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The Second Circuit Holds That Claims Against Lehman Brothers Related to Bilateral Repurchase Transactions Do Not Qualify for Customer Status

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On June 29, 2015, the United States Court of Appeals for the Second Circuit affirmed the decision of the United States Bankruptcy Court for the Southern District of New York, which held that claims asserted by counterparties in relation to bilateral repurchase agreements do not qualify for treatment as customer claims under the Securities Investor Protection Act of 1970 ("SIPA"). The Court of Appeals found that the appellant was not a customer for purposes of SIPA, because a customer must have entrusted assets to a failed broker-dealer, and the repurchase agreements at issue did not involve the entrustment of assets to Lehman Brothers, Inc. This is the second circuit-level decision to hold that repurchase agreement transactions fail to give rise to customer claims under SIPA.

Background

The decision arose when numerous parties objected to the Lehman trustee's determination that certain of their claims relating to their inability to repurchase securities from Lehman should be categorized as general creditor claims, as opposed to customer claims. This distinction is important because under SIPA, only "customers" 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 a certain amount of insurance protection provided by the Securities Investor Protection Corporation.

The bilateral repurchase agreements at issue were governed by an industry-standard Master Repurchase Agreement ("MRA"). Bilateral repurchase agreements are identified by

transactions where the seller delivers securities to a buyer in exchange for a transfer of cash. In turn, the buyer agrees to sell the securities to the seller on a future date in return for an agreed price, which amounts to the initial purchase price plus a premium known as the "repo rate."[1] In these particular transactions, Lehman, as the buyer in the first phase of the transaction, had the right to hold the purchased securities in its own operating account for use in its proprietary business pending the sale in the second phase. Lehman never was obligated to hold the purchased securities in the claimants' accounts, nor did the claimants' accounts hold any such securities as of the commencement of Lehman's SIPA proceeding.

When Lehman's SIPA proceeding began, 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.[3] In their objections to the Lehman trustee's determination, the counterparties argued that physical possession was not the sole relevant factor. Additionally, the counterparties relied heavily on a district court decision[4] which 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.

The bankruptcy court held that the claims of the counterparties 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 district court affirmed.

1 A repo offers the seller a mechanism to convert idle securities into liquid cash, which can be employed for investments or other purposes before returning the cash to the buyer in exchange for the securities at the conclusion of the repo. The buyer, on the other hand, is provided with an outlet for excess cash and for the temporary acquisition of attractive securities. Moreover, the buyer retains the difference between the resale price and the original sale price as a fee for the transaction.

2 15 U.S.C. § 78*lll*(2). Following the commencement of Lehman's SIPA proceeding, 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 "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 Lehman's filing, it is not applicable to the Lehman proceeding.

3 Notably the Bankruptcy Court, in a prior ruling in the Lehman proceedings upholding the Lehman trustee's determination that claims based on "to-be-announced" (TBA) contracts were not entitled to customer status, endorsed the reasoning of those cases and determined that entrustment required actual possession by Lehman of the cash or securities. *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, please 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/.

4 *In re Bevill, Bresler & Schulman Asset Mgmt. Corp.*, 67 B.R. 557 (D.N.J. 1986) ("*Bevill, Bresler*").

Analysis of the Court of Appeals for the Second Circuit

The Court of Appeals for the Second Circuit held that an investor who delivers securities to a broker-dealer as part of a repurchase agreement is not protected by SIPA, because the investor did not entrust assets to the broker-dealer. This entrustment requirement consistently has been critical to the definition of the term "customer." The appellant argued that repurchase agreements necessarily involve entrustment, as appellant delivered securities to the broker-dealer "for some purpose connected with participation in the securities market" and invoked Lehman's supposed general fiduciary duty to consummate the repurchase agreement. The Court of Appeals disagreed, stating that mere delivery is not entrustment; instead, entrustment must bear "the indicia of the fiduciary relationship between a broker and his public customer."[5] This fiduciary relationship arises out of the broker's obligation to handle the customer's assets for the customer's benefit.[6] Here, the securities were not entrusted to Lehman; instead, they were sold to Lehman. Lehman acquired full legal title to the securities and was free to sell, transfer, pledge or hypothecate the securities as it desired. Lehman's discretion to do what it saw fit with the securities even extended to situations where its interests would be adverse to those of the appellant. At most, the repurchase agreement imposed a contractual obligation on Lehman to resell the underlying securities at the conclusion of the repo. Without any indicia of a fiduciary relationship, which did not exist here, the Court of Appeals found that appellant did not entrust the securities to Lehman.[7]

The Court of Appeals was not persuaded by the argument that appellant retained an economic interest in the securities once they were sold.[8] To constitute entrustment, the appellant's economic interests must have somehow constrained Lehman to use the securities on appellant's behalf, which was not the case here, as Lehman held title to the securities and could dispose of them as it saw fit. The Court of Appeals also found it notable that the MRA described the relationship between the parties as "contractual" and did not make any mention of a fiduciary relationship. The Court of Appeals concluded that Lehman's unrestricted ownership of the securities defeats any suggestion that appellant entrusted the securities to Lehman when it entered into the repos. As a result, appellant is not a customer for purposes of SIPA.[9]

5 Citing *SEC v. F.O. Baroff Co.*, 497 F.2d 280, 284 (2d Cir. 1974).

6 Examples of behavior which should demonstrate that the broker was holding the assets as part of a fiduciary relationship with a customer include selling the assets for the customer, using the assets as collateral to make margin purchases of other securities for the customer, or otherwise using the assets to facilitate securities trading by the customer. *Id*.

7 The Court of Appeals found it notable that appellant did not cite a single case for the proposition that a repo counterparty breached a fiduciary duty by failing to resell (or repurchase) securities at the conclusion of a repo. The Court of Appeals further noted that even if such a duty existed, it would not be the type of fiduciary relationship in which a broker-dealer holds assets on a customer's behalf.

8 Appellant argued that it had the expectation of repurchasing the securities at the end of the repo; appellant's books accounted for the securities as if they still owned them; appellant bore the market risk associated with the securities; and appellant received any principal or interest payments generated by the securities during the course of the repos in the form of regular payments from Lehman.

9 The Court of Appeals separately addressed appellant's reliance on *Bevill*, *Bresler*, stating that although *Bevill*, *Bresler* acknowledges *Baroff*, it also conflicts with the holding in *Baroff* and does not actually demonstrate how repo participants entrust assets to failed broker-dealers. As a result, the Court of Appeals declined to follow *Bevill*, *Bresler*, finding it inconsistent with the relevant caselaw.

Conclusion

This decision aligns the Second Circuit Court of Appeals with the Eleventh Circuit Court of Appeals, which also expressly considered whether repurchase agreements involve the entrustment of assets.[10] Unlike the decision in *ESM*, however, the decision in *Lehman* does not extend to the broader holding that repo counterparties are not customers under the Bankruptcy Code, as that question was not before the court. Furthermore, this case is factually distinguishable from *Bevill*, *Bresler*, where the securities were held in custody; the result conceivably could be different if there was a requirement for the broker-dealer, as purchaser in the first phase of the transaction, to hold the securities in custody.

10 *In re ESM Gov't Sec., Inc.*, 812 F.2d 1374 (11th Cir. 1987) ("*ESM*").

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