



Exceptional Insolvencies: Provisions of the Bankruptcy Code and SIPA Regarding Broker-Dealers and Other Financial Market Participants and Contracts

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Recent turmoil in the financial markets has focused attention on the potential insolvencies of broker-dealers and other financial market participants, whose businesses are intertwined with myriad investors and counterparties through investment accounts, securities and commodities contracts, repurchase agreements, swaps, and master netting agreements.

Indeed, because of the effects such insolvencies might have on these investors and counterparties, and on the financial markets themselves, there are special provisions of the United States Bankruptcy Code (the Bankruptcy Code) and the Securities Investor Protection Act of 1970 (SIPA) that are designed to address these types of insolvencies in a manner different from the insolvency of a business where these concerns do not exist.

Thus, the liquidation of a stockbroker or commodities broker is different in process and substance from the liquidation of another type of business. The adverse impact on a bankrupt broker's customers and their investments will likely be less severe under the special bankruptcy and SIPA rules than it would be under the general bankruptcy rules. Additionally, the effect of a broker's or other financial participant's bankruptcy on a customer's or counterparty's overall business may be reduced as a result of the many exceptions to the general bankruptcy rules under which a non-debtor party may close out financial transactions with a debtor, despite the debtor's bankruptcy. These differences--and what they put at stake--are highlighted in recent judicial decisions arising from the bankruptcies of, among others, Refco and American Home Mortgage.

I. SPECIALIZED PROVISIONS FOR STOCKBROKER AND COMMODITIES BROKER LIQUIDATIONS

Section 109(d) of the Bankruptcy Code¹ provides that stockbrokers and commodity brokers may be debtors only in a Chapter 7 liquidation--forcing brokers to enter bankruptcy, if at all, subject to the special provisions applicable to brokers under Chapter 7 and precluding them from reorganizing under Chapter 11. Chapter 7 of the Bankruptcy Code contains special provisions for liquidations of stockbrokers,²

commodity brokers,³ and clearing banks.⁴ These special provisions contain different rules for the distribution of assets in stockbroker liquidations than other liquidations. The types of assets (e.g., customer name securities versus other securities) and the types of creditors (e.g., customers versus non-customers) will determine the extent of the recoveries available to the claimants in the liquidation. In addition, the regulatory role of the Securities Investor Protection Corporation (SIPC) and the potential availability of SIPA insurance may affect the process and outcome of the liquidation. As a general matter, a broker's customers stand to be affected less, and less adversely, by a broker's liquidation under the special bankruptcy and SIPA provisions than if the liquidation were conducted under bankruptcy rules of general application.

When is a broker a broker? The term "stockbroker" is defined under the Bankruptcy Code as a person or entity that:

- has a "customer," as defined in Section 741 of the Bankruptcy Code⁵; and
- is engaged in the business of effecting transactions in securities (i) for the account of others or (ii) with members of the general public, from or for such person or entity's own account.⁶

To be a stockbroker, one must deal with at least one "customer." A customer includes someone whose securities account or accounts are dealt with in the ordinary course of a stockbroker's business for at least one of the following reasons:

- for safekeeping;
- with a view to sale;
- to cover a consummated sale;
- pursuant to a purchase;
- as collateral under a security agreement; or
- for the purpose of effecting registration or transfer.⁷

The definitions of "stockbroker" and "customer" are important in determining whether an entity is subject to the Chapter 7 stockbroker liquidation provisions. In *In re Refco*,⁸ for example, a group of customers moved to convert Refco's Chapter 11 case to a stockbroker liquidation under Chapter 7 on the ground that Refco was a stockbroker and, as such, could be liquidated only through Chapter 7's special stockbroker provisions.⁹ In opposition to the conversion motion, Refco's banking group argued that Refco was not a stockbroker because (1) Refco did not have customers for whose account it traded, and (2) Refco did not effect securities transactions with members of the general public. The banking group alleged that Refco did not segregate clients' deposits or otherwise hold such deposits in trust such that a fiduciary customer relationship was created. Rather, the banking group alleged, Refco held the deposits as its own capital and transacted business at arm's length with its clients as counterparties. With respect to its assertion that Refco did not effect transactions as a dealer with members of the general public, the banking group argued that the group of customers seeking conversion to Chapter 7 was composed of "institutional or financially sophisticated investors, trading in an unregulated securities industry [who] are not within the class the [Bankruptcy Code] deemed to be within the ambit of its protections under the designation, 'members of the general public.'"¹⁰

Following a trial on the conversion motion, the Bankruptcy Court concluded in a preliminary ruling that

Refco was a "stockbroker" with at least one "customer," as such terms are defined in the Bankruptcy Code. The Court postponed a final ruling on the matter and conversion of the case, however, to provide the parties with additional time to negotiate a settlement on the terms of a Chapter 11 plan. The Chapter 11 plan that resulted from such negotiations represented a compromise that allowed the customers some of the protections of the special stockbroker provisions of Chapter 7 within the Chapter 11 context. This result underlines the potential complexity of applying Chapter 7's special provisions to a large entity that bears some marks of a "stockbroker," but also has operations that appear inconsistent with that defined term.¹¹

Why are stockbroker liquidations unique? Stockbroker liquidations are unique because, in addition to holding their own assets, stockbrokers hold assets for their customers, including cash and securities. Unlike non-broker liquidations, where most of the assets being liquidated belong to the debtor, stockbroker liquidations involve the liquidation both of the broker's assets and property specifically allocable to customers and customer investments. Customers of brokers have priority rights in such property in a stockbroker liquidation. Similar priority rights do not exist in non-broker liquidations.

How are assets distributed in a stockbroker liquidation? The way assets are distributed in a stockbroker liquidation depends upon whether those assets are "customer name securities," "customer property," or general assets of the stockbroker. "Customer name securities" are any non-transferable securities that are registered, or in the process of being registered, in a customer's own name.¹² "Customer property" includes all property, including securities and cash, that was, or should have been, set aside for the particular customer in accordance with SEC guidelines.¹³

In a stockbroker liquidation, customer name securities are distributed directly to their customer owner so long as the customer does not have negative equity in its investments with the broker.¹⁴ In contrast, customer property is pooled and distributions are shared ratably by all customers to the extent of their "net equity claims."¹⁵ To the extent a customer's claim is not satisfied by its pro rata share of customer property (and any customer name securities held for and distributed to it), the customer will share equally with general creditors in the general estate from any assets that are neither customer name securities nor customer property.

How are broker liquidations under the Bankruptcy Code related to broker liquidations under other laws? SIPC, which was created under SIPA to administer a fund to protect the accounts of securities investors, and the Securities and Exchange Commission are entitled to be notified upon the entry of an order for relief under Chapter 7 against a stockbroker.¹⁶ Notwithstanding bankruptcy's automatic stay, SIPC may then file in the district court an application for a protective decree under SIPA, which application would stay all bankruptcy proceedings until the SIPA action is completed.¹⁷ After granting the requested protective decree under SIPA, the district court is required to appoint a trustee of SIPC's choosing¹⁸ and order the removal of the entire liquidation proceeding to the bankruptcy court in the same judicial district.¹⁹ Thus, to a certain extent, SIPC can displace a Chapter 7 bankruptcy filing by the initiation of a SIPA liquidation proceeding. But the provisions of the Bankruptcy Code will nonetheless apply in the SIPA liquidation to the extent they are not inconsistent with SIPA.

In commodity broker liquidations, the Commodities Futures Trading Commission (CFTC) is entitled to be notified upon the entry of an order for relief under Chapter 7 against a commodities broker. The CFTC is

generally responsible for the regulation of the commodity markets. As such, it has the right to appear and be heard in any commodity broker liquidation. Although the law is unclear, the CFTC apparently also has the right to appeal any adverse decision.²⁰ There is no non-bankruptcy federal liquidation procedure for commodity brokers.

II. EXCEPTIONS FOR CERTAIN FINANCIAL CONTRACTS

A number of exceptions available to certain brokers and other financial institution parties allow those parties to net, offset, liquidate, terminate, and accelerate certain contracts, and thereby close out financial transactions with their debtor counterparty, despite the counterparty's bankruptcy and the general bankruptcy rules that would prevent these actions under other contracts. As a practical matter, the exceptions reduce the risk that the bankruptcy of a counterparty to a financial contract will delay or prevent the non-debtor from closing out financial positions, which closing out may be required as part of the non-debtor's overall business with many other non-debtor parties. However, these "process" exceptions for eligible contracts do not reduce the economic risk that the claims of a party against a debtor remain unpaid, especially where those claims are far in excess of any amounts owed by the non-debtor party to the debtor or any collateral held by the non-debtor.

To what general bankruptcy rules do the exceptions apply? The exceptions for certain financial contracts are exclusions from several of the most basic and important rules of general application in bankruptcy:

- **Automatic Stay.** In general, the commencement of a bankruptcy case activates the "automatic stay,"²¹ which protects the debtor from actions taken by creditors, such as collecting pre-bankruptcy debts and filing lawsuits against the debtor, without Bankruptcy Court permission. Such permission is not routinely given.
- **Ipso Facto Termination.** In general, contractual provisions that allow a party to terminate or modify a contract based solely on the bankruptcy or insolvency of its counterparty (so-called "ipso facto" clauses) are not enforceable once the counterparty files for bankruptcy.²²
- **Setoff.** In general, a creditor may not exercise setoff rights against a debtor with respect to a claim acquired by the creditor within 90 days before the bankruptcy for the purpose of obtaining a right of setoff.²³ In addition, the trustee may generally avoid a setoff that occurs in the 90 days before the bankruptcy filing to the extent the creditor improved its position during that 90 day period.²⁴
- **Rejection Damages.** In general, a bankruptcy debtor may elect to reject a contract under which the debtor and its counterparty have continuing performance obligations, effectively terminating the debtor's ongoing obligations under the contract and leaving the counterparty with a general unsecured claim for damages that is measured as of the date the bankruptcy is filed.²⁵
- **Avoidance Powers.** In general, a bankruptcy debtor or trustee can sue third parties to recover for the bankruptcy estate payments made to third parties prior to the bankruptcy filing, as preferential or fraudulent transfers, subject to certain limitations and defenses.²⁶

What types of parties and contracts are eligible for the exceptions? Only certain types of parties and contracts are eligible for the financial contract exceptions to these general principles, including:²⁷

- **commodity brokers** (not defined) and **financial participants**,²⁸ with respect to **commodity contracts**;
- **forward contract merchants** and financial participants, with respect to **forward contracts**;²⁹
- **stockbrokers**,³⁰ **financial institutions**,³¹ **financial participants**, and **securities clearing agencies**, with respect to **securities contracts**;
- **repo participants** and financial participants, with respect to **repurchase agreements**;
- **swap participants** and financial participants, with respect to **swap agreements**; and³²
- all of the above-listed parties (called "**master netting agreement participants**"), with respect to **master netting agreements**.

What are the exceptions? For the eligible parties and contracts, the general bankruptcy rules described above do not apply with full or, in some instances, any effect. Instead, the Bankruptcy Code contains express exceptions that allow these parties to administer and enforce these contracts free from the restrictions that their counterparty's bankruptcy would otherwise impose. These exceptions include:

- **Automatic Stay Exceptions.** Sections 362(b)(6), (7), (17), and (27) of the Bankruptcy Code³³ allow the eligible parties to exercise their "contractual rights"³⁴ related to eligible contracts, including rights to offset or net out any termination value, payment amount, or other transfer obligation under those contracts or master agreements for those contracts, notwithstanding the automatic stay. For example, a bankruptcy filing by a party to a master netting agreement will not likely prohibit a counterparty from performing the netting permitted under the agreement.
- **Ipsso Facto Exceptions.** Sections 555, 556, 559, 560, and 561 of the Bankruptcy Code³⁵ allow the eligible parties to cause the liquidation, termination, or acceleration of the eligible contracts based on the bankruptcy or insolvency of the debtor, if the eligible parties have "contractual rights" to do so. For example, if, by its terms, a repurchase agreement may be accelerated upon the bankruptcy filing of the party obligated to make the repurchase, this acceleration is not prohibited by the Bankruptcy Code.
- **Setoff Exception.** Section 553 of the Bankruptcy Code³⁶ allows eligible parties to set off prepetition claims and debts as permitted by the automatic stay exceptions and the ipso facto exceptions, notwithstanding the general rules creating an automatic stay against such setoffs without relief therefrom and limiting setoffs of debts owing to the debtor incurred in the 90 days prior to the bankruptcy filing.
- **Rejection Damages Exception.** Section 562 of the Bankruptcy Code³⁷ contains special rules for measuring damages claims arising from the rejection of the eligible contracts, which rules also apply to measuring damages in connection with an eligible party's liquidation, termination, or acceleration of an eligible contract. Rather than measuring damages as of the bankruptcy filing date, damages are measured as of the earlier of the date of the debtor's rejection of the contract and the date of the eligible party's liquidation, termination, or acceleration of the contract. If there are no commercially reasonable determinants of value as of that date, a later date may be used. This exception is an extension of permitting the eligible party to act to close out or terminate a contract before the debtor rejects the contract. It also ties the eligible party's claim to the date it acts, giving the eligible party more control over the consequences of its act.
- **Avoidance Action Exceptions.** Sections 546(e), (f), and (g) of the Bankruptcy Code³⁸ prohibit a debtor or trustee from using its avoidance powers to sue to recover margin payments,³⁹

settlement payments,⁴⁰ and other transfers made by, to, or for the benefit of eligible parties before the bankruptcy filings, except in cases where the payment was made with the actual intent to hinder, delay or defraud the debtor's other creditors under Section 548.⁴¹ These defenses to preference, "constructive fraud," and state law actual fraud avoidance actions are important to preserve the stability of financial market transactions effected prior to a bankruptcy filing.

Two recent decisions from the American Home Mortgage, Inc. Chapter 11 case demonstrate both the importance of these exceptions and the extent to which parties will litigate over whether these exceptions apply. In *American Home I*,⁴² the Delaware bankruptcy court held that Calyon, the non-debtor buyer of mortgage loans under a mortgage loan repurchase agreement, was not stayed from exercising its rights to close out the agreement and enforcing its rights against the underlying mortgage loans. However, the court also held that the loan servicing provisions of the mortgage repurchase agreement, which was sold on a "servicing retained" basis, were severable from the repurchase provisions and were not themselves a "repurchase agreement" within the meaning of the Bankruptcy Code. Accordingly, the servicing provisions did not qualify for the financial contract exceptions. Significantly, the court left open the issue of whether the servicing provisions of mortgage repurchase agreements that are sold on a "servicing released" basis would be a part of the repurchase agreement and would qualify for the safe harbor.

In *American Home II*,⁴³ the parties had entered into a repurchase agreement that allowed Lehman Brothers to terminate the agreement and dispose of certain notes subject to the agreement if American Home filed for bankruptcy. When American Home objected in the bankruptcy court to Lehman Brothers' attempt to exercise its rights under the *ipso facto* clause, the court held that the safe harbors of Sections 555 and 559 applied and that Lehman Brothers was entitled to enforce its rights under the repurchase agreement without violating the automatic stay.

How do the exceptions apply in broker liquidations under other laws? As discussed above, the Bankruptcy Code is not the only potentially relevant statute for the liquidation of certain entities who are parties to financial contracts, such as stockbrokers and commodity brokers. In the case of a stockbroker liquidation under Chapter 7 of the Bankruptcy Code, the bankruptcy court is permitted to disregard the *ipso facto* exceptions--in other words, to enforce the rules of general application even on eligible contracts--if permitted under SIPA. Moreover, the commencement of a stockbroker liquidation under SIPA has the potential to essentially supplant any Bankruptcy Code liquidation of the stockbroker, and thereby to supplant the rules and exceptions of the Bankruptcy Code, to the extent the Bankruptcy Code is inconsistent with SIPA. Finally, even within the Bankruptcy Code there are some limits on the exceptions for eligible contracts--for example, netting under commodity contracts with a debtor that is a commodity broker is limited, under Section 561(b)(2),⁴⁴ to cases in which the netting party has positive net equity in its commodity accounts at the debtor.

The Bottom Line

The Bankruptcy Code and SIPA have been designed to reduce the implications of insolvency and bankruptcy on the financial markets and those who rely on the uninterrupted functionality of those

markets. However, these statutes are complex and limited in scope. Knowledge of the specifics of the standard Bankruptcy Code and SIPA rules, as well as the exceptions, is essential to understanding and utilizing these statutes in financial market insolvencies.

1 11 U.S.C. § 109(d).

2 11 U.S.C. §§ 741-753.

3 11 U.S.C. §§ 761-767.

4 11 U.S.C. §§ 781-784.

5 11 U.S.C. § 741.

6 11 U.S.C. § 101(53A).

7 11 U.S.C. § 741(2)(A).

8 Case No. 05-60006 (RDD) (Bankr. S.D.N.Y.).

9 Motion to Convert Refco Capital Markets, Ltd.'s Chapter 11 Proceeding to a Chapter 7 Stockbroker Liquidation Under Subchapter III, ¶¶ 17-18 (quoting Collier's on Bankruptcy ¶ 109.05[2] (2005)).

10 Memorandum of Law In Support of Opposition of Bank of America, N.A., as Administrative Agent, to Motion to Convert Refco Capital Markets, Ltd.'s Chapter 11 Proceeding to a Chapter 7 Stockbroker Liquidation, 9-10 (quoting *In re SSIW Corp.*, 7 B.R. 735, 743 (Bankr. S.D.N.Y. 1980)).

11 See also *In re Slatkin*, 525 F.3d 805 (9th Cir. 2008) (9th Cir. Case No. 06-56334, May 6, 2008), a recent decision under Section 546(e) of the Bankruptcy Code (which exempts margin and settlement payments from preference and certain fraudulent transfer powers normally applicable in bankruptcy), addressing whether an investment manager operating a Ponzi scheme was a "stockbroker." The Court of Appeals held that, while Mr. Slatkin had "customers" and dealt in securities, his inability to effect trades of securities without the assistance of brokers precluded his qualifying as a "stockbroker." See also *In re Stewart Finance Co.*, 367 B.R. 909 (Bankr. M.D. Ga. 2007), in which the court considered whether an entity could be a "stockbroker" with respect to certain transactions but fail to qualify as a stockbroker with respect to other transactions, also for the purposes of Section 546(e). Without answering that question generally, the court held that "stockbroker" should be broadly construed--at least for Section 546(e) purposes--and found the entity to be a "stockbroker."

12 11 U.S.C. § 741.

13 11 U.S.C. § 741(4).

14 If negative net equity obligations exist, such obligations must be satisfied before customer name securities are distributed to customers, notwithstanding the priority granted with respect to such customer name securities.

15 11 U.S.C. § 752(a). "Net equity," defined in Section 741(6) (11 U.S.C. § 741(6)), means, with respect

to all accounts of a customer, the aggregate dollar balance that would remain in the accounts after the liquidation of all securities in the accounts other than customer name securities, minus any claim of the debtor against the customer that would have been owing immediately after the liquidation.

[16](#) 11 U.S.C. § 743.

[17](#) 11 U.S.C. § 742.

[18](#) 15 U.S.C. § 78eee(b)(3).

[19](#) 15 U.S.C. § 78eee(b)(4).

[20](#) Compare 11 U.S.C. 762(b), the text of which omits a restriction on the CFTC's right to appeal, to 11 U.S.C. 1109(a), in which the SEC is granted the right to appear in chapter 11 cases, but is explicitly prohibited from appealing any judgment, order or decree.

[21](#) 11 U.S.C. § 362(a).

[22](#) 11 U.S.C. § 365(e)(1).

[23](#) 11 U.S.C. § 553(a)(3).

[24](#) 11 U.S.C. § 553 (b).

[25](#) 11 U.S.C. § 365(a).

[26](#) 11 U.S.C. §§ 544, 547, and 548.

[27](#) Most of these terms are defined under the Bankruptcy Code. Some of the more complex definitions are described in the following footnotes.

[28](#) "Financial participant" is defined under Section 101(22A) of the Bankruptcy Code (11 U.S.C. § 101(22A)) to mean either a clearing organization or a party to securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements, and/or master netting agreements that have a combined notional value of \$1 billion across the debtor and all other counterparties or that have gross mark-to-market positions of \$100 million with any one counterparty, measured on the date of the relevant contract, on the date of the bankruptcy filing, or on any date within 15 months before the bankruptcy filing.

[29](#) See, e.g., *In re Borden Chemicals and Plastics Operating L.P.*, 336 B.R. 214 (Bankr. D. Del. 2006) (evaluating whether a particular natural gas contract is a "forward contract").

[30](#) See the discussion of stockbroker liquidations, above, for a detailed description of the term "stockbroker."

[31](#) "Financial institution" is defined under Section 101(22) of the Bankruptcy Code (11 U.S.C. § 101(22)) to mean an Investment Company Act of 1940 investment company, for any securities contract, and a Federal Reserve Bank or other bank, and a customer of the bank for whom the bank acts as agent or custodian. The inclusion of "customer" in this definition makes the applicability of the financial contract exceptions broader than first apparent from the text of the exceptions themselves.

[32](#) See, e.g., *In re National Gas Distributors, LLC*, 369 B.R. 884 (Bankr. E.D.N.C. 2007) (evaluating

whether a natural gas contract was a "swap agreement").

33 11 U.S.C. § 362(b)(6), (7), (17), and (27).

34 "Contractual rights" are defined as common law rights, merchant law rights, rights arising by reason of normal business practices, and rights established by clearing organizations and agencies, national securities associations, boards of trade, and similar institutions. In essence, the definition covers the types of rights that would allow the regular operation of the contract mechanics outside of bankruptcy.

35 11 U.S.C. §§ 555, 556, 559, 560, and 561.

36 11 U.S.C. § 553.

37 11 U.S.C. § 562.

38 11 U.S.C. § 546(e), (f), and (g).

39 Defined in 11 U.S.C. §§ 101, 741, and 761.

40 Defined in 11 U.S.C. §§ 101 and 741.

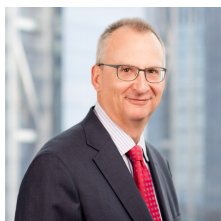
41 Notably, a debtor or trustee may avoid actually fraudulent transfers that constitute margin or settlement payments only when such avoidance action is commenced under 11 U.S.C. § 548(a). See *In re National Forge Co.*, 344 B.R. 340 (W.D. Pa. 2006) ("if Congress had intended to exempt from § 546(e)'s protections allegations of actual fraud under state law fraudulent transfer theories, it could easily have done so").

42 *Calyon New York Branch v. Am. Home Mortgage Corp. (In re Am. Home Mortgage Inc.)*, 379 B.R. 503 (Bankr. D. Del. 2008).

43 *Am. Home Mortgage Inv. Corp. v. Lehman Bros. Inc., (In re Am. Home Mortgage Holdings Inc.)*, No. 07-11047, Adv. Proc. No. 07-51739, 2008 WL 2156323 (Bankr. D. Del. May 23, 2008).

44 11 U.S.C. § 561(b)(2).

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