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S.D.N.Y. Bankruptcy Court Finds That Claims Against Lehman Brothers Inc. Related to Bilateral Repurchase Transactions Do Not Qualify for Customer Status

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

Contacts

United States

Douglas P. Bartner
New York
+1.212.848.8190
dbartner@shearman.com

Fredric Sosnick
New York
+1.212.848.8571
fsosnick@shearman.com

Andrew V. Tenzer
New York
+1.212.848.7799
atenzer@shearman.com

Edmund M. Emrich
New York
+1.212.848.7337
edmund.emrich@shearman.com

Jill Frizzley
New York
+1.212.848.8174
jfrizzley@shearman.com

United Kingdom

Solomon J. Noh
London
+44.20.7655.5795
solomon.noh@shearman.com

The United States Bankruptcy Court for the Southern District of New York recently entered a memorandum opinion in the Lehman Brothers Inc. (LBI) proceeding under the Securities Investor Protection Act (SIPA).[1] The Bankruptcy Court's opinion concerned the issue of whether claims asserted by counterparties in relation to bilateral repurchase agreements qualified for treatment as customer claims under SIPA. Judge James M. Peck concluded that such claims were not entitled to customer status because a necessary predicate to a customer claim is the entrustment of property with the broker-dealer, which the counterparties were unable to establish. The decision is significant because the Bankruptcy Court reached a different conclusion than the United States District Court for the District of New Jersey, the only other court to address the issue, albeit in the context of hold-in-custody repurchase agreements.

[1] *In re Lehman Brothers Inc.*, 492 B.R. 379 (Bankr. S.D.N.Y. 2013).

Background

The decision arose from objections by numerous parties to the LBI Trustee's determination that certain of their claims, based on repurchase agreements, should be categorized as general creditor claims, as opposed to customer claims. This distinction is important because under SIPA, 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 and securities) and to receive up to a certain amount of any shortfall from insurance provided by the Securities Investor Protection Corporation (SIPC).

The repurchase agreements at issue in the counterparties' objections were bilateral repurchase agreements governed by an industry standard Master Repurchase Agreement (MRA). Bilateral repurchase agreements are identified by transactions where the seller delivers purchased securities to a buyer in exchange for a transfer of cash. In the MRA, the buyer agrees to return the securities to the seller on an agreed date in return for the transferred cash, plus a premium known as the "repo rate." In these particular transactions, LBI, as the buyer, had the right to hold the purchased securities in its own operating account for use in its proprietary business. LBI was never obligated to hold the purchased securities in the claimants' accounts nor did the claimants' accounts hold any property as of the commencement of LBI's SIPA proceeding.

Counterparties' Arguments

At the time of the commencement of LBI's SIPA proceeding, the term "customer" 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."[2] Numerous courts have interpreted that definition to require entrustment of cash or securities with the failed broker-dealer. Notably, the Bankruptcy Court, in a prior ruling in the LBI proceedings upholding the LBI Trustee's determination that claims based on "to-be-announced," or TBA contracts were not entitled to customer status, endorsed the reasoning of those cases and determined that entrustment required actual possession by LBI of the cash or securities.[3]

In their objections to the LBI Trustee's determination, the counterparties argued that physical possession was not the sole key to establishing entrustment for purposes of customer status and went to great pains to distinguish the Bankruptcy Court's TBA decision. The counterparties emphasized LBI's contractual obligation to return the securities, the fact that the purchased securities were electronically linked to the claimants' accounts, and that LBI received and acquired the

[2] 15 U.S.C. § 78*lll*(2). Subsequent to the commencement of LBI's proceeding under SIPA, 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.

[3] *In re Lehman Brothers Inc.*, 462 B.R. 53, 57-58 (Bankr. S.D.N.Y. 2011). 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. For a detailed discussion of the decision, you may wish to refer to *Lehman Brothers: Treatment of TBA Contracts*, Shearman & Sterling Client Publication, Jan. 4, 2012, available at http://www.shearman.com/lehman-brothers-treatment-of-tba-contracts-01-04-2012/.

securities at the outset of the repurchase transaction. Additionally, the counterparties cited to a United States District Court for the District of New Jersey case, *In re Bevill, Bresler & Schulman Asset Mgmt. Corp.*, 67 B.R. 557 (D.N.J. 1986), that held that claims under hold-in-custody repurchase agreements (in which the purchased securities are not delivered to the buyer but rather placed in an internal safekeeping account by the seller) were customer claims under SIPA.

Court's Analysis

The Bankruptcy Court ultimately held in favor of the LBI Trustee. In dismissing the counterparties' arguments, the Bankruptcy Court's analysis focused on entrustment and the possession requirement it previously articulated in connection with its TBA decision. The Bankruptcy Court found that, to establish entrustment, the counterparties would have to show that LBI received, acquired, or held the securities so as to actually possess the securities, which the counterparties were unable to do.

In support of its conclusion, the Bankruptcy Court noted that the contractual duty to return securities was not the same as actual possession, highlighting that the counterparties' account statements confirmed that LBI was not in possession of the securities. Moreover, the Bankruptcy Court did not find the counterparties' argument with respect to the electronic linkage of the securities to be relevant to the question of whether the counterparties were customers under SIPA because payments made through the counterparties' accounts were made for securities being held by third parties, pursuant to the terms of the MRA.

The Bankruptcy Court flatly rejected arguments by the counterparties to the effect that Lehman's subsequent hypothecation of the securities received at the outset of the repo transaction was not relevant to the issue of whether a customer relationship for purposes of SIPA existed, deeming the argument to be specious. In support of that conclusion, the Bankruptcy Court observed that in putting forth that argument, the claimants failed to acknowledge the "reality of the onward movement of the securities." Instead, the Bankruptcy Court held that the argument ends with a finding that the securities "were either (i) hypothecated or (ii) held by LBI in its own operating account for use in its proprietary business, and that no property was being held for the Representative Claimants" at the commencement of the SIPA proceedings.[4] On the same basis, the Bankruptcy Court distinguished the *Bevill, Bresler* decision in that the repurchase agreements in that case were hold-in-custody agreements in which the broker-dealer was actually holding the property for the claimants.

In its analysis, the Bankruptcy Court also looked to the establishment by LBI of delivery-versus-payment (DVP) accounts. The DVP accounts were structured in a way that allowed institutions other than LBI to hold the securities that LBI purchased from the claimants. Such a structure demonstrated to the Bankruptcy Court that the repurchase transactions between the parties were not intended for the purpose of having LBI retain possession of the securities.

In concluding its opinion, the Bankruptcy Court found the claims to be transactional in nature and arising from contractual rights between the parties. Therefore, the claims against LBI were breach of contract claims, not customer claims for the recovery of securities.

[4] *In re Lehman Brothers Inc.*, 492 B.R. at 390.

Implications

This latest opinion in the Southern District of New York continues the trend of narrow judicial interpretation of the definition of "customer" under SIPA. According to the Bankruptcy Court, actual entrustment of property is the principle focus for determining customer status and transactions involving bilateral repurchase agreements do not satisfy that requirement. The decision is significant in that SIPC has long challenged the holding of the *Bevill, Bressler* decision and now has more ammunition to challenge it in other cases. It also marks a major victory for the LBI Trustee, as claims based on repurchase agreements constitute some $342 million of the claims pool. The decision, however, has been appealed so it remains to be seen whether it will stand.

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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