

By SAMUEL HODSON AND NICHOLAS BEHRENS

## Customer Claim Priority in Commodity Broker Bankruptcies

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In light of the \$1.6 billion shortage of customer funds identified during the recent bankruptcy of MF Global,<sup>1</sup> understanding the regulations and safeguards for the protection of customer property in commodities broker liquidations is more important than ever. The protections for customers are extensive and were enacted with the goal of ensuring that the impact of a broker's bankruptcy will be less severe for customers than a bankruptcy filed by other types of debtors. Several factors may impact the amount that a customer recovers in a broker bankruptcy case. When fraud (*e.g.*, commingling customer funds to cover margin calls for the firm's proprietary trading positions) is in play, customers need to be aware of their statutory protections and the mechanisms by which they operate. This article explains the operation of the priority customer claims in commodity broker bankruptcies.

Regulation of customer property held by commodities brokers is dictated by rules promulgated by the Commodity Futures Trading Commission (CFTC), the authority of which stems from both the Commodity Exchange Act (CEA) and the Bankruptcy Code. The CFTC rules protect customers impacted by commodity broker liquidation,<sup>2</sup> are designed to "ensure that the property entrusted by customers to their brokers will not be subject to the risks of the broker's business and will be available for disbursement to customers if the broker becomes bankrupt."<sup>3</sup>

"[C]ommodity customers are granted the highest priority against the bankrupt broker's estate."<sup>4</sup> Section 766 of the Bankruptcy Code provides that the trustee "shall distribute customer property ratably to custom-

ers on the basis and to the extent of such customers' allowed net-equity claims, and in priority to all other claims," except for certain administrative expenses.<sup>5</sup> The CFTC, acting pursuant to 7 U.S.C. § 24, has enacted procedures for trustees implementing the CEA and subchapter IV of title 11 of the Bankruptcy Code.<sup>6</sup> In particular, these regulations (1) define what constitutes "customer property;"<sup>7</sup> (2) establish a system of customer classes and account classes designed to ensure a fair and orderly process of *pro rata* distribution;<sup>8</sup> and (3) provide a formula for calculating allowable "net equity" claims.<sup>9</sup> Generally, all customer claims must be satisfied in full before property of the estate may be used to pay any general unsecured claims,<sup>10</sup> and no "insider" who also happens to be a brokerage customer can be paid until all public customers' claims have been fully satisfied.<sup>11</sup>

The definition of "customer property" is governed by both the Bankruptcy Code and the CEA. The CEA allows the CFTC to augment the definition of "customer property" that has been established in 11 U.S.C. § 761(10).<sup>12</sup> Indeed, the CEA provides that "[n]otwithstanding Title 11 [of the U.S. Code]," the CFTC may issue regulations to "provide ... that certain cash, securities, other property, or commodity contracts are to be included in or excluded from customer property."<sup>13</sup> The CFTC, in turn, promulgated 17 C.F.R. § 190.08, which creates several categories of "consumer property," including (1) segregated customer property;<sup>14</sup> (2) property that should have been segregated;<sup>15</sup> (3) property that was unlawfully removed from segregation to the debtor's general estate;<sup>16</sup> (4) property recovered by the trustee in an avoidance action that would otherwise be covered by 17 C.F.R. § 190.08(a)(1)(i)(A) because it was "received, acquired or held to margin, guarantee, secure, purchase or sell a commodity contract";<sup>17</sup> (5) specially identifiable property, as defined in § 190.01(kk), which is non-fungible property posted as collateral; and (6) other estate

5 See 11 U.S.C. § 766(h).

6 See 17 C.F.R. § 190.01-10 and appendices.

7 *Id.* at § 190.08.

8 *Id.* at §§ 190.01(a), (m), (bb) and (hh).

9 *Id.* at § 190.07.

10 See 11 U.S.C. § 766(h); 17 C.F.R. § 190.08(b).

11 See 11 U.S.C. § 766(h); 17 C.F.R. § 190.08(b) and (c)(2).

12 *Note v. Berg (In re Chic. Disc. Commodity Brokers Inc.)*, No. 86-C-4036, 1987 WL 5256, at \*2 (N.D. Ill. Jan. 5, 1987).

13 7 U.S.C. § 24(a) (emphasis added).

14 17 C.F.R. § 190.08(a)(ii)(A).

15 *Id.* at § 190.08(a)(i)(A).

16 *Id.* at § 190.08(a)(ii)(F).

17 *Id.* at § 190.08(a)(i)(ii)(D).

1 *In re MF Global Inc., et al.*, Case No. 11-02790-MG (Bankr. S.D.N.Y. 2011).

2 See *Oxford Organisation Ltd. v. Peterson (In re Stotler & Co.)*, 144 B.R. 385, 392 (N.D. Ill. 1992); *State Bank of Spring Hill v. Bucyrus Grain Co. Inc. (In re Bucyrus Grain Co. Inc.)*, 127 B.R. 45, 48 (D. Kan. 1988).

3 *In re Stotler*, 144 B.R. at 387 (quoting S. Rep. No. 95-989, at 106 (1978)).

4 *In re Bucyrus Grain Co.*, 127 B.R. at 48.

property that might be needed to satisfy the claims of public customers if enumerated customer property is insufficient.<sup>18</sup>

Section 766 of the Bankruptcy Code requires that commodity customer property be distributed ratably.<sup>19</sup> Moreover, the trustee must allocate the “property of the debtor’s estate ... among account classes and between customer classes.”<sup>20</sup> Each of the allocated amounts is treated as “a separate estate of the customer class and the account class to which it is allocated.”<sup>21</sup> Thus, it is necessary to understand the different account classes, as well as the different customer classes. Section 190.01(n) establishes two “customer classes”: public customers and non-public customers.<sup>22</sup> Generally, a “non-public customer” is a customer who is also an insider, affiliate or other controlling person or entity of the debtor,<sup>23</sup> all other customers are public customers.<sup>24</sup> All allowable net-equity claims by public customers must be satisfied in full before any distribution may be made to any insider customer.<sup>25</sup>

Section 190.01(a) of the Code of Federal Regulations specifies six types of customer accounts that must be recognized by the trustee as separate “account classes” in liquidation: (1) futures accounts; (2) foreign futures accounts; (3) leverage accounts; (4) commodity-option accounts; (5) delivery accounts; and (6) over-the-counter (OTC) derivative accounts.<sup>26</sup> The reason for creating classes of accounts is to facilitate *pro rata* distribution within the different types of investment accounts.<sup>27</sup> Trustees are required to attribute all customer property to an appropriate account class.

Section 190.08(c)(1) next provides that “property held by or for the account of a customer, which is segregated on behalf of a specific account class, or *readily traceable* on the filing date to customers of such account class, must be allocated to the customer estate of the account class for which it is segregated or to which it is readily traceable.”<sup>28</sup> Once the traceable customer property has been properly allocated to its class, any customer property that is not segregated or traceable to a particular class must be allocated in a manner designed to equalize the recovery in each class.<sup>29</sup> However, less certain exceptions — such as the Part 190 account classes that “correspond directly to the classes of transac-

tions protected by the segregation requirements,” as well as other contracts that do not qualify — will not be “subject to the CFTC’s core regulatory requirements.”<sup>30</sup>

The Bankruptcy Code further requires that *pro rata* distributions be made “on the basis and to the extent of such customers’ allowed net equity claims.”<sup>31</sup> Section 24(a)(5) of the CEA authorizes the CFTC to provide by rule or regulation “how the net equity of a customer is to be determined.”<sup>32</sup> Section 190.07(b) defines “net equity” as “the total claim of a customer against the estate of the debtor based on the commodity contracts held by the debtor,” net of certain amounts, and then describes a six-step process for the calculation of net equity.<sup>33</sup> This valuation process considers the net proceeds from sales of securities liquidated by the trustee,<sup>34</sup> settlement prices of unliquidated securities<sup>35</sup> and the date on which the accounts or proceeds are returned to the customer.<sup>36</sup> Tort claims and other obligations of a debtor to customers not related to their contract obligations are not included in the analysis,<sup>37</sup> but if the non-commodity contract obligations of a customer exceed the non-commodity obligation of a debtor to that customer, the difference may be deducted from the net-equity balance.

Customers may receive distributions from multiple classes depending on the composition of their portfolios. Any negative net-equity amounts in one class are used to offset any positive-equity balance that the same customer might have in a different class.<sup>38</sup> Section 190.07(c) governs the determination of the *pro rata* amount that each claimant could be paid based on the funds available in the estate (which is referred to as the “funded balance”). This amount is what the customer will be paid for each account class, up to the amount of the customer’s allowable net-equity claim.<sup>39</sup>

Ultimately, as previously described, commodity broker customers enjoy significant protections in commodity broker liquidations. In *MF Global*, for example, customers were able to recover an estimated 94 percent of their funds (which had been improperly commingled)<sup>40</sup> because of these protections. Therefore, it is critical for parties to understand these regulations in order to better protect their interests in commodity broker cases. **abi**

18 *Id.* at § 190.08(a)(1)(ii)(J).

19 11 U.S.C. § 766(h).

20 17 C.F.R. § 190.08.

21 *Id.*

22 17 C.F.R. § 190.01(n).

23 *Id.* at § 190.01(cc).

24 *Id.* at § 190.01(ii).

25 See 11 U.S.C. § 766(h) (“Notwithstanding any other provision of this subsection, a customer net-equity claim based on a proprietary account, as defined by Commission rule, regulation, or order, may not be paid either in whole or in part, directly or indirectly, out of customer property unless all other customer net-equity claims have been paid in full.”); 17 C.F.R. § 190.08(b) and (c)(2).

26 17 C.F.R. § 190.01(a)(1).

27 Bankruptcy, 46 Fed. Reg. 57535-01, 57536 (proposed Nov. 24, 1981) (to be codified at 40 C.F.R. pt. 190).

28 17 C.F.R. § 190.08(c)(1).

29 See 17 C.F.R. § 190.08(c)(2).

30 *Moore Capital Mgmt. LP v. Giddens (In re Lehman Bros. Inc.)*, 533 B.R. 362, 374-75 (S.D.N.Y. 2015).

31 11 U.S.C. § 766(h).

32 7 U.S.C. § 24(a)(5); see also 11 U.S.C. § 761(17) (subjecting statutory definition of “net equity” to “such rules and regulations as the [CFTC] promulgates under the [CEA]”).

33 17 C.F.R. § 190.07(b).

34 *Id.* at § 190.07(e)(5).

35 *Id.* at § 190.07(e).

36 Bankruptcy, 46 Fed. Reg. at 57546.

37 See *Collier on Bankruptcy* ¶ 761.18[3] (Alan N. Resnick and Henry J. Sommer eds. 16th ed.).

38 17 C.F.R. § 190.07(b)(3)(iii).

39 *Id.* at § 190.07(c).

40 Rena S. Miller, “The MF Global Bankruptcy, Missing Customer Funds, and Proposals for Reform,” Cong. Research Serv. (Aug. 1, 2013), available at [fas.org/sgp/crs/misc/R42091.pdf](http://fas.org/sgp/crs/misc/R42091.pdf) (last accessed June 28, 2016).

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