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Lehman Brothers: Treatment of TBA Contracts

On December 8, 2011, the United States Bankruptcy Court for the Southern District of New York entered a memorandum decision in favor of the trustee for the liquidation of Lehman Brothers Inc. in a dispute regarding the status and treatment of claims relating to "TBA contracts." Judge James M. Peck found that TBA contracts are not "securities" and the TBA contract claimants at issue were not "customers" within the meaning of the Securities Investor Protection Act of 1970. The decision is significant given the prevalence of TBA contracts in the mortgage-backed securities market and because it addresses an issue of first impression.

Background

"TBA contracts" are forward contracts for the future purchase of "to be announced" debt obligations of the three US government-sponsored agencies that issue or guarantee mortgage-backed securities. These bilateral contracts have two distinguishing features. First, the mortgaged-backed securities to be bought or sold are not specified when the parties enter into the agreement. The parties agree on six general parameters of the debt obligations to be transferred: date, issuing agency, interest rate, maturity date, total face amount of the obligation and price. Then, immediately prior to the time of performance, the seller will specify how many and which securities will be used to satisfy the contract. Second, these contracts contemplate delayed delivery. Typically, there is an interval of several weeks between the trade date, the time of contract, and the settlement date, at which the time of performance when simultaneous "delivery versus payment" exchange of cash and securities occur. Although no cash or securities are exchanged during this interval, TBA contracts are assigned CUSIP numbers and a contracting party may enter into one or more off setting contracts.

Lehman Brothers Inc. ("LBI") had a series of TBA contracts with various counterparties. In the fall of 2008, shortly after an order was entered for the orderly liquidation of LBI, the Securities Industry and Financial Markets Association issued protocols setting forth instructions for market participants with open TBA contracts with LBI to terminate and close them out and provide the trustee for the LBI estate (the "SIPA Trustee") with notice of the close out cost. In accordance with these protocols, the TBA claimants submitted termination notices setting forth the damages and replacement costs. In addition, the TBA claimants asserted "customer claims" under the Securities Investor Protection Act of 1970 ("SIPA") for amounts due from LBI. Customer status is significant in a SIPA proceeding because only customers, and not general unsecured creditors, are entitled to receive a *pro rata* share of "customer property" (which generally means the failed broker-dealer's pool of non-proprietary cash, securities and futures positions) and to receive up to a certain amount of any shortfall from insurance provided by the Securities Investor Protection Corporation.

The SIPA Trustee issued determination notices denying TBA contract claims customer status under SIPA and reclassifying the asserted customer claims as general creditor claims in an unspecified amount.

The SIPA Trustee's Motion

On June 24, 2011, the SIPA Trustee filed a motion seeking confirmation of its determination that TBA claims are not customer claims under SIPA. The SIPA Trustee argued that the definition of customer should be construed narrowly and, because the TBA claimants did not entrust any securities to LBI, the TBA claimants do not fall within the definition of customers under SIPA. At the time, the term "customers" was defined under SIPA as any person "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 a 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."[1] The SIPA Trustee recited the definition of customer under SIPA and cases that have held that "actual entrustment of securities or cash into the possession of a debtor" is the "bright line test that separates customer claims from all other claims."[2] According to the SIPA Trustee, the TBA claimants had not transferred any property to LBI with respect to any open TBA contracts and in fact elected not to entrust property to LBI by establishing non-custodial delivery-versus-payment accounts. Further, the SIPA Trustee maintained that the TBA claimants' damages claims are only contractual claims for benefit-of-the-bargain damages resulting from LBI's default and are not claims for return of cash or securities.

The SIPA Trustee relied on SIPA's legislative history to support its position. In particular, the SIPA Trustee pointed to the fact that there was a proposal to expand the definition of customer under SIPA to include claimants who held executory contracts for the purchase of securities, but this proposal was rejected and the current definition does not include such claimants. Moreover, the SIPA Trustee asserted that allowing TBA claims to be treated as customer claims would be unfair to all of the customers who actually entrusted property in reliance of SIPA.

The SIPA Trustee also argued, in the alternative, that even if the TBA claimants fall within the meaning of customers under SIPA, they could not be deemed customers because the TBA claimants did not have a fiduciary relationship with LBI. The SIPA Trustee claimed that secured creditors and those that had some collateral arrangement with the debtor are more akin to an ordinary debtor-creditor relationship rather than a fiduciary relationship between a broker and a public customer. Because the TBA claimants had a collateral arrangement with LBI, the SIPA Trustee argued that the claimants are general unsecured creditors rather than customers of LBI.

The Securities Investor Protection Corporation ("SIPC") filed a memorandum in support of the SIPA Trustee's motion.[3] SIPC agreed with the SIPA Trustee that TBA claimants are not customers within the meaning of SIPA on the following grounds: (i) TBA contracts are not securities under SIPA and claimants can only be customers for securities on deposit with the debtor; (ii) the TBA claimants had no property held for them by LBI and they do not have any claims to LBI's property; (iii) the TBA claims are contractual damage claims; and (iv) because no property was set aside or reserved for the TBA claimants, granting TBA claimants customer status would harm all other customers who had accounts at LBI that were proper subjection of segregation or reserves.

[1] Subsequent to LBI's filing, the definition of customer under SIPA was amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The amended definition adds to the definition of customer, "any person who has a claim against the debtor for cash, securities, futures contracts, or options on futures contracts received, acquired or held in a portfolio margining account carried as a securities account pursuant to a portfolio margining program approved by the [Securities and Exchange] Commission." Because the amendment took place after LBI's filing, it is not applicable to the LBI proceeding.

[2] *See* Trustee's Motion for an Order Confirming the Trustee's Determination of Claims Related to TBA Contracts, *In re Lehman Brothers Inc.*, Case No. 08-01420.

[3] *See* Memorandum of Law of the Securities Investor Protection Corporation in Support of Trustee's Motion for Order Confirming the Trustee's Determination of Claims Related to TBA Contracts, *In re Lehman Brothers Inc.*, Case No. 08-01420.

Opposition to the SIPA Trustee

Pacific Investment Management Company LLC, Rogge Global Partners PLC and Morgan Stanley Investment Management Inc. each filed separate objections to the SIPA Trustee's motion.[4] Each of the objectors argued that the TBA claimants are customers under SIPA. First, they asserted that the definition of customer under SIPA is meant to capture all investors who interacted with a broker-dealer and lost money or securities as a result of the insolvency of a broker-dealer. Second, according to the objectors, TBA contracts satisfy each of the requirements of a customer. The contracts are vehicles for the purchase and sale of securities, and LBI was obligated to obtain the securities and deliver them to the claimant's custodian. Finally, the objectors maintained that the TBA contracts do not fall within any express exclusions to the customer definition.

In addition, the objectors responded to each of the SIPA Trustee's arguments. With respect to the entrustment argument, the objectors asserted that entrustment is only one of the six alternatives for meeting the "received, acquired or held" test and that at a minimum, the transactions under the TBA contracts meet the "pursuant to purchases" and "for the purposes of effecting transfer" tests. The objectors also relied on *In re Adler Coleman Clearing Corp.*, 211 B.R. 486 (Bankr. S.D.N.Y. 1997), to argue that parties trading through delivery versus payment accounts have customer status.[5] Moreover, the objectors cited to LBI's accounting policy review and other accounting statements to show that LBI's books and records did reflect the net equity value created by the TBA contracts. The objectors also noted that the SIPA Trustee did not cite to any cases directly on point and the legislative history cited by the SIPA Trustee did not relate to TBA contracts. Finally, the objectors distinguished the cases cited by the SIPA Trustee regarding the requirement of a fiduciary relationship. The objectors maintained that a fiduciary relationship is not a prerequisite to being a customer. Therefore, the objectors asserted that the SIPA Trustee's motion should be denied and the TBA claimants should be deemed customers under SIPA.

Bankruptcy Court's View

On December 8, 2011, the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court") issued its *Memorandum Decision Confirming the Trustee's Determination of Claims Relating to TBA Contracts* (the "Memorandum Decision"). The Bankruptcy Court agreed with the SIPA Trustee that the TBA contract claims do not fit the definition of customer claims under SIPA and properly are classified as general unsecured claims against the estate.

The Bankruptcy Court's decision was based on the fact that the claimants did not entrust customer property to LBI. As of LBI's filing date, the claimants' LBI accounts did not have any cash or securities, which the Bankruptcy Court

[4] *See, e.g.* Opposition of Rogge Global Partners PLC to Trustee's Motion for an Order Confirming the Trustee's Determination of Claims Related to TBA Contracts; Morgan Stanley Investment Management Inc.'s Memorandum of Points and Authorities in Opposition to Trustee's Motion for an Order Confirming the Trustee's Determination of Claims Related to TBA Contracts; Memorandum of Law of Pacific Investment Management Company LLC in Opposition to Trustee's Motion for an Order Confirming Determination of Claims Related to TBA Contracts, *In re Lehman Brothers Inc.*, Case No. 08-01420.

[5] In *Adler Coleman*, the debtor Adler Coleman was a SIPC member and a broker dealer that acted as a clearing firm. RCM Capital Management Corporation was a registered investment advisor that transacted with the debtor on behalf of its clients. On February 24, 1995, RCM instructed its broker to purchase shares on behalf of its customers. The broker purchased the shares through the debtor, with a scheduled settlement date of March 3, 1995, four days after the filing date. The debtor had sent written trade confirmations but because the trade terms provided for delivery versus payment, neither RCM nor the broker had advanced any money or property to the debtor. Thus, as of the filing date, the debtors' books and records showed in the aggregate delivery versus payment a credit of the shares against a debit of the purchase price. RCM filed a claim demanding delivery of the shares in kind. The trustee rejected the claim and determined that RCM was a customer of the debtor and entitled to a customer claim for the net equity in its account.

concluded was a distinguishing fact from *Adler Coleman*, as the claimant in *Adler Coleman* had securities in its account and the debtors' books and records showed this account as having securities. The Bankruptcy Court also relied on two Circuit Court cases to hold that an investor is entitled to compensation from the SIPC "only if he had entrusted cash or securities to a broker-dealer who becomes insolvent; if an investor has not so entrusted cash or securities, he is not a customer and therefore not entitled to recover from the SIPC trust fund."[6] Therefore, the Bankruptcy Court concluded that the claims at issue are not claims for recovery of property held for the customer, but are claims for breach of the TBA contracts. As a result, the TBA claims are not customer claims and the TBA claimants are not entitled to customer protections under SIPA.

The Bankruptcy Court then went on to discuss whether TBA contracts are securities for purposes of SIPA even though this fact is "not essential to confirming the [t]rustee's determination." It held that TBA contracts are not one of the enumerated examples of a security and do not fall within the definition of the term "security" under SIPA. The Bankruptcy Court noted that the only evidence in the record showing that TBA contracts are commonly known as securities was the deposition of the claimants' expert witness. Although TBA contracts display many of the same characteristics as securities, the Bankruptcy Court found that they are outside the applicable definition and are not securities within the meaning of SIPA.

On December 20, 2011, the Bankruptcy Court issued the Order Confirming the Trustee's Determination of Claims Related to TBA Contracts. As of the time of this client publication, no appeal of this order has been filed yet.

Implications

The Memorandum Decision has several key implications. First, whether TBA claimants are entitled to customer status in a SIPA proceeding was an issue of first impression. The Bankruptcy Court acknowledged the novelty of the issue and further acknowledged that the TBA contracts at issue were test cases that may have a binding effect on other TBA contracts, although other TBA contracts may have distinguishable facts. Second, TBA contracts are well-established mechanisms for the purchase and sale of mortgaged-backed securities. As a result of the Memorandum Decision, future investors, in order to manage counterparty risk, may alter the way they purchase and sell such securities. Finally, according to the SIPA Trustee's latest state of the estate presentation, claims for termination costs under TBA contracts against the LBI estate total approximately $300 million. Deeming these claims general unsecured claims and not customer claims will result in a larger pool of assets for those LBI creditors that are deemed customers under SIPA.

[6] Memorandum Decision at 12 (citing *In re Brentwood Secs., Inc.*, 925 F.2d 325 (9th Cir. 1991); *In re Stalvey & Assocs., Inc.*, 750 F.2d 464 (5th Cir. 1985).

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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