



Bankruptcy ADVISORY ■

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Bankruptcy Court Finds Some Repo Participants Are Not SIPA “Customers”

On June 25, 2013, the Bankruptcy Court for the Southern District of New York (the “Court”) issued a memorandum decision in the *Lehman Brothers* SIPA proceeding¹ holding that claims asserted by certain repurchase agreement (“repo”) counterparties (the “Representative Claimants”) did not qualify for treatment as customer claims under SIPA. This decision is arguably a departure from prior case law holding that certain repo counterparties were entitled to customer status.² However, while the repos in the prior decision involved securities that were actually being held by the SIPC member firm for the claimants, the *Lehman* decision involved counterparties who the Court found did not entrust any property to Lehman Brothers Inc. (LBI) as their broker-dealer. In this case, the Court found that distinction to be dispositive.

Customer Status Under SIPA

The Securities Investor Protection Act (SIPA)³ provides a mechanism for the Securities Investor Protection Corporation (SIPC) to liquidate insolvent regulated broker-dealers. SIPA provides certain protections to persons or entities who qualify as “customers.” Under SIPA, “[t]he term ‘customer’ of a debtor means any person (including any person with whom the debtor deals as principal or agent) who has a claim on account of securities received, acquired, or held by the debtor in the ordinary course of its business as a broker or dealer from or for the securities accounts of such person for safekeeping, with a view to sale, to cover consummated sales, pursuant to purchases, as collateral, security, or for purposes of effecting transfer.”⁴ A customer does not include, in relevant part, any person to the extent the person’s claim is either for cash or securities that are part of the capital of the debtor or is subordinated to the claims of other creditors of the debtor.⁵

¹ *In re Lehman Brothers Inc.*, No. 08-01420 (JMP) (SIPA) (Bankr. S.D.N.Y. June 25, 2013) [hereinafter *Lehman*].

² *Cohen v. Army Moral Support Fund (In re Beville, Bresler & Schulman Asset Mgmt.)*, 67 B.R. 557 (D.N.J. 1986).

³ 15 U.S.C. §§ 78aaa *et seq.*

⁴ 15 U.S.C. § 78lll(2). The Court applied the definition of “customer” that was in effect on the date LBI filed for bankruptcy. While the definition of “customer” under SIPA was amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the amended definition is not applicable to the issues decided in the memorandum decision.

⁵ *Id.*

Creditors with customer status are in a preferred position, and all customers are entitled to share ratably in customer property to the exclusion of other creditors. Customers can then assert any remaining deficiency against the general insolvency estate and share in the remaining assets of the broker-dealer. Customers are covered by SIPC up to \$500,000 for all accounts at a failed institution, including \$100,000 in cash, while general unsecured creditors are left to share in whatever assets of the broker-dealer that are left once customers and other secured creditors have been paid. Thus, customers invariably do no worse, and often do better, than general unsecured creditors.

Facts

The repos at issue in *Lehman* were bilateral repos—where one party agrees to sell securities to the counterparty, and the counterparty simultaneously agrees to re-sell the subject securities to the original seller at a later date. Pursuant to the industry-standard Master Repurchase Agreements (MRAs) between the Representative Claimants and LBI, the Representative Claimants sold securities to LBI through long-term repo transactions. However, as is general practice, the Representative Claimants considered the securities they transferred to LBI as continuing to be owned by the Representative Claimants for tax and accounting purposes.

Pursuant to the MRAs, LBI had the ability to use the purchased securities for its own purposes until the repurchase date. As such, LBI was under no obligation to segregate the purchased securities or otherwise hold them for the benefit of the respective Representative Claimants. LBI established delivery-versus-payment accounts (“DVP Accounts”) for each of the Representative Claimants. Instead, the DVP Accounts were used only to record transactions. Indeed, on the date LBI’s SIPA proceeding commenced (the “Commencement Date”), LBI did not hold any of the purchased securities for the Representative Claimants.

Court’s Holding

The Court rejected the Representative Claimants request to be treated as customers. It held that “[t]he critical aspect of the ‘customer’ definition is the entrustment of cash or securities to the broker-dealer for the purpose of trading securities.”⁶ The Court further held, “There is no substitute for actual possession by the broker-dealer.”⁷ Under the MRAs, LBI did not hold the subject securities and was under no obligation to do so. Rather, the DVP Accounts were structured and utilized in a manner that enabled other institutions to hold securities purchased from the Representative Claimants. Thus, the Court found that the DVP Accounts were not possessory, which it held defeated the Representative Claimants’ request for customer status.

Similarly, although LBI had a contractual duty to return the purchased securities, the Court held that this obligation was not a substitute for LBI actually holding an inventory of securities for the Representative Claimants. “The simple and unavoidable truth is that the LBI accounts of the Representative Claimants held no property on the Commencement Date, and that indisputable fact alone is dispositive.”

Takeaway

Under the *Lehman* holding, a broker-dealer must actually have received, acquired or held securities or cash for the purpose of purchasing securities on behalf of the claimant (and not for its own transactions where it serves as principal) in order for the counterparty to assert customer status in any SIPA proceeding against the broker-dealer. Under such a theory, repo participants cannot rely upon the availability of a SIPA customer claim if their broker-dealer counterparty fails.

⁶ *Lehman*, No. 08-01420 (JMP) (SIPA), at *14 (citing *In re Bernard L. Madoff Invs. Secs. LLC*, 654 F.3d 229, 236 (2d Cir. 2011)).

⁷ *Id.* at *15.

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