as it is an ordinary securities transaction.[46]

C. *An Exception to the Exception: Fraudulent Transfers and the Effect of Ponzi Schemes*

As noted, the Code provides a safe harbor for stockbrokers as an exception to the trustee's power to avoid certain transactions made by the debtor in bankruptcy.[47] In addition, an exception to the stockbroker defense exists for fraudulent transfers: a trustee *can* avoid transfers made with "actual intent to . . . defraud."[48] Therefore, even in the case of stockbroker transfers, trustees can reclaim assets that occurred as a part of a fraudulent transfer and use the money to pay the debtor's creditors.

One context in which fraudulent transfer claims arise is when transfers are made in connection with a Ponzi scheme. The term Ponzi scheme refers to "an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors."[49] Inherently, Ponzi schemes lack any legitimate business and operate by distributing proceeds from new investors to old investors, thus creating the misconception that the enterprise is profitable.[50] Although Ponzi schemes can last years or even decades, they ultimately crash whenever the operator fails to recruit enough new investors to pay current ones.[51] When this inevitable collapse occurs, the Ponzi scheme operator or entity will typically be subject to several legal proceedings.[52] Federal prosecutors

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44. 11 U.S.C. § 741(8) (2012).

45. *See Frost*, 564 F.3d at 986 ("[T]he phrase follows a long list of various kinds of settlement payments and so we think it is most naturally read as a catchall phrase intended to underscore the *breadth* of the § 546(e) exemption.").

46. *See, e.g.*, *QSI Holdings*, 571 F.3d at 550 ("[N]othing in the text of § 546(e) precludes its application to settlement payments involving privately held securities."); *Frost*, 564 F.3d at 986 ("Nothing in the relevant statutory language suggests Congress intended to exclude these payments from the statutory definition of 'settlement payment' simply because the stock at issue was privately held.").

47. *See supra* Part I.A.

48. *See* § 548(a)(1)(A).

49. *Ponzi Schemes*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/answers/ponzi.htm (last visited Mar. 25, 2014); *see* Kim, *supra* note 1, at 673.

50. *See* Kim, *supra* note 1, at 673–74.

51. *See* KIRKLAND ALERT, *supra* note 7, at 1.

52. *See id.*

usually bring criminal charges against the Ponzi scheme operator,[53] but any related business enterprise will likely file for liquidation in bankruptcy as well.[54]

The existence or allegation of a Ponzi scheme can affect the availability of safe harbor provisions for stockbrokers in numerous ways. For example, in bankruptcy proceedings, courts have created a so-called "Ponzi scheme presumption." Under this approach, "the finding of a Ponzi scheme creates a presumption of actual fraud as a matter of law on all parties and transactions involved."[55] When the Ponzi scheme presumption is applied, the court presumes that all transactions are fraudulent for purposes of § 548(a)(1) and permits trustees to avoid these transfers generally.[56]

However, in some scenarios, the Ponzi scheme presumption may not allow avoidance of all Ponzi scheme transfers. For example, because courts use the presumption to assume the presence of actual fraud, the presumption may not apply in lawsuits against transferees that received transfers from the fraudulent entity if the transferee can establish its good faith.[57] In addition, § 548(a)(1) only applies to

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53. *See* Benjamin B. Wagner, *Financial Crimes on Main Street Are as Devastating as Those on Wall Street*, U.S. DEP'T OF JUSTICE, http://www.justice.gov/usao/briefing_room/fin/investment_fraud.html (last visited Mar. 25, 2014).

54. *See* KIRKLAND ALERT, *supra* note 7, at 1–2. Several dissolution proceedings may occur, including Securities and Exchange Commission ("SEC") receivership, Securities Investor Protection Corporation ("SIPC") liquidation, and bankruptcy. *Id.* Additionally, the SEC may bring enforcement actions against individuals and entities for operating the Ponzi scheme. *See SEC Enforcement Actions Against Ponzi Schemes*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/spotlight/enf-actions-ponzi.shtml (last updated Sept. 6, 2013).

55. Kim, *supra* note 1, at 674; *see, e.g.*, Perkins v. Haines, 661 F.3d 623, 626 (11th Cir. 2011); Quilling v. Schonsky, 247 F. App'x 583, 586 (5th Cir. 2007); Christian Bros. High Sch. Endowment v. Bayou No Leverage Fund, LLC (*In re* Bayou Group, LLC), 439 B.R. 284, 294 (S.D.N.Y. 2010); Bear, Stearns Sec. Corp. v. Gredd (*In re* Manhattan Inv. Fund Ltd.), 397 B.R. 1, 10 (S.D.N.Y. 2007); Stoebner v. Ritchie Capital Mgmt., L.L.C. (*In re* Polaroid Corp.), 472 B.R. 22, 36 (Bankr. D. Minn. 2012); Liebersohn v. Campus Crusade for Christ, Inc. (*In re* C.F. Foods, L.P.), 280 B.R. 103, 110 (Bankr. E.D. Pa. 2002).

56. *See* Craig T. Lutterbein, Note, *"Fraud and Deceit Abound" but Do the Bankruptcy Courts Really Believe Everyone Is Crooked: The* Bayou *Decision and the Narrowing of "Good Faith,"* 18 AM. BANKR. INST. L. REV. 405, 407–08 (2010); *see also* Mark A. McDermott, *Ponzi Schemes and the Law of Fraudulent and Preferential Transfers*, 72 AM. BANKR. L.J. 157, 173–75 (1998) (providing an in-depth analysis of the relationship between Ponzi schemes and fraudulent transfer claims). For an illustration of how a party's assertion of the stockbroker defense can be adversely affected a court's application of the Ponzi scheme presumption, see Kim, *supra* note 1, at 676–79. Academics have long criticized the application of the Ponzi scheme presumption. While these criticisms are beyond the scope of this Recent Development, for an example of how the Ponzi scheme presumption may result in inequitable consequences, see Rothschild, *supra* note 22, at 1386–1402.

57. *See* 11 U.S.C. § 550(b)(1) (2012).

transfers made within two years of the bankruptcy filing.[58] Therefore, even if the Ponzi scheme presumption is applied and the presumption of actual fraud is not rebutted, only transfers made two years before the bankruptcy filing would be avoided. As a result, transfers made in connection to early Ponzi scheme profits would not be returned to creditors.[59] Most recently, the Fourth Circuit addressed the application of the stockbroker defense in the Ponzi scheme context in *Derivium Capital.*

II. *GRAYSON CONSULTING, INC. V. WACHOVIA SECURITIES, LLC* (IN RE *DERIVIUM CAPITAL LLC*)

A. Factual Background and the Fourth Circuit's Ruling

Derivium Capital, LLC ("Derivium") was the debtor in a Chapter 7 bankruptcy proceeding as the result of the collapse of its "90% Stock-Loan Program," an alleged Ponzi scheme.[60] Under the loan program, investors pledged publicly traded stock in exchange for loans worth ninety percent of the stock's market value.[61] At the end of three years, "customers had the option of repaying the principal plus interest and recovering the stock, surrendering the stock, or refinancing the loan for an additional term."[62] The investors placed their investments into Wachovia brokerage accounts under the promise that Derivium would hedge their collateral using a "confidential, proprietary formula."[63] Instead, Derivium instructed Wachovia to liquidate the stock immediately.[64] After liquidation, Derivium's operators used the proceeds to fund customers' loans and their own start-up ventures.[65] When the loans matured, Derivium could not return the stock to customers, prompting Wachovia to close the accounts and Derivium to file for bankruptcy.[66] In 2007, the

58. *Id.* § 548(a)(1).

59. *See* Rothschild, *supra* note 22, at 1378.

60. *See* Grayson Consulting, Inc. v. Wachovia Sec., LLC (*In re* Derivium Capital LLC), 716 F.3d 355, 358–59 (4th Cir. 2013).

61. *Id.* at 359.

62. *Id.*

63. *Id.*

64. *Id.*

65. *Id.* at 358–59.

66. *Id.* at 358. Derivium originally filed for Chapter 11 bankruptcy in the Southern District of New York, but that court converted the case to Chapter 7 and transferred it to the District of South Carolina. *Id.* at 358–59. Kevin Campbell was appointed Derivium's trustee, but Campbell assigned the claims to Grayson Consulting, Inc. ("Grayson"), which purchased the Trustee's rights for $25,000 and was substituted as the plaintiff in December

trustee filed tort[67] and avoidance claims[68] against Wachovia, seeking the avoidance of "commissions, fees, and margin interest paid to Wachovia" as fraudulent transfers under § 548(a)(1).[69]

At the bankruptcy court hearing, the court first considered whether the commissions, fees, and margin interest payment Derivium paid to Wachovia[70] could be protected from recovery under § 546(e).[71] The court concluded that the transfers could be protected if the commissions at issue were reasonable and customary in the securities industry.[72] After conducting a subsequent evidentiary hearing to determine whether the commissions were reasonable and customary in the industry, the court ruled that the commissions were protected from avoidance under the stockbroker defense.[73]

On appeal to the Fourth Circuit, Grayson argued that § 546(e) does not protect commissions, and even if it did, "Wachovia's commissions ... were uncommonly low and therefore should have been excluded from protection under the bankruptcy court's own test."[74] Specifically, Derivium received a sixty percent discount from Wachovia's standard commission rate.[75] In addition, Grayson contended that Wachovia only conferred discounts on less than two percent of its customers, thus the low commissions Derivium paid to

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of 2007. Grayson Consulting, Inc. v. Wachovia Sec., LLC (*In re* Derivium Capital, LLC), 396 B.R. 184, 187–88 (Bankr. D.S.C. 2008).

67. The tort claims were: "(1) aiding and abetting fraud; (2) aiding and abetting breach of fiduciary duty; (3) aiding and abetting fraudulent conveyance; (4) aiding and abetting conversion; (5) negligence; (6) breach of fiduciary duty; (7) conversion; (8) civil conspiracy; and (9) constructive trust." *Derivium Capital*, 716 F.3d at 359 n.3.

68. *Id.* at 359.

69. *Id.*

70. Derivium Capital, LLC is the debtor in bankruptcy and Bancroft Ventures Limited ("Bancroft"), WITCO Services (UK) Ltd. ("WITCO"), and Optech Limited ("Optech") are considered "Stock Loan Entities." *See* Grayson Consulting, Inc. v. Wachovia Sec., LLC (*In re* Derivium Capital, LLC), 437 B.R. 798, 802–03 (Bankr. D.S.C. 2010), *aff'd*, 716 F.3d 355 (4th Cir. 2013). The plaintiff's Third Amended Complaint alleged that the owners and operators of Derivium Capital "exercised dominion and control over the Stock Loan Entities" and that Derivium Capital "had brokerage accounts with [Wachovia] in the name of [Derivium Capital] and in the names of the Stock Loan Entities." *Id.* at 802, 804. As such, when this Recent Development refers to commissions paid by Derivium, it includes those commissions paid by Bancroft, WITCO, and Optech.

71. *Id.* at 810–13.

72. *See id.*

73. Grayson Consulting, Inc. v. Wachovia Sec., LLC (*In re* Derivium Capital, LLC), No. 5-15042, 2011 Bankr. LEXIS 577, at *9 (Bankr. D.S.C. 2011), *aff'd*, 716 F.3d 355 (4th Cir. 2013).

74. *Derivium Capital*, 716 F.3d at 363.

75. Grayson Consulting, Inc. v. Wachovia Sec., LLC (*In re* Derivium Capital, LLC), No. 5-15042, 2011 Bankr. LEXIS 577, at *6 (Bankr. D.S.C. 2011).

Wachovia were neither reasonable nor customary.[76] In contrast, Wachovia argued that approximately fifty to seventy-five percent of its clients received discounted commissions ranging anywhere from five to ninety-five percent.[77]

In one final attempt to avoid the transfers at issue before the Fourth Circuit, Grayson urged the court to adopt an extra-statutory Ponzi scheme exception to § 546 that would permit avoidance even if the transfers qualified as "settlement payments" and would otherwise be protected under the stockbroker defense.[78] Grayson argued that without an extra-statutory Ponzi scheme exception, "a broker [would be allowed] to retain its ill-gotten profits," which "undermines the equitable goals of the Bankruptcy Code."[79]

Ultimately, the Fourth Circuit held that the commissions, fees, and margin interest Derivium paid to Wachovia could be protected under the stockbroker defense even though Wachovia charged Derivium commissions at a substantially discounted rate[80] and even though Derivium likely paid these commissions with Ponzi scheme profits. In addition, the Fourth Circuit upheld the bankruptcy court's novel test that the commissions could be protected as "settlement payments" under the stockbroker defense as long as they are shown to be reasonable and customary when settling securities transactions.[81] The court also refused to add an extra-statutory Ponzi scheme exception to § 546(e), reasoning that such an exception was unnecessary given the current fraudulent transfer exceptions the Code already provides.[82]

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76. *Derivium Capital*, 716 F.3d at 365.

77. *Id.*

78. *Id.* at 366.

79. Brief for Plaintiff-Appellant at 51, *Derivium Capital*, 716 F.3d 355 (No. 12-1518), 2012 WL 2360891, at *51.

80. *Derivium Capital*, 716 F.3d at 364–65. Between September 1, 2002, and September 1, 2005, Bancroft paid Wachovia $359,842.51 in commissions, which averaged 0.34% of the transaction value of the securities on the account, Optech paid $293,464.19, which averaged 0.37% of the transaction value of the securities on the account, and WITCO paid $52,562.72, which averaged 0.21% of the transaction value of the securities on the account. Grayson Consulting, Inc. v. Wachovia Sec., LLC (*In re* Derivium Capital, LLC), No. 5-15042, 2011 Bankr. LEXIS 577, at *6–9 (Bankr. D.S.C. 2011). Thus, Wachovia received commissions from the Stock Loan Entities totaling $705,869.42. In addition to the holdings discussed, the Fourth Circuit also affirmed several other aspects of the district court's decision: (1) the Customer Transfers were not transfers of Derivium's property; (2) Wachovia was not the initial transferee of the Cash Transfers; (3) margin interest payments qualified as "margin payments" under § 546(e); and (4) *in pari delicto* barred Grayson's tort claims against Wachovia. *Derivium Capital*, 716 F.3d at 363–67.

81. *See Derivium Capital*, 716 F.3d at 364–65.

82. *See id.*

In the end, the court never reached the issue of whether Wachovia committed actual fraud under § 548(a)(1).[83] Thus, the court permitted Wachovia to retain the commissions, fees, and margin payments it received from an entity that operated a Ponzi scheme.[84]

B. *The Fourth Circuit's Approach: Broad Application of "Settlement Payment"*

In deciding whether Wachovia's commissions and fees constituted "settlement payments" under the stockbroker defense, the Fourth Circuit followed the methodology of other courts by examining legislative intent and industry texts.[85] The court noted, and both parties agreed, that Congress's intent behind enacting § 546(e) was to stabilize the securities market in the event of a major bankruptcy.[86] Moreover, the court concluded that an analysis of industry texts was necessary because Congress included the phrase "any other similar payment commonly used in the securities trade" when defining the phrase "settlement payment."[87]

After examining two industry texts[88] and *Black's Law Dictionary*,[89] the Fourth Circuit defined a "settlement payment" as a "transfer of funds paid in connection with completing a securities transaction."[90] This broad definition of "settlement payment" aligned with the definitions provided by the Third, Sixth, Eighth, and Tenth Circuits.[91] When applying this definition to Wachovia's transfers, the court held that "Section 546(e)'s plain language, viewed through the lens of its legislative intent, does not exclude commissions and fees

83. *See id.* at 366. The bankruptcy court did not reach the issue of whether Grayson established a fraudulent transfer claim under § 548(a)(1)(A), finding it "not ripe for determination." Grayson Consulting, Inc. v. Wachovia Sec., LLC (*In re* Derivium Capital, LLC), 437 B.R. 798, 813 (Bankr. D.S.C. 2010), *aff'd*, 716 F.3d 355 (4th Cir. 2013).

84. *Derivium Capital*, 716 F.3d at 366. These claims were later settled out of court. *Id.*

85. *See id.* at 364.

86. *See id.*

87. *Id.* at 363–64 (citing 11 U.S.C. § 741(8) (2012)).

88. *See id.* at 364 (citing N.Y. STOCK EXCH., THE LANGUAGE OF INVESTING GLOSSARY 30 (1983); GRP. OF THIRTY, CLEARANCE AND SETTLEMENT SYSTEMS IN THE WORLD'S SECURITIES MARKETS 86 (1989)).

89. *See id.* (citing BLACK'S LAW DICTIONARY 398 (9th ed. 2009)).

90. *Id.*

91. *See id.* (citing QSI Holdings, Inc. v. Alford (*In re* QSI Holdings, Inc.), 571 F.3d 545, 549 (6th Cir. 2009); Contemporary Indus. Corp. v. Frost, 564 F.3d 981, 985 (8th Cir. 2009); Lowenschuss v. Resorts Int'l, Inc. (*In re* Resorts Int'l, Inc.), 181 F.3d 505, 515 (3d Cir. 1999); Kaiser Steel Corp. v. Pearl Brewing Co. (*In re* Kaiser Steel Corp.), 952 F.2d 1230, 1237 (10th Cir. 1991)).

commonly paid to stockbrokers as part of settling a regular securities transaction."[92]

Even though the Fourth Circuit defined "settlement payments" broadly to include commissions, it did not apply this definition without limitation. The court held that only commissions shown to be reasonable and customary in the sale of stock are encompassed within the definition of "settlement payments."[93] For example, the court provided that a commission payment for the solicitation of investors would not be protected under the definition.[94] In summary, by examining the bankruptcy court's opinion, legislative intent, industry texts, and definitions used by sister circuits, the Fourth Circuit broadly defined "settlement payments" and was the first appellate court to include commission payments found to be reasonable and customary in the industry in that definition.

III. THE FOURTH CIRCUIT'S ANALYSIS: A VAGUE BUT WORKABLE STANDARD AND PROPER REFUSAL TO ADD AN EXTRA-STATUTORY EXCEPTION

A. Vague, yet Workable: How Parties Should Interpret "Reasonable and Customary"

The Fourth Circuit aligned with other circuits by defining "settlement payments" broadly,[95] but the Fourth Circuit's extension of "settlement payments" to include commissions that are reasonable

92. *Id.* at 364–65.

93. *See id.* Along with commissions and fees paid to Wachovia, the trustee also sought to avoid margin interest payments made to Wachovia that the bankruptcy court protected as "margin payments" under § 546. *See id.* at 365. The interpretation and analysis of "margin payments" is beyond the scope of this Recent Development. For purposes of this analysis, it is only crucial to understand that the Fourth Circuit held that margin interest payments qualified as "margin payments" under § 546(e) and thus could receive protection under the stockbroker defense. *See id.* at 365–66; *see also* 11 U.S.C. § 741(5) (2012) (defining "margin payment" as "payment or deposit of cash, a security, or other property, that is commonly known to the securities trade as original margin, initial margin, maintenance margin, or variation margin, or as a mark-to-market payment, or that secures an obligation of a participant in a securities clearing agency"); Hays v. Morgan Stanley DW Inc. (*In re* Stewart Fin. Co.), 367 B.R. 909, 917 (Bankr. M.D. Ga. 2007) (applying a broad definition of "margin payment").

94. *Derivium Capital*, 716 F.3d at 364. The court focused on the "closing" or "settling" of trades and securities accounts to make the "settlement payments" determination. *See id.* Arguably, when a commission payment is made for the solicitation of an investor, the payment is being made for the acquisition of services, not the closing of a specific trade. Therefore, these payments would not constitute "settlement payments" and would not be protected under § 546(e). *See id.*

95. *See supra* Part II.B.

and customary in the industry was neither based on the statutory text of § 546(e) nor case law.[96] Consequently, the Fourth Circuit has established new law that extends the protection of the stockbroker defense to commissions, but it also has a new standard "that requires a stockbroker to take the additional evidentiary step of showing that the commissions in question were reasonable and customary in the industry."[97]

The Fourth Circuit based its establishment of new stockbroker defense law on the legal conclusions of the bankruptcy court, but it should have reviewed the bankruptcy court's conclusions in greater depth. Generally, circuit courts are required to review legal conclusions de novo in reviewing appeals from bankruptcy proceedings.[98] The definition of "settlement payment" is a matter of statutory construction, and thus is a question of law,[99] yet the court failed to apply that standard. To provide adequate de novo review, the Fourth Circuit should have considered the application of the stockbroker defense to commissions as if it had never been decided.[100] However, in its analysis, the court relied only on its broad definition of "settlement payments" and the inclusion by *Black's Law*

96. *See* Costella & Siracusa, *supra* note 19, at 64.

97. *Id.*

98. *Derivium Capital*, 716 F.3d at 360 (citing Goldman v. Capital City Mort. Corp. (*In re* Nieves), 648 F.3d 232, 237 (4th Cir. 2011)). Considering a matter de novo requires the court to "determine it anew, as if it had not been heard before and no decision had been rendered. Properly defined, *de novo* treatment comprehends a new hearing." Yepes-Prado v. U.S. Immigration & Naturalization Serv., 10 F.3d 1363, 1367 n.5 (9th Cir. 1993) (internal citation omitted).

99. *See, e.g.*, *Enron Creditors II*, 651 F.3d 329, 334 (2d Cir. 2011). The Fourth Circuit's reasonable and customary standard originated with the bankruptcy court's order in the *Derivium Capital* litigation. That court discussed the standard in its conclusions of law:

> By order issued September 14, 2010, the Court determined that recovery of the commissions at issue in this adversary proceeding may be barred as [a] matter of law by the "stockbroker defense," as "payment[s] commonly made in the securities industry," if they were reasonable and customary. Considering that the application of the stockbroker defense to commissions appears to be one of first impression, the Court, in an abundance of caution, sought facts to ensure that the commissions at issue were not unusually high or in variance with commissions commonly received in the industry. In expressing that inquiry, the Court articulated the "reasonable and customary" standard. It does not appear in the language of the statute.

Grayson Consulting, Inc. v. Wachovia Sec., LLC (*In re* Derivium Capital, LLC), No. 5-15042, 2011 Bankr. LEXIS 577, at *6–7 (Bankr. D.S.C. 2011), *aff'd*, 716 F.3d 355 (4th Cir. 2013).

100. *See, e.g.*, United States v. George, 971 F.2d 1113, 1118 (4th Cir. 1992) ("By definition, *de novo* review entails consideration of an issue as if it had not been decided previously.").

Dictionary of a "broker's commission" as an example of a "transaction cost" before concluding that commissions qualify as "settlement payments."[101] The court's analysis hardly seems to rise to the level of considering the issue "anew."[102] If the Fourth Circuit had analyzed the bankruptcy court's legal conclusions in greater depth, it could have provided more insight into how lower courts and litigants should apply the stockbroker defense to commissions.

At first glance, the Fourth Circuit's analysis of the stockbroker defense seems to contribute to the defense's convolutedness. The court added two inherently abstract concepts—"reasonable" and "customary"—to an already obscure doctrine. Without more insight into what exactly constitutes reasonable and customary in the industry, the court's ruling is vague and overly broad. In future litigation, parties and lower courts attempting to apply the Fourth Circuit's holding will have little knowledge about which transactions would be considered reasonable and customary and which evidentiary steps to take to meet the standard. The court could have avoided some potential confusion that may result from its ruling by analyzing the bankruptcy court's establishment of the reasonable and customary standard for commissions in greater depth.

Even though the Fourth Circuit's adoption of this new stockbroker defense may appear overly vague and broad, when applied in practice, it should act as a benefit to stockbrokers, thus conforming to Congress's intent for enacting § 546(e).[103] Parties and lower courts attempting to discern the Fourth Circuit's ruling and obtain insight into the application of the reasonable and customary standard should review the factual findings of the bankruptcy court in *Derivium Capital*.[104]

When the Fourth Circuit reviewed the bankruptcy court's factual findings, it recognized that when settling the stock transactions at issue, Wachovia charged commissions to Derivium at substantially discounted rates.[105] Nevertheless, the court upheld these commissions

101. *See Derivium Capital*, 716 F.3d at 364 (citing BLACK'S LAW DICTIONARY 398 (9th ed. 2009)).

102. *See Yepes-Prado*, 10 F.3d at 1367 n.5.

103. *See supra* notes 29–31 and accompanying text (discussing Congressional intent underlying the stockbroker defense).

104. Grayson Consulting, Inc. v. Wachovia Sec., LLC (*In re* Derivium Capital, LLC), No. 5-15042, 2011 Bankr. LEXIS 577, at *3–9 (Bankr. D.S.C. 2011), *aff'd*, 716 F.3d 355 (4th Cir. 2013).

105. *See Derivium Capital*, 716 F.3d at 365. Wachovia representatives testified that approximately fifty to seventy-five percent of Wachovia's clients received discounted rates

as reasonable and customary because an industry representative testified at the bankruptcy court evidentiary hearing that they were "fair, reasonable, and customary and well within the ... FINRA [Financial Industry Regulatory Authority], NASD [National Association of Securities Dealers] rules."[106] Therefore, it seems that parties and lower courts should look to industry resources such as FINRA and NASD rules or expert testimony in order to decide whether a "settlement payment" qualifies as reasonable and customary in the industry. For example, Wachovia's representative testified that a substantial portion of its clients receive commission discounts, thus providing evidence that the commissions at issue were customary.[107] In addition, the bankruptcy court explained that NASD rules require commissions to be "fair," which usually means they do not exceed 5% of the transaction amount and discounts are permitted as long as they are "in variance in with commissions commonly received in the industry."[108] Even though the bankruptcy court's factual findings do not offer comprehensive guidance as to how to apply the reasonable and customary standard to commissions, they should give direction to parties attempting to argue whether certain commissions qualify as "settlement payments" under the stockbroker defense.

Likely, the commissions that lower courts will consider reasonable and customary will be determined by practice. Perhaps what is reasonable and customary will depend on the type of account, length of relationship between the parties, or specific volume of business expected.[109] Litigants should be prepared to provide

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at anywhere between five and ninety-five percent discounts. *Id.* Brokerage firms may offer steep discounts to clients to attract a large amount of business. *See id.*

106. *Id.* (alterations in original) (citation omitted) (internal quotation marks omitted). NASD was the former name of the regulating agency for securities firms, which combined with the New York Stock Exchange member regulation operations to form FINRA in 2007. *See* News Release, FINRA, NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority – FINRA (July 30, 2007), *available at* http://www.finra.org/Newsroom/NewsReleases/2007/p036329. FINRA is a not-for-profit organization authorized by Congress to regulate the securities industry by "writing and enforcing rules governing the activities of more than 4,100 securities firms with approximately 635,800 brokers; examining firms for compliance with those rules; fostering market transparency; and educating investors." *About FINRA*, FINRA, http://www.finra.org/AboutFINRA/ (last visited Mar. 25, 2014).

107. *See Derivium Capital*, 716 F. 3d at 365.

108. Grayson Consulting, Inc. v. Wachovia Sec., LLC (*In re* Derivium Capital, LLC), No. 5-15042, 2011 Bankr. LEXIS 577, at *11 (Bankr. D.S.C. 2011).

109. *See id.* at *4–5. In its findings of fact, the bankruptcy court noted that "[d]iscounts of 60% or higher from a firm's standard commission rate were not unusual for, among

evidence to support their arguments regarding commissions under the reasonable and customary standard—potentially, this will entail consulting an expert witness or other industry resources. In *Derivium Capital*, only Wachovia provided expert testimony, and, coincidence or not, Wachovia prevailed.[110] If this result is any indication of the weight courts will give to expert testimony when making the reasonable and customary determination, parties should seek out experts to help make their cases. Therefore, while the reasonable and customary standard may appear vague on its face, subsequent case law should work out the nuances of the standard.

B. *The Fourth Circuit Correctly Declined to Create a Ponzi Scheme Exception*

The Fourth Circuit's refusal to establish an extra-statutory Ponzi scheme exception to § 546(e) suggests that protection for stockbrokers was one of its foremost considerations.[111] In its decision, the court relied on the Ponzi scheme presumption and express exception for fraudulent transfers[112] to uphold the Code's equitable goals. Adoption of an extra-statutory Ponzi scheme exception to § 546 in *Derivium Capital* would have permitted avoidance of the commissions, fees, and margin interest payments Derivium paid to Wachovia even if they otherwise qualified as "settlement payments," thus barring the application of the stockbroker defense.[113] Unlike the Ponzi scheme presumption, an extra-statutory Ponzi scheme would apply even in the absence of actual fraud. Presumably, an extra-statutory Ponzi scheme exception would override the stockbroker defense, forgoing the need for a trustee to establish the existence of a Ponzi scheme to evoke the Ponzi scheme presumption in order to assume actual fraud.

Given the existence of the Ponzi scheme presumption and exception for fraudulent transfers under § 548(a)(1), the Fourth Circuit correctly refused to add an extra-statutory Ponzi scheme exception to the stockbroker defense. An extra-statutory Ponzi scheme exception to the stockbroker defense is both unnecessary,

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others, large clients who conducted, or were expected to conduct, a significant volume of business with a full service brokerage firm." *Id.*

110. *See Derivium Capital*, 716 F.3d at 365.

111. *See id.* at 366 ("Grayson fails to convince us we need to establish an extra-statutory fraud exception to the stockbroker defense.").

112. *See id.*

113. *See id.*

and, more importantly, would disrupt the balance between the goals of the Code and securities law.

An extra-statutory Ponzi scheme exception is unnecessary because the stockbroker defense already excludes fraudulent transfers in two specific ways. As explained by the court, a statutory exception applies when actual fraud can be proven.[114] Next, and most important in this case, Ponzi scheme transfers inherently will be excluded from the industry meaning of "settlement payment."[115] A Ponzi scheme transfer can never be considered reasonable and customary because it is marked by fraud. By its very nature, "a transaction bearing badges of fraud will rarely be one that a market participant would call customary."[116] In order to conceal the fraud, parties involved will "resort to unusual combinations of contracts" and take abnormal measures during the transaction.[117] Under the Fourth Circuit's new reasonable and customary test for commissions, a Ponzi scheme transaction would necessarily be excluded because the fraud underlying the transaction would be atypical for the securities industry, and thus could not be considered reasonable and customary. Therefore, an additional extra-statutory Ponzi scheme exception to the stockbroker defense is unnecessary.

Furthermore, such an exception would disrupt the balance between the goals of bankruptcy and securities law. The tension between these goals is most evident in the relationship between the Code's stockbroker defense and fraudulent transfer exception.[118] The stockbroker defense exists to stabilize the securities market, while the fraudulent transfer exception exists to remedy securities fraud.[119] When applying these provisions, courts are aware of the need to balance both goals. The Second Circuit has aptly characterized the issue: "By restricting a bankruptcy trustee's power to recover payments that are otherwise avoidable under the Bankruptcy Code, the safe harbor stands 'at the intersection of two important national legislative policies on a collision course—the policies of bankruptcy

114. *See* 11 U.S.C. § 548(a)(1)(A) (2012). An exception to the stockbroker defense also exists when transfers are found to be constructively fraudulent. *See id.* § 548(a)(1)(B).

115. *See* Rothschild, *supra* note 22, at 1405 (citations omitted).

116. Edward R. Morrison & Joerg Riegel, *Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges*, 13 AM. BANKR. INST. L. REV. 641, 659 & n.115 (2005) (citing Kipperman v. Circle Trust F.B.O. (*In re* Grafton Partners, L.P.), 321 B.R. 527, 540 (B.A.P. 9th Cir. 2005)).

117. *Id.* at 659.

118. *See* Rothschild, *supra* note 22, at 1377–78.

119. *Id.*

and securities law.' "[120] If courts established an extra-statutory Ponzi scheme exception, the goals of bankruptcy law would be given preference. In effect, an extra-statutory Ponzi scheme exception would disrupt this balance by favoring the goals of bankruptcy law over those of securities law, thus destroying the very harmony courts should aim to preserve when applying the stockbroker defense.[121]

IV. BROKERAGE FIRMS, BREATHE EASIER: SUGGESTIONS AND OUTLOOK AFTER *DERIVIUM CAPITAL*

In this case of first impression for the Fourth Circuit, the court's broad application of "settlement payments" strengthened the protections of the Code for brokerage firms against fraudulent transfer claims in the Ponzi scheme context.[122] In effect, brokerage firms now will be able to retain commissions, margin payments, and other fees associated with a transaction as long as they are reasonable and customary in the securities industry—even in the context of an alleged Ponzi scheme.[123] Presently, the Fourth Circuit is the first and only court to extend the protections of the stockbroker defense to commission payments and to adopt the "reasonable and customary in the industry" standard, and it remains to be seen whether other courts adopt this standard as well.[124]

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120. *Enron Creditors II*, 651 F.3d 329, 334 (2d Cir. 2011) (quoting Lowenschuss v. Resorts Int'l, Inc. (*In re* Resorts Int'l, Inc.), 181 F.3d 505, 515 (3d Cir. 1999)).

121. *See* Kipperman v. Circle Trust F.B.O. (*In re* Grafton Partners, L.P.), 321 B.R. 527, 538 (B.A.P. 9th Cir. 2005) ("[T]he statutory protection of settlement payments presupposes that securities laws are not being offended. In other words, Public Law 97-222 operated to coordinate and harmonize the securities laws and the Bankruptcy Code."); *see also supra* note 10 and accompanying text (describing the enactment of § 546(e)).

122. *See* Kathy Bazoian Phelps, *Fourth Circuit Makes New Fraudulent Transfer Law*, PONZI SCHEME BLOG (June 19, 2013), http://www.theponzibook.blogspot.com/2013/06/fourth-circuit-makes-new-fraudulent.html.

123. *See* Grayson Consulting, Inc. v. Wachovia Sec., LLC (*In re* Derivium Capital LLC), 716 F.3d 355, 364–66 (4th Cir. 2013).

124. Costella & Siracusa, *supra* note 19, at 64. For example, the Second Circuit refused to require that "settlement payments" be "commonly used in the securities industry." *Enron Creditors II*, 651 F.3d at 336. The court reasoned:

> [A]pplication of the safe harbor in every case [would] depend on a factual determination regarding the commonness of a given transaction. It is not clear whether that determination would depend on the economic rationality of the transaction, its frequency in the marketplace, signs of an intent to favor certain creditors . . . or some other factor. This reading of the statute would result in commercial uncertainty and unpredictability at odds with the safe harbor's purpose and in an area of law where certainty and predictability are at a premium.

The Fourth Circuit's holding in *Derivium Capital* was just one example of how courts are broadening the definition of "settlement payments" under the stockbroker defense. However, going forward, courts should be wary of expanding this definition to an even greater degree. Because Congress "intended the safe harbors to protect the market from systematic risks by providing stability, consistency, and clarity,"[125] courts should seek to provide stability, consistency, and clarity when applying safe harbor law.

When courts inappropriately broaden the definitions and interpretations of crucial safe harbors, they risk undermining the purpose of these provisions. When a statute's plain language is ambiguous, courts consider legislative intent or legislative history.[126] The plain language of § 546 is undoubtedly ambiguous,[127] yet since Congress enacted § 546(e) in 1978, courts have continued to expand its scope far beyond the original congressional intent.[128] Congress intended the stockbroker defense to reduce systematic risk in the financial market by preventing the insolvency of one firm from disrupting the market as a whole.[129] However, some courts are now applying the stockbroker defense when there is little to no risk the transactions would impact the market at all.[130] By applying the stockbroker defense to insignificant transactions, to which Congress did not intend for the defense to apply, courts move further away from using the safe harbor as a tool to promote market stability. In doing so, courts untether the exception from its justification.[131] Therefore, courts should only apply the stockbroker defense to cases

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Id. Similarly, in *Kaiser Steel*, the Tenth Circuit held that payments in connection with a leveraged buyout constituted "settlement payments" under § 546(e) even though the leveraged buyout may not be a "routine" securities trade. *See* Kaiser Steel Corp. v. Pearl Brewing Co. (*In re* Kaiser Steel Corp.), 952 F.2d 1230, 1239–40 (10th Cir. 1991).

125. Kim, *supra* note 1, at 693.

126. *See* Hoffman v. Comshare, Inc. (*In re* Comshare, Inc. Sec. Lit.), 183 F.3d 542, 549 (6th Cir. 1999).

127. *See supra* Part I.A.

128. *See* George V. Utlik & Schuyler G. Carroll, *The Safe Harbor Provided for "Settlement Payments" by Section 546(e)*, 19 NORTON J. BANKR. L. & PRAC. 321, 331 (2010).

129. *See supra* Part I.A.

130. *See, e.g.*, Cyganowski v. Lapides (*In re* Batavia Nursing Home, LLC), Bankr. Nos. 11-13223 K, 11-13225 K, Adv. No. 12-1145 K, 2013 WL 3934237, at *1, *2 (Bankr. W.D.N.Y. July 29, 2013) (holding that § 546(e) could be applied to protect $1.2 million at issue in leveraged buyout of privately held securities even though the amount "seems to be far more remote from the 'financial markets' than [another case involving $106 million]").

131. *Cf.* Arizona v. Gant, 556 U.S. 332, 343 (declining to adopt a broad interpretation of an exception to the Fourth Amendment's warrant requirement because doing so would "untether the [exception] from [its] justifications").

in line with congressional intent and only protect "settlement payments" from avoidance when doing so would actually stabilize the financial market.

The inconsistency with which courts have interpreted "settlement payments" under the stockbroker defense, coupled with the increasing number of bankruptcy proceedings, act as a call to Congress or the Supreme Court to provide some finality on the issue. Either Congress will have to clarify the ambiguous definition of "settlement payment" provided in the Code or the Supreme Court will have to set a concrete standard for applying this safe harbor provision.[132] In the interim, it remains to be seen how courts will interpret "settlement payments" in the Ponzi scheme context following the Fourth Circuit's establishment of new fraudulent transfer law. As one commentator noted, until then, "Section 546(e) will remain one of the most controversial provisions of the Bankruptcy Code in bankruptcy litigation, and the settlement payment defense will continue to serve as a transferee's most effective weapon."[133]

CONCLUSION

By determining that commissions, fees, and margin payments qualified as "settlement payments" under the stockbroker defense, the Fourth Circuit contributed to the broadening application of § 546(e). In doing so, the court also created a new standard—reasonable and customary in the industry—that requires stockbrokers to take an extra step in proving that they should be able to retain the underlying commissions paid by a debtor in bankruptcy proceedings. Currently, it is unclear exactly how stockbrokers will prove a transaction was reasonable and customary. Even with this uncertainty, they still came out ahead in *Derivium Capital* because the standard appears to be extremely generous given that substantial discounts passed under the test.[134] Therefore, unless the transactions are specifically avoided under § 548(a)(1), brokerage firms will be able to keep these "settlement payments" even if the transactions are associated with a Ponzi scheme.

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132. *See* Richardson, *supra* note 39, at 46.

133. Michael Klein, *Briefly: A Defendant's Best Friend in Fraudulent Transfer Cases*, TURNAROUND MGMT. ASS'N (Mar. 12, 2012), http://www.turnaround.org/Publications/Articles.aspx?objectID=13756.

134. In *Derivium Capital*, Wachovia's industry representative testified that Wachovia clients received discounts of up to ninety-five percent. Grayson Consulting, Inc. v. Wachovia Sec., LLC (*In re* Derivium Capital LLC), 716 F.3d 355, 365 (4th Cir. 2013).

The Fourth Circuit utilized an unprecedented approach to applying the stockbroker defense that extended the definition of "settlement payments" to include broker commissions shown to be reasonable and customary in the industry. However, it will be up to lower courts to discern what amounts qualify as reasonable and customary in the industry and how parties can satisfy the standard. With an increasing number of courts applying the stockbroker defense in conflicting ways, and Ponzi scheme litigation on the rise, eventually either Congress or the Supreme Court should decide the proper application of this safe harbor provision.

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