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## Commodity Broker Liquidations: What Qualifies as a “Commodity Contract”?

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1

The Seventh Circuit’s recent decision in *Secure Leverage* put to bed nearly five years of litigation on the question of what contracts are sufficiently “similar to” futures contracts under § 761(4) of the Bankruptcy Code to receive the highest priority of repayment in a commodity broker liquidation.<sup>[1]</sup> The court held that in order for a contract to be considered a commodity contract within the meaning of § 761(4), it must bear certain fungible features.<sup>[2]</sup>

### **The Bankruptcy Code and Commodity Broker Liquidations**

Subchapter IV of chapter 7 of the Bankruptcy Code governs commodity broker liquidation.<sup>[3]</sup> It provides certain protections for commodity contracts for the purpose of promoting market stability in the event of a broker’s insolvency.<sup>[4]</sup> For example, customers of an insolvent commodity broker are granted priority in the distribution of customer property.<sup>[5]</sup> The trustee is required to distribute customer property ratably to customers on the basis and to the extent

of such customers’ allowed net equity claims, and in priority to all other claims, except for § 507(a)(2) administrative priority claims.<sup>[6]</sup> Customer property is defined as “property received, acquired, or held to margin, guarantee, secure, purchase, or sell a commodity contract.”<sup>[7]</sup> Thus, whether or not a customer is entitled to receive priority in distribution depends on whether its contract falls within the § 761 definition of a commodity contract.

### **Background of Secure Leverage**

Peregrine Financial Group was a registered “future commission merchant” that dealt in futures contracts, as well as in retail foreign currency transactions (forex) and over-the-counter (OTC) metal transactions.<sup>[8]</sup> Within months of the petition date, the trustee filed a motion seeking authority under § 766(h) to make interim distributions of customer property to Peregrine customers who had traded in commodity contracts.<sup>[9]</sup> Peregrine’s forex and OTC metal customers were excluded from this partial distribution, however, on the ground that forex and OTC metal accounts did not qualify as “commodity contracts.”<sup>[10]</sup>

The excluded customers filed an adversary complaint against the trustee arguing that their forex and OTC metal transactions with Peregrine were sufficiently “similar to” futures contracts to qualify as commodity contracts under § 761(4)(F)(i) and that the funds in those accounts should have been included in the interim distribution.<sup>[11]</sup>

The bankruptcy court granted summary judgment in favor of the trustee, concluding that the customers’ forex and OTC metals contracts were not sufficiently “similar to” future contracts and dismissing the related counts of the customers’ complaint.<sup>[12]</sup> The customers appealed, and the district court affirmed.<sup>[13]</sup> On appeal, the Seventh Circuit affirmed the district court and took the rare step of adopting the district court’s opinion as its own.

### ***The “Similar to” Provision***

In finding for the trustee, the district court, in large part, relied on the Seventh Circuit’s reasoning in *In re Zelener*.<sup>[14]</sup> In *Zelener*, the court considered whether forex transactions were contracts of sale of a commodity for future delivery regulated by the Commodity Futures Trading Commission.<sup>[15]</sup> Applying the reasoning of *Zelener*, the district court concluded that forex transactions are not “similar to” futures because the two types of transactions were not alike in “substance or essentials.”<sup>[16]</sup> Futures contracts are fungible instruments.<sup>[17]</sup> A futures transaction involves the sale of “the contract,” includes standard terms, and the risk of

counterparty default falls on a clearinghouse.<sup>[18]</sup> In contrast, forex contracts bear no fungible features.<sup>[19]</sup> A forex transaction involves the sale of the commodity, unique currencies in varying quantities and with varying settlement dates, and the risk of counterparty default falls squarely on the shoulders of the customer.<sup>[20]</sup>

The *Zelener* court also indicated that an otherwise-nonfungible contract could qualify as a futures contract *if* the seller of the contract promised to sell another contract against which the buyer could offset the first.<sup>[21]</sup> Such a promise would essentially make the contract work as if it were fungible.<sup>[22]</sup> But the district court found this exception to be inapplicable in *Secure Leverage* because the customers failed to identify any such promise by Peregrine.<sup>[23]</sup>

Finally, the district court reasoned that nothing within § 761 or its legislative history indicates that Congress intended to protect forex and OTC metal traders.<sup>[24]</sup> Congress could have included either forex or OTC metal transactions within the definition of commodity contracts, but instead limited the breadth of § 761(4) to an array of cleared transactions.<sup>[25]</sup> Accordingly, the district court concluded that it was reasonable to infer that Congress implicitly excluded all uncleared transactions from § 761.<sup>[26]</sup> Such a conclusion is in accord with the purpose of the chapter 7 protections for commodity contracts: market stability. In a commodities market, market volatility is exacerbated by gains and losses on open positions, which are paid out on a daily basis, and the risk of the transactions are taken on by a clearinghouse.<sup>[27]</sup> Thus, any delay by a trustee in closing positions could have a ripple effect in the market.<sup>[28]</sup> There is no similar concern for uncleared transactions, such as forex or OTC metals, because such transactions do not involve a clearinghouse and the customers themselves assume the risk of the exchange.<sup>[29]</sup>

## Conclusion

*Secure Leverage* clarifies the breadth of the definition of “commodity contract” in § 761(4). At bottom, § 761 is limited to an array of cleared transactions that bear certain fungible features, including standard terms and an offsetting transaction. As for the contracts that fall outside of the “commodity contract” definition, their unfortunate owners have to get in line for distribution with all other general unsecured creditors.

[1] *In re Peregrine Fin. Grp, Inc.*, No. 16-3424, 2017 WL 3381355, at \*2 (7th Cir. Aug. 7, 2017), *as amended* (Aug. 8, 2017).

[2] *Id.*

[3] *See* §§ 761–767.

[4] *Secure Leverage Grp. Inc. v. Bodenstein*, 558 B.R. 226, 231–32 (N.D. Ill. 2016), *aff’d sub nom.*, *In re Peregrine Fin. Grp. Inc.*, No. 16-3424, 2017 WL 3381355 (7th Cir. Aug. 7, 2017), *as amended* (Aug. 8, 2017).

[5] § 766(h).

[6] *Id.*

[7] § 761(10)(A)(i).

[8] *Secure Leverage*, 558 B.R. at 231.

[9] *Id.*

[10] *Id.*

[11] The excluded customers also argued, in the alternative, that their funds had been held in a resulting trust by Peregrine and thus should be distributed apart from the bankruptcy estate. *Id.*

[12] *Id.* at 232–33.

[13] *Id.* at 231.

[14] *Id.* at 240; *Commodity Futures Trading Comm’n v. Zelener*, 373 F.3d 861, 862 (7th Cir. 2004).

[15] *Secure Leverage*, 558 B.R. at 240; *Zelener*, 373 F.3d at 862.

[16] *Secure Leverage*, 558 B.R. at 241.

[17] *Id.*

[18] *Id.*

[19] *Id.*

[20] *Id.*

[21] *Id.*

[22] *Id.* at 241–42.

[23] *Id.* at 242.

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] *Id.*

[28] *Id.*

[29] *Id.*