Hughes Hubbard & Reed

Lehman Team Secures 2nd Circuit Victory in Repo Case

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July 17, 2015 — Hughes Hubbard earned a third consecutive victory in litigation over whether claims arising out of repurchase transactions (repos) qualify for customer protection in the Securities Investor Protection Act (SIPA) liquidation of Lehman Brothers Inc. (LBI).

On June 29, 2015, the U.S. Court of Appeals for the Second Circuit affirmed two lower court decisions—U.S. District Judge Denise Cote in 2014 and U.S. Bankruptcy Judge James Peck in 2013— holding that CarVal Investors UK Limited's $44 million in repo claims did not involve the entrustment of securities to LBI, and therefore CarVal did not qualify as a "customer" under SIPA.

The three-judge panel's decision relied heavily upon, and simultaneously reinforced, a precedent-setting decision won by Hughes Hubbard in 1974. The decision also solidified the status of repos in bankruptcy for parties who participate in the multitrillion-dollar US repo market, which provides crucial liquidity to the world's financial markets and helps to finance the national debt.

More than 40 years ago, the Second Circuit proclaimed in *SEC v. F.O. Baroff Company* that courts must look beyond the literal words of the SIPA "customer" definition in determining whether a claimant entrusted securities to a failed broker. James W. Giddens and James B. Kobak Jr. acted as counsel to the trustee in the case. Today, Giddens is the trustee and Kobak is counsel to the trustee in LBI's SIPA liquidation. Since Baroff, a few lower courts issued decisions muddling and misapplying the entrustment rule. The Second Circuit's recent decision in favor of Hughes Hubbard offers a clear repudiation of those cases and recognizes Baroff's entrustment requirement as the established law of the Second Circuit and several sister circuits.

Offering perhaps the clearest statement yet on what constitutes an entrustment under SIPA, Chief Judge Katzmann wrote for the panel: "[M]ere delivery [of assets to the broker] is not entrustment. Entrustment, as contemplated by Baroff, must bear the 'indicia of the fiduciary relationship between a broker and his public customer.' This 'fiduciary relationship,' in turn, arises out of the broker's obligation to handle the customer's assets for the customer's benefit."

Noting that the parties' contracts gave LBI legal title over the securities used in the repos and discretion to use the securities as it wished, the Court found that LBI was not acting as CarVal's fiduciary. Rather, the repos were an arms-length deal struck between contractual counterparties that each party entered into for its own benefit. Without indicia of a fiduciary relationship, the Court held that there was no entrustment, and CarVal was not a customer under SIPA. The Second Circuit's comprehensive ruling categorically rejecting customer treatment for CarVal's repo claims provides solid ground for the LBI trustee to move forward with reclassifying over $75 million of other repo claims, which, if successful, will provide a greater recovery for LBI's general creditors.

Giddens called the decision "a significant milestone in winding down and closing the Lehman Brothers Inc. estate, and it affirms longstanding policy and practice that repurchase agreements are akin to commercial borrowings, not customer transactions."

The decision also represents a significant win for the Securities Investor Protection Corporation (SIPC), the entity that oversees broker-dealer liquidations under SIPA. SIPC has argued for decades that repos should not be accorded customer status, and treating repo counterparties as customers would have dealt a serious blow to SIPC's ability to make the customers of failed broker-dealers whole.

Hughes Hubbard's victory was reported by The New York Times, The Wall Street Journal, Reuters and Law360. The repo litigation is being handled for Giddens by Michael Salzman (who argued the case before the Second Circuit), Kobak, Chris Kiplok and Seth Schulman-Marcus.

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