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Where Repo And 'Customer' Claims Differ Under SIPA

Law360, New York (July 10, 2013, 4:10 PM ET) -- Judge James M. Peck of the Bankruptcy Court for the Southern District of New York held, on June 25, 2013 (the "Lehman Op."),[1] that claims under repurchase transactions (repos) do not qualify as customer claims and therefore are not entitled to the priority or coverage provided for customers' claims under the Securities Investor Protection Act (SIPA).

The trustee overseeing the liquidation of Lehman Brothers Inc. (LBI) filed a motion seeking a bankruptcy court order confirming his determination that repo claims were not customer claims under SIPA. Three banks that acted as representatives of the numerous repo counterparties, opposed the trustee's motion. The court upheld the trustee's determination, holding that the claims were not customer claims because the transferred securities were never actually entrusted to LBI, distinguishing the primary case relied on by the banks.[2]

The Facts

In a repo, one party agrees to transfer securities to another party against the transfer of cash, and the buyer simultaneously agrees to transfer back the securities to the seller at a future, agreed-upon date against payment. The claims at issue here arose from repos entered into between the banks, as sellers, and LBI, as buyer. The repos were each governed by an industry-standard master repurchase agreement (MRA).[3]

There are three different types of delivery requirement for repos: (i) bilateral repos, in which the parties deliver the cash and securities at the outset of the transaction, (ii) safekeeping or hold-in-custody repos, in which the purchased securities are not delivered to the buyer but are held by the seller for the buyer and (iii) tri-party repos, in which the securities are held by a third-party custodian.[4] The repos at hand were bilateral repos.

Under the MRAs, LBI was free to use the transferred securities for its own purposes and was not required to segregate them or otherwise hold them for safekeeping. LBI's system distinguished among custodial accounts in which LBI held assets for customers that were segregated from securities used by LBI in its proprietary business, and delivery-versus-payment accounts (DVP accounts) in which transactions were recorded but did not hold any cash or securities. The repo transactions among the banks and LBI were recorded in DVP accounts, in which no cash or securities were held. These accounts were used solely for the purposes of recording the movement of cash and securities.

After the SIPA liquidation proceeding for LBI was commenced, various repo counterparties filed customer claims against LBI. The trustee rejected the claims and the counterparties objected to the trustee's determination. The trustee thus brought the motion seeking confirmation of his determination that the repo claimants were not customers within the meaning of SIPA and therefore not entitled to SIPA coverage.

The Issue

Those who qualify as customers under SIPA are entitled to special protections and have preferred status relative to general, unsecured creditors. To qualify as a customer under SIPA, the person or entity must have entrusted cash or securities to a broker-dealer. The entrustment of cash or securities to a broker-dealer for the purpose of trading securities is the critical aspect of the customer definition.[5]

The trustee argued that the claimants did not meet this requirement because their DVP accounts did not actually hold any cash or securities on the date the liquidation proceeding commenced. In contrast, the claimants argued that they were customers under SIPA because they had delivered securities to LBI with the intent that they would be returned, and that they, on their own books and records, treated the securities as owned by them. The claimants asserted that "there is more to entrustment than physical possession in a brokerage account and that the contractual obligation to return the securities constitutes a kind of deemed entrustment."[6]

The Court's Decision

The court confirmed the trustee's determination and found that the repo claims did not qualify as customer claims. The transferred securities were never entrusted to LBI because the securities were never actually held by LBI for the claimants; instead, the securities were either repledged to other parties or held by LBI in its own operating account for its own use, as was permitted by the MRAs.

The court explained that the repo claims were based on the contractual obligations of LBI under the MRAs and therefore amounted to breach of contract claims, not customer claims: "A contractual obligation by LBI to return securities is no substitute for an account statement that includes an inventory of securities actually held by a broker-dealer for its customer. ... [T]here is no way to ignore or navigate around this missing possessory requirement for customer status."[7]

In reaching this decision, the court distinguished the Bevill, Bresler case[8] relied on by the banks. The Bevill, Bresler court had held that claims in relation to certain repos were customer claims under SIPA. The repos in that case, however, were hold-in-custody repos "in which the SIPC member firm actually was holding property for the claimants."[9]

This recent decision relies and builds on the court's prior TBA decision, an earlier decision issued in the LBI liquidation in which the court held that claims relating to "to be announced" contracts did not qualify as customer claims under SIPA either.[10] The banks tried to distinguish the TBA decision on the ground that no securities were delivered to LBI under the TBA contracts. The court found this distinction insignificant since while the banks did deliver securities to LBI, LBI did not hold them on behalf of the claimants.

Implications

This case reaffirms that the definition of "customer" under SIPA is a narrow one[11] and does not extend to claims that in truth are simply breach of contract claims, even if the underlying contract dealt with securities. The decision furthers SIPA's policy of providing special protections to only a limited class of claimants.

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[1] In re Lehman Brothers Inc., 2013 WL 3203300 (Bankr. S.D.N.Y., June 25, 2013).

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

[3] Counterparties also use a Global Master Repurchase Agreement, which is a different industry standard contract. According the Trustee, the provisions relevant to the dispute at hand are substantially similar in both agreements. See Lehman Op., n.7.

[4] Lehman Op., at 6.

[5] In re Bernard L. Madoff Inv. Sec. LLC, 654 F.3d 229, 236 (2d Cir. 2011).

[6] Lehman Op., at 16.

[7] Lehman Op., at 17.

[8] 67 B.R. 557 (D.N.J. 1986).

[9] Lehman Op., at 20.

[10] In re Lehman Brothers Inc., 462 B.R. 53, 57-58 (Bankr. S.D.N.Y. 2011); In re MF Global Inc., Case No. 11-2790 (MG) (Bankr. S.D.N.Y., June 27, 2013) (same).

[11] In re Lehman Bros. Inc., 474 B.R. 139, 145 (Bankr. S.D.N.Y. 2012).