UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

In re: MF GLOBAL INC., Debtor.	Case No. 12 Civ. 6014 (KBF)

REPLY MEMORANDUM IN SUPPORT OF CONOCOPHILLIPS' MOTION TO WITHDRAW THE REFERENCE WITH RESPECT TO THE TRUSTEE'S MOTION TO CONFIRM HIS TREATMENT OF LETTERS OF CREDIT PROVIDED BY CONOCOPHILLIPS

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September 11, 2012

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PRELIMINARY STATEMENT

The briefs filed in response to ConocoPhillips' motion to withdraw the reference only confirm that the motion should be granted. The Trustee's opposition makes perfectly clear that he is relying on a novel, untested interpretation of a CFTC regulation promulgated under the Commodity Exchange Act and that resolution of this dispute will require intense consideration of both the regulation and the Act itself. Likewise, the CFTC's very appearance — and its interposition of a premature "merits" brief that explicitly does *not* oppose withdrawal of the reference — only proves the point: this matter turns upon the CEA and associated regulations and is in no way "routine." Under Second Circuit law, the sole question presented at this stage is whether resolution of this proceeding requires "significant interpretation" of federal non-bankruptcy law. It plainly does.

The Trustee's arguments against withdrawal are wholly unpersuasive. First, there is no merit to the argument that the CFTC regulations at issue are exempt from the mandatory withdrawal statute because they "implement" and are "referred to" in title 11. Opp. at 7-8. The governing statute, 28 U.S.C. § 157(d), draws an unambiguous distinction between "title 11" and "other laws of the United States" such as CFTC regulations and the CEA. It does not exempt laws that are somehow related to title 11. Moreover, the statute applies with full force to cases referred to the bankruptcy court under SIPA. As shown below, the Trustee's assertion to the contrary is at odds not only with *every* case to address the issue but also with the language of SIPA, which dictates that SIPA proceedings are to be conducted "as though" they were commenced under title 11.

Second, it defies credulity for the Trustee to claim that withdrawal is unwarranted because the issues presented here are "straightforward." Opp. at 12-13. The Trustee concedes that, outside of bankruptcy, MF Global would "unquestionably" be prohibited as a matter of contract and state law from drawing on the letters of credit absent a default by ConocoPhillips. Opp. at 17. The Trustee likewise does not dispute that the same would be the case in an ordinary bankruptcy proceeding: letter-of-credit terms and state law would be fully respected. Instead, as to *all* of the letters of credit at issue, the Trustee argues that CFTC Rule 190.08(a), by defining the "proceeds" of a letter of credit as "customer property": (1) implicitly authorizes the *creation* of such "proceeds" in violation of the parties' contracts; (2) implicitly preempts uniform state law that treats an unauthorized draw on a letter of credit as "material fraud" and breach of warranty; and yet (3) does not run afoul of the CEA itself, which explicitly prohibits the CFTC from exercising *any* regulatory authority with respect to letters of credit. These arguments are anything but "straightforward."

After reading the Trustee's brief, the only thing that *is* "straightforward" is that — even if one were to give effect to the CFTC's dubious "Supplementary Information" — the Trustee lacks even a colorable basis for his treatment of the two "foreign" letters of credit that he permitted to *expire* undrawn. (Moreover, those letters of credit could not have been honored by the issuing bank because they were expressly conditioned on certification of an event of default.) As demonstrated in ConocoPhillips' opening brief, both CFTC Rule 190.08(a) and the "Supplementary Information" conclusively refute the Trustee's position that he is entitled to the value of such expired letters: the regulation refers only to the "proceeds" of letters of credit, making clear that the letters must be *presented* and *honored* for the rule to apply. Moreover, the Supplementary Information itself expressly "requires" a trustee to "draw" on a letter of credit to realize its value. The Trustee's complete failure to respond to these points exposes the futility of his argument that this matter can be resolved *in his favor* based on "routine" legal analysis.

ARGUMENT

I. THE MANDATORY WITHDRAWAL STATUTE APPLIES WITH FULL FORCE TO THE CFTC PART 190 REGULATIONS.

The Trustee contends that the CFTC Part 190 Regulations fall outside the mandatory withdrawal statute because they "implement and are *effectively* part of title 11." Opp. at 6 (emphasis added). This argument flies in the face of the language of the mandatory withdrawal statute, which draws an explicit distinction between "title 11" (the Bankruptcy Code) and "other laws of the United States." 28 U.S.C. § 157(d). The CFTC's Part 190 Regulations are obviously not part of the Bankruptcy Code. As the Trustee and the CFTC recognize, the CFTC's very authority to promulgate those regulations comes from the CEA, not the Bankruptcy Code. Opp. at 8; CFTC Statement at 6. Just as courts in this District have withdrawn the reference of proceedings that require interpretation of SIPA despite that statute's interrelationship with the Bankruptcy Code, this Court should withdraw the reference of this proceeding, which requires interpretation of both CFTC regulations and the CEA. *See, e.g.*, *Picard* v. *JPMorgan Chase & Co.*, 454 B.R. 307, 316 (S.D.N.Y. 2011) (withdrawal required to interpret SIPA despite bankruptcy court's "familiarity" with the Act); Opening Br. 11-12.

Nor is there merit to the Trustee's suggestion that withdrawal of the reference here would lead to the flooding of district courts with routine matters arising out of commodity broker liquidations. *See* Opp. at 10. The Second Circuit has already *guaranteed* that this cannot happen: it has held that withdrawal is mandated only when "*substantial and material* consideration" of non-bankruptcy law — not just *any* consideration — is required. *Shugrue* v. *Air Line Pilots Ass'n, Int'l*, 922 F.2d 984, 995 (2d Cir. 1990) (emphasis added).

The Trustee also argues that 28 U.S.C. § 157(d) does not apply at all here because the first sentence of that subsection, which governs discretionary withdrawal, provides that a district court "may withdraw . . . any case or proceeding referred *under this section* . . . for cause shown," and this case was referred to bankruptcy court under SIPA, not Section 157. Opp. at 10-12. Putting aside that, by its terms, the second sentence of Section 157(d), which is at issue here, neither repeats the "this section" requirement of that first sentence nor incorporates that proviso by reference — rather, notably, it refers to "*a* proceeding" (emphasis added) and not to "*such* proceeding"* — the courts have rejected the Trustee's position on a separate ground: SIPA itself requires that a SIPA proceeding "be conducted in accordance with, and as though it were being conducted under . . . Title 11." 15 U.S.C. § 78fff(b). *See Barton* v. *SIPC*, 185 B.R. 701, 703 (D.N.J. 1994) ("Since SIPA proceedings are treated like bankruptcy proceedings, in an appropriate case they c[an] be withdrawn to the district court."); *accord Keller* v. *Blinder*, 162 B.R. 555, 559 (D. Colo. 1994). As the Trustee acknowledges, courts in this Circuit have thus uniformly held that the withdrawal statute *does* apply in SIPA cases.** We are aware of no case to the contrary.

II. WITHDRAWAL OF THE REFERENCE IS REQUIRED HERE TO ADDRESS NUMEROUS NOVEL ISSUES OF FEDERAL NON-BANKRUPTCY LAW.

A. Withdrawal of the reference is required in light of the Trustee's unprecedented reliance on CFTC Rule 190.08(a) and related commentary.

There can be no serious question that the Trustee's reliance on CFTC Rule 190.08(a) requires withdrawal of the reference. As shown in the opening brief, the text of Rule

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* *See Milner* v. *Department of the Navy*, 131 S. Ct. 1259, 1273 (2011) (applying "the 'usual rule' that when the legislature uses certain language in one part of the statute and different language in another, the court assumes different meanings were intended" (citation omitted)).

** *See* Opp. at 11-12; *SIPC* v. *Bernard L. Madoff Inv. Sec. LLC*, 2012 WL 2524513 (S.D.N.Y. June 26, 2012); *SIPC* v. *Bernard L. Madoff Inv. Sec. LLC*, 2012 WL 2524367 (S.D.N.Y. June 26, 2012); *Picard* v. *Avellino*, 469 B.R. 408 (S.D.N.Y. 2012); *Picard* v. *Flinn Invs., LLC*, 463 B.R. 280 (S.D.N.Y. 2011); *Picard* v. *JPMorgan Chase & Co.*, 454 B.R. 307 (S.D.N.Y. 2011); *Picard* v. *HSBC Bank PLC*, 450 B.R. 406 (S.D.N.Y. 2011); *SEC* v. *Goren*, 2002 WL 32963582 (E.D.N.Y. Mar. 6, 2002); *Mishkin* v. *Ageloff*, 220 B.R. 784 (S.D.N.Y. 1998).

190.08(a) merely states that the "proceeds" of a letter of credit are to be treated as customer property. The Rule does not purport to authorize a trustee to unlawfully *create* such proceeds, nor does it authorize a trustee to deprive a customer of the value of a letter of credit that has not been presented, could not have been honored, and was permitted to expire.

The Trustee does not even try to argue that the *text* of the Rule authorizes him to violate contracts and state law. Instead, he argues first that "common sense" dictates that letters of credit held as margin should be treated no differently from cash, Opp. at 14 — a highly debatable proposition given that letters of credit consist of contract rights that can be transformed into cash only within a fixed period and under certain conditions.* The Trustee then argues that the Supplementary Information — *i.e.*, agency commentary that lacks the force of law, *see Wyeth* v. *Levine*, 555 U.S. 555, 576-80 (2009) — permits a trustee to seize the face value of letters of credit "irrespective of their terms," even though the language of the regulation offers zero support for this conclusion. Opp. at 14-15 (quoting 48 Fed. Reg. 8716, 8718 (Mar. 1, 1983)).

The Trustee's *ipse dixit* that letters of credit equate with cash and his reliance on the non-binding Supplementary Information as authority to disregard contract terms and state law present questions of first impression requiring withdrawal of the reference.

B. Withdrawal is further required to resolve a direct conflict between the Trustee's interpretation of CFTC Rule 190.08(a) and the Commodity Exchange Act, which prohibits the CFTC from regulating letters of credit.

Section 27a of the CEA — another law undisputedly outside of title 11 — categorically *prohibits* the CFTC from "exercis[ing] regulatory authority . . . with respect to, an identified banking product," a term defined to include "letters of credit." 7 U.S.C. § 27a(a)(1);

* In its merits brief, ConocoPhillips will explain further why the Trustee and the CFTC are wrong to conflate letters of credit with cash. As reflected by the CFTC's response, even the CFTC recognizes that letters of credit have characteristics that distinguish them from cash, and has calibrated its margin regulations accordingly. CFTC Response at 3.

see also 7 U.S.C. § 27(b) (cross-referencing definition of the term "identified banking product" to § 206(a) of the Gramm-Leach-Bliley Act, codified at 15 U.S.C. § 78c note). By its plain terms, therefore, the CEA prohibits the CFTC from exercising the regulatory authority that the Trustee claims it has with respect to the letters of credit provided by ConocoPhillips.

In the face of Section 27a, the Trustee and the CFTC resort to legislative history to try to show that the statute is actually much narrower than its unambiguous language dictates. Opp. at 18-19; CFTC Statement at 10-12. As ConocoPhillips will demonstrate in its merits brief, there is no basis to disregard the plain language of the CEA. *See, e.g.*, *WPIX, Inc.* v. *ivi, Inc.*, -- F.3d --, 2012 WL 3645304, at *3 (2d Cir. Aug. 27, 2012) (no resort to legislative history if "the statutory text . . . is unambiguous"). Moreover, the Trustee's attempt to conflate letters of credit with cash, which is *not* a "banking product," does not hold up. At this stage, however, it suffices to say that the Trustee's insistence on elevating the statute's supposed legislative history over its unambiguous language mandates withdrawal of the reference.

C. Withdrawal is further required to address substantial preemption issues raised by the Trustee's motion.

The Trustee and the CFTC erect a straw man in their discussion of preemption. No one disputes that Congress may preempt state law if *Congress* chooses to do so. The questions here are: (1) whether Congress ever manifested any intent that CFTC regulations could abrogate uniform state law as to letters of credit; and (2) if so, whether the CFTC validly exercised preemptive authority by way of this particular Supplementary Information. Although the Trustee asserts that the only preemption effected here "is the typical overriding of non-liquidation state law contract rights that occurs in any bankruptcy," Opp. at 18, the *opposite* is true: for one thing, in a "typical" bankruptcy, state-law restrictions on a debtor-beneficiary's ability to draw on letters of credit are *respected*, not supplanted. *See, e.g.*, *Farmer* v. *Crocker*

Nat'l Bank, 30 B.R. 490, 496 (B.A.P. 9th Cir. 1983). Accordingly, as set forth in the opening brief, there are substantial questions regarding whether CFTC Rule 190.08(a) — or, rather, commentary purporting to interpret that regulation but in fact rewriting it — can be deemed to preempt state letter-of-credit law. *See Wyeth*, 555 U.S. at 576-80.

D. Withdrawal is yet further required to resolve conflicts between the Trustee's interpretation of CFTC Rule 190.08(a) and the Bankruptcy Code.

The Trustee nowhere disputes that, if there is a conflict between non-bankruptcy federal law and the Bankruptcy Code, withdrawal of the reference is required. *See* Opening Br. at 21. Yet the Trustee has not shown how his treatment of the letters of credit, which is predicated on a CFTC rule, can be reconciled with the Bankruptcy Code. Section 541(a) of the Bankruptcy Code "creates an estate" consisting of "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1). Under that provision, a "bankruptcy estate can have no greater interest in property included in it than the debtor had when the petition was filed," *Brown* v. *Dellinger*, 734 F.2d 119, 124 (2d Cir. 1984) — a principle that applies fully to a debtor's interest in a letter of credit, *see Farmer*, 30 B.R. at 495.

Nevertheless, it is the Trustee's position that the CFTC Part 190 Regulations give rise to an "estate" of "customer property" that is *broader* than a debtor's estate under Section 541(a). Opp. at 20. That creates a plain conflict with the Bankruptcy Code. The definition of estate property in Section 541(a) has been held to be "all-encompassing." *SIPC* v. *Bernard L. Madoff Inv. Sec., LLC*, 460 B.R. 106, 114 (Bankr. S.D.N.Y. 2011). Moreover, CFTC Rule 190.08 on its face is intended to "allocate . . . [t]he property of *the debtor's estate*"; it says nothing about *expanding* that estate. 17 C.F.R. § 190.08 (emphasis added). The Bankruptcy Code itself further confirms that "customer property" is merely a subset of estate property: Section 766 provides that after customer claims are satisfied, "customer property" is distributed to *creditors* in accordance with Section 726, which governs "Distribution of property of the estate." 11 U.S.C. § 766(j)(1). Thus, the Trustee's claim that "customer property" under CFTC rules is *broader* than "property of the estate" — such that a trustee can violate a debtor's contracts even though an ordinary trustee could not — raises a conflict between bankruptcy and "other" law, mandating withdrawal.

As explained in the opening brief, there is also a conflict between the Trustee's interpretation of CFTC Rule 190.08(a) and Section 766(f) of the Bankruptcy Code, which directs a trustee to reduce property to cash "consistent with good market practice." 11 U.S.C. § 766(f); *see* CFTC Rule 190.02(f) (directing a trustee to liquidate property subject to "applicable procedures under the Bankruptcy Code"). Conduct that constitutes material fraud and breach of warranty under uniform state law, as codified in the U.C.C., is in no sense "good market practice," yet neither the Trustee nor the CFTC addresses Section 766(f) or Rule 190.02(f).

E. Withdrawal of the reference is required to address the Trustee's novel theory that he is entitled to the value of conditional letters of credit that he permitted to expire.

Two letters of credit obtained by ConocoPhillips expired by their own terms on November 23, 2011, long before the parties entered into their interim agreement on March 26, 2012. Under the parties' contracts and state law, the expiration of those letters of credit necessarily means that their beneficiary, namely MF Global or its successor, can no longer access their value.* Moreover, these expired letters of credit expressly require their beneficiary to *certify* that a default has taken place prior to presentation. Kleinhaus Decl. Exs. D-E, I. As there was concededly no default here, that requirement poses another insuperable obstacle to any

* Under Section 108(b) of the Bankruptcy Code, the expiration of the letters of credit was potentially tolled by 60 days following the October 31, 2011, petition date, but no longer. *See* Opening Br. at 23.

generation of "proceeds": absent a criminally fraudulent certification, the issuing bank under no circumstances could have honored such presentment.

Accordingly, the Trustee's entire reliance upon Rule 190.08(a) in his treatment of these expired letters is baseless. That provision explicitly speaks in terms of the "proceeds" of letters of credit, making clear that: (a) the letters at issue must still be capable of being drawn, which manifestly is not the case following their expiration; and (b) the bank must honor any attempted draw, which a bank could not do here absent a fraudulent certification. Moreover, the Supplementary Information, which the Trustee otherwise embraces, states plainly that a trustee is "*required to draw* the full value of a letter of credit posted as margin and treat *the funds received* as customer property." 48 Fed. Reg. at 8718 (emphasis added). Assuming the Supplementary Information has any force, the Trustee has failed to meet its express requirements.

The Trustee's opposition provides no meaningful response to these points. It argues that ConocoPhillips' position "is not supported anywhere in the Part 190 Regulations or elsewhere in the Bankruptcy Code," Opp. at 16, but that is nonsense. As explained above, CFTC Rule 190.08(a) plainly supports ConocoPhillips' position: it refers to the "proceeds" of a letter of credit, not its "face amount." Likewise, Bankruptcy Code Section 541(a) grants a trustee only those rights belonging to the debtor, meaning that a trustee's "[p]ossession of *expired* rights is the equivalent of the possession of no rights." *Sullivan* v. *Willock*, 854 F.2d 196, 199 (7th Cir. 1988) (emphasis added).

In the absence of even a colorable argument to support his claim to the non-existent "proceeds" of the expired letters of credit, the Trustee should withdraw that claim. But since the Trustee persists in arguing that CFTC Rule 190.08(a) entitles him to the value of these expired letters, this Court should determine that issue.

III. THIS MATTER SHOULD NOT BE REMANDED TO THE BANKRUPTCY COURT FOR PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW.

As a fallback, the Trustee urges the Court to remand this matter to the bankruptcy court for proposed findings and conclusions, even if it determines that withdrawal of the reference is mandatory. That invitation should be rejected for multiple reasons.

First, the procedure proposed by the Trustee lacks any statutory basis. The authority of bankruptcy courts to submit proposed findings of fact and conclusions of law is set forth in 28 U.S.C. § 157(c), which addresses the ability of bankruptcy judges to hear certain "non-core" proceedings. In contrast, the statutory provision mandating withdrawal of the reference — Section 157(d) — contains no suggestion that, when its requirements are met, the district court may withdraw the reference only to remand the case back to the bankruptcy court.

Second, the Trustee's proposed mode of proceeding would defeat the purpose of Section 157(d). The mandatory withdrawal statute ensures that substantial issues of federal non-bankruptcy law are "decided by a district judge rather than a bankruptcy judge." Opp. at 7. Congress's insistence that district courts decide such issues of federal non-bankruptcy law would hardly be served by withdrawing a case only to remand it back to the bankruptcy court.

Third, returning this case to the bankruptcy court following withdrawal would be wasteful: it would simply "generate another level of briefing and expense." *Mishkin*, 220 B.R. at 801 n.13. Since this proceeding presents no factual disputes, no efficiencies would result from the bankruptcy court's considering the purely legal issues in the first instance.

CONCLUSION

The reference of this proceeding should be withdrawn.

Dated: New York, New York
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