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Repurchase Agreement Transactions in Securities Investor Protection Act Proceedings

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REPURCHASE AGREEMENT TRANSACTIONS
IN SECURITIES INVESTOR PROTECTION ACT
PROCEEDINGS

I. Introduction

One of the primary duties of a bankruptcy trustee is to maximize the estate of a bankrupt. In order to accomplish that goal, the trustee is vested with the power to control assets in which the bankrupt has a legal or equitable interest. For example, because the bankrupt retains an equitable interest in assets pledged as collateral for a loan, a bankruptcy trustee can prevent creditors from

3. The Bankruptcy Code provides that when a bankruptcy case is commenced under §§ 301, 302 or 303, an estate is created. See 11 U.S.C. § 541 (1982). That estate consists of all legal and equitable interests of the debtor in property, with some exceptions. See id. The “depositor” is a “person . . . concerning whom a case has been commenced” under the Bankruptcy Code. See id. § 101(12) (1982). To avoid confusion when speaking about debt transactions, this Note uses the term “bankrupt” rather than “debtor” when speaking about a person liquidated by the Bankruptcy Code. Congress declined to use “bankrupt” in the Bankruptcy Code because of its negative connotations. See H.R. Rep. No. 595, 95th Cong., 1st Sess. 310 (1977). This Note also uses the term “insolvent broker” when speaking about a broker liquidated under SIPA.
4. In re Gustav Schaefer Co., 103 F.2d 237 (6th Cir. 1939); In re Kessler, 186 F. 127 (2d Cir. 1911), aff’d, 228 U.S. 634 (1913); 4 W. Collier, Collier on Bankruptcy ¶ 704.01 (15th ed. 1986) [hereinafter Collier].
5. See 11 U.S.C. § 363(b) (1982). Section 363 of the Bankruptcy Code gives bankruptcy trustees the power to use or sell property of the estate. Id. Section 541(a)(1) of the Bankruptcy Code provides that the estate of the bankrupt includes “all legal or equitable interests of the debtor in property as of the commencement of the case” 11 U.S.C. § 541(a)(1) (1982); see also 4 Collier, supra note 4, ¶ 541.01, at 541-5. A bankruptcy case is commenced when a voluntary, joint or involuntary petition is filed with the bankruptcy court. See 11 U.S.C. §§ 301-303 (1982).
6. 4 Collier, supra note 4, ¶ 541.08[3], at 548-46.1. A debtor can give a creditor two types of collateral: he can pledge property, see id. ¶ 541.08[9], or he can encumber his property by giving a creditor a security interest. See id. ¶ 541.08[3]. If a debtor pledges collateral, the creditor receives a possessory interest rather than an ownership interest in the property. See id. ¶ 541.08[9]. Accordingly, if a creditor files for bankruptcy while holding pledged collateral, that pledged collateral is not considered part of his estate in bankruptcy. See id.
foreclosing on collateral.7 In contrast, if the bankrupt sold the assets, transferring ownership rights to the buyer,8 the bankruptcy trustee must allow the new owner of the property to dispose of it at will.9

These distinctions have forced bankruptcy courts to classify complex transactions as either sales or loans.10 Courts have found it difficult to make this determination when dealing with financial instruments called repurchase agreements (REPOS).11 REPOS are executed in two steps. First, the REPO issuer sells securities to the REPO buyer. The REPO buyer pays for the securities and agrees to sell the securities back to the REPO issuer at a later date. Second, at the later date, the REPO buyer returns the securities and the

In contrast, if a creditor retains a security interest in collateral, the Bankruptcy Code states that collateral is included in a creditor’s estate in bankruptcy. See id. ¶ 541.08[3], at 541-46.2. For the purposes of this Note, collateral is presumed to be held subject to a security interest, and is, therefore, included in a debtor’s estate when the bankruptcy case is commenced. But see In re Financial Corp., 1 Bankr. 522, 526 n.7 (W.D. Mo. 1979) (repurchase agreement (REPO) is a pledge, and does not create a security interest).

7. See 11 U.S.C. § 362 (1982) ("a petition filed under section 301, 302 or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970, operates as a stay, applicable to all entities"); 4 COLLIER, supra note 4, ¶ 541.01, at 541-6 (trustee has many powers that spring from court’s determination that property in dispute is property of bankrupt’s estate); see also infra notes 139-41.

8. Brown describes the transfer of ownership rights, or title, as the point at which the risk of loss moves from the seller to the buyer. R. BROWN, THE LAW OF PERSONAL PROPERTY 191 (3d ed. 1975). Yet, under the Uniform Commercial Code (U.C.C.), the passage of title is irrelevant in determining when ownership changes. See U.C.C. § 1-201 official comment 1 (1978). Instead, the U.C.C. works to assure that an ownership interest in a security becomes irrevocable when a security has been transferred in a way that gives all the world notice of the change in ownership. See U.C.C. § 8-321 official comment 1-2 (1978).

9. A person who holds unencumbered title to property can dispose of it at will, unless the bankruptcy trustee can avoid the transfer that created the property interest. See 11 U.S.C. § 548(c) (1982); 4 COLLIER, supra note 4, ¶ 548.07, at 541-67. See infra notes 141-47 and accompanying text for a discussion of the SIPA trustee’s avoidance powers under the Bankruptcy Code. A SIPA trustee, however, cannot avoid the transfer if someone perfects his interest according to the applicable provisions of the U.C.C. of the state in which the property is located. See 11 U.S.C. § 546 (1982); U.C.C. § 9-321(2) (1978).


11. See, e.g., In re E.S.M. Gov’t Sec., Inc., 52 Bankr. 372, 375 (S.D. Fla. 1985) (court received exhaustive memoranda and spent considerable time researching sale/loan issue). For an explanation of repurchase agreements, see infra notes 11, 52-62 and accompanying text.
REPO issuer pays slightly more cash than he had received in the first step.\footnote{12}

In the time between the first portion of a REPO transaction the sale) and the second portion (the repurchase) the securities involved display some characteristics of loan collateral and some characteristics of sold items.\footnote{13} If a REPO participant became insolvent during that period, the structure of the Bankruptcy Code forced a bankruptcy court to choose one of the two characterizations—sale or loan.\footnote{14} Because the courts reached different conclusions on the issue, the participants in the REPO transaction were unsure which characterization a court would adopt.\footnote{15} The characterization was crucial\footnote{16} because the Bankruptcy Code treats collateral\footnote{17} differently than it treats sold items.\footnote{18}

Finally, in 1984, Congress amended the Bankruptcy Code to resolve this uncertainty.\footnote{19} Congress prescribed specific, technical rules for

\begin{itemize}
\item \footnote{13} Courts have recognized that "REPO" transactions are similar to loans, see infra notes 66-78, and commented that they should be treated as such. See, e.g., In re Legel, Braswell Gov't Sec. Corp., 648 F.2d 321, 324 n.5 (5th Cir. 1981); SEC v. Miller, 495 F. Supp. 465, 467 n.2 (S.D.N.Y. 1980). Other courts, however, have classified REPOS as sales. See, e.g., First Nat'l Bank of Las Vegas v. Estate of Russell, 657 F.2d 668, 676 (5th Cir. 1981); Gilmore v. State Bd. of Admin., 382 So. 2d 861, 863 (Fla. Dist. Ct. App. 1980); see also infra notes 79-88.
\item \footnote{15} See Need for Legislative Action, supra note 10, at 831 n.19; see also Mitchell, supra note 10, at 6, cols. 1-2 (courts split on sale/loan question); Portnoy, supra note 10, at 25, col. 2 (REPOS have been treated equivocally by the courts); Quint, Lombard and Iowa Rulings Spark Review of REPO Agreements, L.A. Daily J., Oct. 1, 1982, at 3, col. 1 (securities dealers hoping decision classifying REPOS as loans would not be relied upon as precedent) [hereinafter Quint].
\item \footnote{16} See Portnoy, supra note 10, at 25, col. 2; see also Mitchell, supra note 10, at 6, col. 1.
\item \footnote{17} See 11 U.S.C. §§ 363(a), (c)(2) (1982).
\item \footnote{18} When property has been unconditionally sold by the bankrupt for value and in good faith, the trustee cannot recover the property. See 11 U.S.C. § 548(c) (1982). In addition, the powers of a bankruptcy trustee are subject to any generally applicable law that gives a property holder with a perfected interest in property rights against all others. See 11 U.S.C. § 546(b) (1982).
\end{itemize}
courts to follow when they encountered REPO transactions in a bankruptcy proceeding. A problem remains, however, because a significant number of insolvent REPO participants are stockbrokers. Courts liquidate the holdings of stockbrokers under the Securities Investor Protection Act (SIPA). SIPA is an independent act that incorporates only those provisions of the Bankruptcy Code that are consistent with SIPA’s aims. Congress designed SIPA to settle claims without requiring a SIPA trustee to liquidate securities and to afford one class of creditors—customers—preference over all other creditors. In contrast, the Bankruptcy Code attempts to insure that REPOS can be liquidated and prevents a SIPA trustee from recovering securities underlying a REPO transaction to satisfy the claims.

20. See infra notes 99-103 and accompanying text.


27. See 11 U.S.C. § 559 (Supp. III 1985); 4 COLLIER, supra note 4, ¶ 750.01, at 750-52.
of customers. Since the bankruptcy provisions are inconsistent with SIPA, they do not apply to SIPA proceedings. Therefore the sale/loan problem remains. SIPA forces courts once again to determine how to characterize securities underlying a REPO transaction.

In each SIPA proceeding, a SIPA trustee has a duty to return securities to an insolvent broker's customers and to reimburse those customers for any securities he fails to return. Until he depletes them, the SIPA trustee uses the cash and securities that the bankrupt broker set aside for customers. He then uses the assets of the


32. A SIPA trustee liquidates the assets of members of the Securities Investor Protection Corporation (SIPC) who are in danger of failing to meet their obligations to customers and either are insolvent as that term is defined by the Bankruptcy Code, 11 U.S.C. § 101(29) (Supp. III 1985), are the subject of any court or agency proceeding in which a receiver, trustee or liquidator has been appointed; or fail to comply with the Exchange Act's rules regarding financial responsibility or use of customer securities. See 15 U.S.C. §§ 78eee(b)(1), 78llll(12) (1982).

33. A SIPA trustee is appointed to liquidate SIPC members. See 15 U.S.C. § 78eee(b)(3) (1982). Membership in SIPA is limited to brokers or dealers registered under 15 U.S.C. § 78o of the Exchange Act, and entities which are members of a national securities exchange. See 15 U.S.C. § 78ccc(a)(2) (1982) ("all persons registered as brokers or as dealers" required to become SIPC members); see also id. § 78llll(12) (1982) ("persons registered as broker-dealers" defined to include any person who is a member of a national securities exchange).


36. The SIPA trustee uses cash or securities received, acquired or held by the insolvent broker for the account of his customers, and the proceeds of any such property to reimburse customers. See 15 U.S.C. § 78llll(4) (1982). In addition, the
SIPC has limited resources.\textsuperscript{40} SIPA trustees, therefore, attempt to maximize the assets of an insolvent broker-dealer’s estate so that those assets are sufficient, in themselves, to compensate customers.\textsuperscript{41} Since SIPA trustees may be able to add assets characterized as collateral to the insolvent’s estate,\textsuperscript{42} they urge courts to characterize REPO transactions as loans and to treat the securities underlying those REPOs as collateral.\textsuperscript{43} Under such a characterization, the SIPA trustees might be able to include securities involved in a REPO in the failed broker’s estate,\textsuperscript{44} but exclude the securities’ owners from trustee can use the insolvent broker’s own cash and securities to compensate customers when the debtor should have set aside their cash and securities, but failed to do so. See 15 U.S.C. § 78ll(4)(D) (1982).

37. See 15 U.S.C. § 78ccc(a)(1) (1982). SIPC was created by SIPA. See id. SIPA advances up to $500,000 to satisfy each customer’s claim without regard to whether the debtor’s estate can reimburse SIPA. See 15 U.S.C. § 78fff-3 (1982) (authorizing SIPA trustee to use advances to buy securities for customers); id. § 78fff-2(b)(1) (1982) (requiring SIPC to advance funds to SIPA trustee whether or not insolvent broker’s estate can reimburse SIPC). In turn, SIPC is made a subrogee to the customer’s claim, id. at § 78fff-2(c)(1)(C) (1982), and recoups its advance payments from the debtor’s estate, id. § 78fff-2(c)(1)(D) (1982). Therefore, the customers, in effect, receive assets held for them by their dealer and, if necessary, assets of SIPC.


41. SIPA gives its trustees the powers and duties of bankruptcy trustees, see 15 U.S.C. § 78fff-1(b) (1982), and bankruptcy trustees must maximize the assets in a debtor’s estate. See supra note 2. Therefore, the SIPA trustee has a duty to maximize an insolvent broker-dealer’s estate. See, e.g., 15 U.S.C. § 78fff-1(b)(2) (1982) (SIPA allows its trustees to repay loans of insolvent broker only if collateral thus freed is worth more than face amount of loan).

42. See infra notes 224-25 and accompanying text.

43. See, e.g., Motion by the Securities Investor Protection Corporation as amicus curiae at 9, In re E.S.M. Gov’t Sec. Inc., Bankr. No. 85-6254 [hereinafter SIPC Amicus Memorandum]; see also REPO Participants Not Customers, supra note 29, at 1003 (SIPC’s position in ESM case); Oversight of Government Securities, supra note 21, ¶ 83,760, at 87,405 n.50 (SEC noted SIPC’s position that REPO transaction is loan but that REPO participant is not “customer”).

44. See infra notes 236-43 and accompanying text.
qualifying as "customers," thus preventing them from recovering their property. After examining the basic structure of a REPO transaction, this Note recounts the history of the loan/sale controversy in bankruptcy proceedings prior to 1984. The Note then examines the policies that prompted Congress to enact SIPA and to confer certain powers upon a SIPA trustee. Against this background, the Note balances the policy and practical effects of the loan classification against the policy and practical effects of the sale classification. Finally, based on this analysis, the Note concludes that courts should treat a REPO transaction as a contract for a sale and a subsequent repurchase of securities, but that courts should not protect REPO participants as "customers" under SIPA.

II. The Structure of a REPO Transaction

A REPO transaction is an exchange, for a limited time, of securities for cash. It consists of two transactions which occur simultaneously: (1) a sale; and (2) an agreement to repurchase. It is best illustrated by the following example. On January 1, a pension fund, the REPO transaction issuer, sells a corporate bond to a brokerage house, the REPO transaction buyer, for $1,000. At the same time, the pension fund agrees to repurchase the bond on February 1 for $1,010. The additional $10 compensates the broker for the use of $1,000 in cash between January 1 and February 1, and both parties view the $10 as an interest payment.

45. See infra notes 260-77 and accompanying text.
46. See infra notes 53-63 and accompanying text.
47. See infra notes 64-103 and accompanying text.
48. See infra notes 104-22 and accompanying text.
49. See infra notes 123-92 and accompanying text.
50. See infra notes 193-277 and accompanying text.
51. See infra notes 321-25 and accompanying text.
52. See infra notes 278-320 and accompanying text.
REPO transactions play an important role in the marketplace. Typically, the parties who issue REPOS are investors who cannot liquidate assets, but who need short-term capital. Conversely, parties buying REPO transactions usually have cash that they will need in the near future, but that they would like to use to generate income. In the example above, the pension fund receives cash to use for thirty-one days. In return, the broker receives: (1) underlying securities to secure its investment; and (2) its cash back after thirty-one days plus interest. Courts find the REPO transaction hard to characterize because it is a hybrid, displaying some characteristics of a loan and some characteristics of a sale and subsequent repurchase. Nonetheless, in the early 1980's, whenever a REPO participant filed for bankruptcy between the sale and the repurchase, courts were forced to choose whether to characterize a REPO transaction as either a contract for a sale and a subsequent repurchase or as a loan.
III. The History of the Sale/Loan Controversy

Understandably, REPO participants urged courts to adopt the characterization—loan or sale—that would allow them to control the underlying securities. Since the question was one of interpretation and was hard fought by each side, courts split on the issue.

A. REPO Transactions as Loans: The REPO Issuer's Argument

If REPO transactions are characterized as loans, REPO issuers retain a property interest in the assets used to secure the loan. A court that adopts this characterization may allow the representative of an insolvent REPO issuer to reclaim those assets as part of the bankrupt's estate. Although participants structure REPO transactions as contracts for a sale and a subsequent repurchase of securities, REPO issuers urge courts to look behind the form of the transaction and to concentrate on its "economic effect."

REPO issuers urge courts to focus on the fact that parties often


66. See Gilmore, 382 So. 2d at 863 (REPO buyer's memo confirming sale read: "It is expressly understood and agreed that title to these securities shall remain vested in [the REPO buyer] until full payment in cash or its equivalent is made therefore") (emphasis in original); supra note 4.

67. See infra notes 244-59 and accompanying text.


69. See, e.g., Application for Order Approving Settlements of Outstanding Reverse Repurchase Agreements Between Lombard-Wall Inc. and Tallman Home Federal Savings and Loan Ass'n at 3, In re Lombard-Wall, Inc., No. 82-B-11556 (Bankr. S.D.N.Y. Sept. 15, 1982). SIPC has made it clear that it will espouse the loan view when a SIPC trustee is holding collateral under a REPO transaction. See, e.g., SIPC Amicus Memorandum, supra note 43, at 9.
use REPO transactions to perform the same functions as loans. The participants compute the amount a REPO issuer must repay to reflect a return of principal plus interest. This amount remains constant even if the market value of the underlying securities fluctuates. Like a loan creditor, a REPO buyer is unaffected by market fluctuations in the value of the underlying securities unless the underlying securities lose so much value that a REPO issuer is induced to breach his commitment to repurchase. In fact, some REPO buyers allow REPO issuers to replace the securities originally deposited as collateral with other securities that are of equal value. In addition, the parties themselves often refer to REPO transactions using the terms employed by lenders and borrowers. For example, REPO issuers are said to pay “interest” for the use of cash, and REPO buyers hold the assets used in REPO transactions “as collateral.” Thus, REPO transactions can easily be classified as loans.

70. See Estate of Russell, 657 F.2d at 669; Miller, 495 F. Supp. at 467 n.2.
71. See Estate of Russell, 657 F.2d at 669; Cosmopolitan Credit & Inv. Corp., 507 F. Supp. at 956; Miller, 495 F. Supp. at 467.
72. See First Am. Nat'l Bank v. United States, 467 F.2d 1098, 1101 (6th Cir. 1972); Union Planters Nat'l Bank, 426 F.2d at 117.
73. See Estate of Russell, 657 F.2d at 675; Miller, 495 F. Supp. at 467; see also First Am. Nat'l Bank, 467 F.2d at 1101; Need for Legislative Action, supra note 10, at 837.
74. See Miller, 495 F. Supp. at 472-73. REPO contracts protect REPO buyers from the risk that the market value of the underlying securities will fall in two ways: (1) the securities in some REPO transactions are sold for less than their market value to protect the REPO buyer's equity if the value of the securities declines slightly, see id. at 470, 472-73; and (2) some REPOs give buyers the right to request additional securities from the REPO issuers if the value of collateral falls. See Net Capital Requirements for Brokers and Dealers, Exchange Act Release No. 18,418 [1981-1982 Transfer Binder] Fed. Sec. L. Rep. ¶ 83,084 n.18 (Jan. 13, 1982) [hereinafter Net Capital Requirements].
75. See Miller, 495 F. Supp. at 469; Portnoy, supra note 10, at 19, col. 4; see also Estate of Russell, 657 F.2d at 670 (REPO transaction involved did not restrict REPO buyer's right to sell or otherwise dispose of securities as long as securities of like kind delivered at specified date); In re Legel, Braswell Gov't Sec., Inc., 648 F.2d 321, 324 (5th Cir. 1981) (REPO issuer given right to purchase “equivalent securities”).
77. See Miller, 495 F. Supp. at 467; see also Estate of Russell, 657 F.2d at 670; Drysdale Sec. Corp., 606 F. Supp. at 296.
78. See Miller, 495 F. Supp. at 467; Sun First Nat'l Bank v. Miller, 77 F.R.D. 430, 432 (S.D.N.Y. 1978); see also Stigum, supra note 56, at 382; Portnoy, supra note 10, at 19, col. 3.
B. REPO Transactions as Sales and Subsequent Repurchases: the REPO Buyer's Argument

In contrast, REPO buyers who hope to retain the assets the insolvent REPO issuer transferred in the REPO, urge that courts should characterize REPOs as contracts for sales and subsequent repurchases. Under such a characterization, a bankruptcy trustee would be unable to claim that asset as part of the bankrupt's estate.

Many REPO issuers structure REPO transactions as sales and subsequent repurchases because they cannot issue loans, or because any loans they make must comply with restrictive regulations. Accordingly, they argue that the court should focus on the intent of the contracting parties and the form of the transaction. In addition, they argue that the REPO buyer takes full legal title to the underlying securities. REPO issuers point to this characteristic as evidence that the REPO buyer's obligation to return securities is purely contractual. This interpretation leads to the conclusion that the REPO issuer has no ownership interest in the securities between


80. See Mitchell, supra note 10, at 6, col. 1. A REPO issuer would not have any legal or equitable interest in securities unconditionally sold to a good faith purchaser, see 11 U.S.C. § 541 (1982); but an insolvent REPO issuer's estate would only have a contract right to retrieve the collateral. See id.; see also In re Financial Corp., 1 Bankr. 522, 526 (W.D. Mo. 1979); 4 COLLIER, supra note 4, ¶ 541.08(6), at 541-51. But see infra notes 145-48 and accompanying text (SIPA trustee can void sale if it violates state law, is fraudulent, or gives preference to one creditor at expense of other creditors).

81. See Miller, 495 F. Supp. at 497; see also Repo Participants Not Customers, supra note 29, at 1003-04; Need for Legislative Action, supra note 10, at 836-41.

82. See BBS Trustee's Memorandum of Law, supra note 64, at 223. Some courts have focused on the intent of the parties. See, e.g., Estate of Russell, 657 F.2d at 670; In re Financial Corp., 1 Bankr. 522, 526 (W.D. Mo. 1979). But see Union Planters Nat'l Bank v. United States, 426 F.2d 115, 117 (6th Cir.) (intent not relevant for tax purposes), cert. denied, 400 U.S. 827 (1970); Cosmopolitan Credit & Inv. Corp., 507 F. Supp. at 956 (title to underlying securities remained with REPO issuer after sale).

83. See, e.g., BBS Trustee's Memorandum of Law, supra note 64, at 223. Courts have also considered the form of a REPO transaction in determining whether it is a sale or loan. See, e.g., Union Planters Nat'l Bank, 426 F.2d at 117 n.2; Gilmore v. State Bd. of Admin., 382 So. 2d 861, 862 (Fla. Dist. Ct. App. 1980).

84. See Gilmore, 382 So. 2d at 863; Mitchell, supra note 10, at 6, col. 1. But see Estate of Russell, 657 F.2d at 676 n.23 (whether parties intended title to pass deemed inconclusive).

85. See In re Financial Corp., 1 Bankr. 522, 526 (W.D. Mo. 1979). Most REPO contracts allow the REPO buyer to use underlying securities freely. See, e.g., In re Legel, Braswell Gov't Sec., 648 F.2d 321, 325 n.5 (5th Cir. 1981); Miller, 495 F. Supp. at 469; Gilmore, 382 So. 2d at 863.
the sale and the repurchase. In support of this interpretation, REPO buyers point out that many REPO transactions allow a REPO buyer to sell the underlying securities as long as the REPO buyer subsequently buys replacement securities that allow him to satisfy his contractual commitment. A creditor would never be permitted to act in an analogous way with ordinary loan collateral.

C. REPO Transactions Under the Bankruptcy Act Prior to 1984

Treating REPO transactions as loans in bankruptcy proceedings would have significantly increased the risks for REPO buyers. Under such a classification, the REPO issuer would have retained an equity interest in the underlying securities held by the REPO buyer. When the underlying securities have been so encumbered, the REPO buyer could have been subject to two risks. First, upon a REPO issuer's bankruptcy, a bankruptcy trustee could have used the REPO issuer's retained ownership interest to force the REPO buyer to turn over underlying securities. Second, if the REPO buyer kept the securities, the bankruptcy trustee could have prevented a REPO buyer from liquidating securities after bankruptcy proceedings commenced. Consequently, if the market value of the underlying securities declined, the REPO buyer could have been forced to stand idle as the value of his collateral diminished and an increasing portion of the debt that the REPO issuer owed to him became unsecured. This result would have created a tremendous amount of risk in an instrument once seen as safe.

86. See Gilmore, 382 So. 2d at 862; Financial Corp., 1 Bankr. at 526.
87. Miller, 495 F. Supp. at 469; Gilmore, 382 So. 2d at 862; Lucas, Jones & Thurston, supra note 57, at 44; Portnoy, supra note 10, at 19, col. 4.
88. See U.C.C. § 9-207 (1978). A secured party must use reasonable care in the custody and preservation of collateral. See id. In fact, the secured party is liable for any loss due to his failure to preserve collateral. See id. § 9-207(3).
89. See Quint, supra note 15, at 3, col. 5; Need for Legislative Action, supra note 10, at 831.
90. See Need for Legislative Action, supra note 10, at 833; Mitchell, supra note 10, at 6, col. 1; Schwarz, supra note 19, at 18, col. 3.
91. See Quint, supra note 15, at 3, col. 1; Schwarz, supra note 19, at 18, col. 3.
92. See Schwarz, supra note 19, at 18, col. 3; see also Mitchell, supra note 10, at 1, col. 1; Portnoy, supra note 10, at 19, col. 1.
93. See Portnoy, supra note 10 at 25, col. 2; see also Letter From Paul Volker, Chairman of the Federal Reserve Board, to Robert Dole, Chairman of the Subcomm. on Courts of the Senate Comm. of the Judiciary (Jan. 20, 1983), reprinted in Bankruptcy Reform: Hearings Before the Subcomm. on Courts, Senate Judiciary Comm., 98th Cong., 1st Sess. 305 (Jan. 24, 1983) (REPO buyer subject to risk of capital loss should interest rates change) [hereinafter Volker Letter].
These risks became probable rather than possible in September, 1982 when Lombard-Wall, a government securities dealer with many outstanding REPO transactions, filed for bankruptcy.\textsuperscript{94} In \textit{In re Lombard-Wall, Inc.},\textsuperscript{95} Federal Bankruptcy Judge Edward Ryan ruled that the open REPO transactions held by that dealer were loans.\textsuperscript{96} Judge Ryan thus implied that the securities pledged for REPO transactions should be considered ordinary loan collateral.\textsuperscript{97} This holding caused a great deal of uncertainty in the securities markets.\textsuperscript{98}

**D. Congress' Response: The Bankruptcy Reform Act of 1984**

The Lombard-Wall decision spurred industry groups to lobby for changes in the Bankruptcy Code.\textsuperscript{99} Congress adopted those changes in 1984.\textsuperscript{100} Although Congress solved the problem, it failed to settle whether a REPO transaction is a loan or a contract for a sale and a subsequent repurchase.\textsuperscript{101} It merely promulgated regulations to insure that a REPO buyer would be able to liquidate securities involved in REPO transactions\textsuperscript{102} and prohibited bankruptcy trustees

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\textsuperscript{95} \textit{In re Lombard-Wall, Inc.}, 23 Bankr. 165 (Bankr. S.D.N.Y. 1982).


\textsuperscript{97} See Quint, \textit{supra} note 15, at 3, col. 2; see also Portnoy, \textit{supra} note 10, at 19, col. 1 (analyzing import of holding that REPOS were loans); cf. Mitchell, \textit{supra} note 15, at 1, col. 1 (same).


\textsuperscript{99} See \textit{Bankruptcy Reform: Hearings Before the Subcomm. on Courts, Senate Judiciary Comm.}, 98th Cong., 1st Sess. 305, 307 (Jan. 24, 1983) (Thomas Strauss, testifying for Public Securities Association confirmed that PSA and virtually entire financial industry had come together in strong support of amending Bankruptcy Code to protect REPO participants) [hereinafter 1983 \textit{Senate Hearings}]; see also Schwarcz, \textit{supra} note 19, at 18, col 1.

\textsuperscript{100} See Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333; see also Cooper, \textit{supra} note 19, at 30; Schwarcz, \textit{supra} note 19, at 18, col. 2.

\textsuperscript{101} The amendments require a court to determine only whether a transaction satisfies the statutory definition of a REPO transaction. See 1983 \textit{Senate Hearings}, \textit{supra} note 99, at 323 (submission of Peter J. Sternlight, Executive Vice President, Federal Reserve Bank of New York); Levin & Donovan, \textit{supra} note 30, at 154.

\textsuperscript{102} See 1983 \textit{Senate Report}, \textit{supra} note 98, at 48.
from unilaterally forcing REPO buyers to turn over underlying securities.103

IV. SIPA

In enacting the 1984 amendment to the Bankruptcy Code, Congress failed to decide how courts should treat REPO transactions in the liquidation of a securities dealer104 under SIPA.105 In SIPA, enacted in 1970, Congress established the Securities Investor Protection Corporation (SIPC),106 a private corporation similar in purpose to the Federal Deposit Insurance Corporation (FDIC).107 SIPC compensates investors who suffer losses due to the bankruptcy of securities dealers.108 In effect, it establishes a separate class of creditors called “customers” who are given priority when a broker becomes insolvent.109

103. See generally id.
104. Congress intended to prevent a bankruptcy trustee from using the automatic stay of the Bankruptcy Code to prevent transfers of securities involved in REPO transactions. See 130 CONG. REC. S8887 (daily ed. June 29, 1984) (statement of Sen. Strom Thurmond), (reprinted in 1984 U.S. CODE CONG. & ADMIN. NEWS 585). Congress, however, continued to allow a SIPA trustee to use SIPA’s automatic stay to prevent transfers of securities underlying a REPO. See 11 U.S.C. § 559 (Supp. III 1985). Although Congress decided to subject underlying securities to SIPA’s automatic stay, Congress did not address whether REPO participants should be considered “customers” under SIPA. See generally Oversight of Government Securities, supra note 21, ¶ 83,760, at 87,404 n.50 (SIPA treatment of REPO transactions is open question); supra note 30 and accompanying text).
105. See Pub. L. No. 91-598, 84 Stat. 1636 (1970) (codified as amended at 15 U.S.C. §§ 78aaa-78111 (1982)). SIPA is a statutory scheme with a different policy orientation than the Bankruptcy Code. See 4 COLLIER, supra note 4, subch. III, at Int-2. SIPA attempts to protect certain public “customers” identified in the Act. See id. As a practical matter, the difference between a bankruptcy proceeding and a SIPA proceeding is that the Bankruptcy Code requires that the bankruptcy trustee convert securities to cash as quickly as possible, see id., subch. III at Int-5, while SIPA charges a SIPA trustee with distributing securities to customers. See id. The Bankruptcy Code operates under two assumptions: (1) customers prefer cash; and (2) even if a customer prefers his securities, he can repurchase those securities before any change in market value occurs, if he receives cash promptly. See id. at Int-6. Conversely, the assumption underlying SIPA is that a customer is an investor and desires to retain his securities. See id. at Int-5. Thus, in a SIPA proceeding, the SIPA trustee will return securities to customers to the maximum extent possible. See id. at Int-6; see also 15 U.S.C. § 78fff-1(b) (1982).
108. See 1970 HOUSE REPORT, supra note 107, at 2, reprinted in 1970 U.S. CODE CONG. & ADMIN. NEWS 5255; see also 15 U.S.C. § 78fff-2(b) (1982). SIPA creates a fund to allow public customers of securities dealers to recover the cash and securities that are in their accounts at the time of insolvency. See id.
SIPA trustees have taken the position that underlying securities should be classified as loan collateral. Critics maintain that such an interpretation is at odds with the policies Congress intended to further when it enacted SIPA.

A. SIPA's Legislative History

The primary purpose in enacting SIPA was to "provide protection for investors if the broker-dealer with whom they are doing business encounters financial troubles." The legislation accomplishes this purpose by attempting to eliminate the risks that lead to customer loss. While speaking at the House hearings to create SIPA, Phillip A. Loomis, General Counsel of the Securities Exchange Commission, pinpointed three such risks. Those risks are: (1) the risk that securities deposited by a customer are not held by the broker-dealer as they should be; (2) the risk that securities a customer pledges for a margin loan are not treated in a way that protects the customer's equity in the securities; and (3) the risk that when a customer orders his broker to transfer securities, his broker may not do so.

To minimize these risks, Congress included provisions in SIPA that give customers an unrestricted right to receive their securities. Courts satisfy the claims of SIPA customers before the claim of any other person who did business with an insolvent securities broker. SIPA defines "customers" as those with securities

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11. See id. at 23; see also Oversight of Government Securities, supra note 21, ¶ 83,760 (SIPC's official position is that REPO participants are not "customers").
12. See infra notes 113-22 and accompanying text.
17. See id.
19. See SEC v. Packer Wilbur & Co., 498 F.2d 978, 983 (2d Cir. 1974); SIPA
accounts received, acquired or held by the debtor in one of three ways: (1) with a view to sale; (2) as collateral security; or (3) for safekeeping.\footnote{120} If SIPA classifies an investor as a customer, that customer is entitled to receive his securities.\footnote{121} If not, he would be entitled to make a claim only as a bankruptcy creditor, after all customers have been satisfied.\footnote{122}

B. The Role of a SIPA Trustee

A SIPA trustee handles two types of customer claims: claims for securities registered in the names of specific customers (customer name securities)\footnote{123} and claims for securities registered in the broker’s name, but held for customers (customer property).\footnote{124} A trustee’s first duty is to distribute the “customer name securities.”\footnote{125} Only after this initial distribution will the SIPA trustee pool the remaining customer securities to form the “customer property” fund,\footnote{126} which is composed of securities held for customers, but registered in the


\footnote{122} See 15 U.S.C. § 78fff-2(c)(1) (1982); 4 COLLIER, supra note 4, ¶ 747.01, at 747-3. After “customers” are satisfied, the liquidation continues as in a normal bankruptcy and creditors must look to the general assets of the insolvent broker’s estate for satisfaction. See Kenneth Bove & Co., 378 F. Supp. at 700.

\footnote{123} See 15 U.S.C. § 78lll(3) (1982). Securities held for the account of a customer on the filing date, or in the process of being registered to a customer on the filing date are “customer name securities,” but securities which were in negotiable form on the filing date are not customer name securities. See id.


\footnote{125} See 15 U.S.C. § 78fff(1)(A) (1982). The SIPA trustee must deliver “customer name securities” if a customer is not indebted to the insolvent broker-dealer, or if a customer who is indebted repays the debt to the trustee. Id. § 78fff-2(c)(2). The SIPA trustee determines the time limit within which a customer has to pay his debt, see id. § 78fff-2(c)(2), but the SIPA trustee cannot refuse payments made within a reasonable time. See In re John Muir & Co., 28 Bankr. 946 (Bankr. S.D.N.Y. 1983) (when customer has failed to pay his margin 60 days after he received notice of SIPA proceeding, reasonable time elapsed and trustee need not treat stock in question as “customer property”).

\footnote{126} See 15 U.S.C. §§ 78lll(4) (1982) (definition of customer property); id. § 78fff-2(b) (requirement that SIPA trustee deliver customer property); id. § 78fff-
broker’s name. Once the contents of the fund are collected, the SIPA trustee begins to use the powers vested in him by the Bankruptcy Code and by SIPA to compensate for any deficiency in the customer property fund and to deliver the collected securities to customers.

A SIPA trustee must fulfill the duties of a traditional bankruptcy trustee, while protecting the securities and cash claimed by customers. The Bankruptcy Code charges a SIPA trustee with maximizing the insolvent’s estate. To accomplish this, the SIPA trustee exercises a bankruptcy trustee’s power to avoid preferential transfers, stay liquidations, and force creditors to turn over assets in which the estate has an interest. In addition, the trustee is directed by SIPA to protect customers’ rights to receive securities that are of the same class and series as those that were in the customer’s account at insolvency. To accomplish this goal he is given a second set of powers by SIPA.

2(c)(1) (guidelines for distributing customer property). Before the SIPA trustee distributes the “customer property” fund, however, the SIPA trustee reimburses SIPC for any money it advanced to pay or guarantee the debts of the failed broker-dealer. See 15 U.S.C. §§ 78fff-1(b)(2) (1982) (granting power to use SIPC funds to pay debts); id. § 78fff-2(c)(1)(B) (providing that trustee must reimburse SIPC) (1982). Then, after the fund satisfies all customers’ claims, SIPC receives another disbursement from the fund, this time as subrogee for the claims of customers. See 15 U.S.C. § 78fff-2(c)(1)(C) (1982). Finally, the customer property fund reimburses SIPC for cash that it advanced to enable the trustee to indemnify brokers who agreed to accept the insolvent’s customer accounts. See 15 U.S.C. § 78fff-3(c)(2) (1982) (providing for transfer of customer accounts); id. § 78fff-2(c)(1)(D) (providing that SIPC trustee must reimburse SIPC).

127. See id. § 78lll(4) (1982) (term “customer property” means cash and securities, except customer name securities delivered to customer, at any time received, acquired, or held by or for debtor from or for customer’s securities account).

128. See 15 U.S.C. § 78fff-2(c)(3) (1982) (trustee can recover transfers whenever customer property is insufficient to both pay customer claims and reimburse SIPC for any cash advanced); see also 4 COLLIER, supra note 4, ¶ 749.02, at 749-9.

129. See 15 U.S.C. § 78fff-1(b)(1) (1982). In addition to liquidating the assets of the debtor as in an ordinary bankruptcy, a SIPA trustee must deliver securities to customers that are of the same class and series as the securities that should have been in the customer’s account at the time of his insolvency. See id.

130. SIPA trustees are vested with the same duties as interim bankruptcy trustees, see 15 U.S.C. § 78fff-1(b) (1982). Interim bankruptcy trustees have essentially the same duties as permanent bankruptcy trustees. See 11 U.S.C. § 701 (1982); 4 COLLIER, supra note 4, ¶ 701.04. The duties of a permanent bankruptcy trustee include maximizing the value of the debtor’s estate. See In re Gustav Schaeffer Co., 103 F.2d 237 (6th Cir. 1939); see also SEC v. Albert & McGuire Sec. Co., 560 F.2d 569, 574 (3rd Cir. 1977) (SIPA also requires trustee to maximize customer property).

131. See infra notes 134-48 and accompanying text.


133. A SIPA trustee is given the power: (1) to pay or guarantee the debts of the failed broker-dealer, see id. § 78fff-1(b)(2) (1982); (2) to transfer customer
I. A SIPA Trustee’s Bankruptcy Powers

The Bankruptcy Code provides that the estate of a debtor includes “all legal or equitable interests of the debtor in property . . . .”134 When a court considers an asset to be property of the insolvent broker’s estate, SIPA automatically freezes that asset,135 and then the Bankruptcy Code forces any creditors with an interest in that asset to petition the court to lift the stay.136 In addition, a SIPA trustee can force others to return assets transferred before insolvency,137 if he can set aside that transfer.138

Section 362(a)(3) of the Bankruptcy Code prevents “any act to obtain possession of . . . or to exercise control over the property of the estate.”139 This stay is automatic,140 and an affected person opposing the stay must bring a legal proceeding to convince the court that the stay should be lifted because it irreparably damages his interest in property.141

accounts, and indemnify brokers to whom accounts are transferred, see id. § 78fff-2(f) (1982); (3) to purchase securities in a fair and orderly market in order to satisfy the claims of “customers,” see id. § 78fff-2(d) (1982); (4) to close out open contractual commitments of the failed broker, see id. § 78fff-2(e) (1982); (5) to recover transfers of securities that are void or voidable under the Bankruptcy Code, see id. § 78fff-2(o)(2) (1982); and (6) to recover transfers that are preferential under the Bankruptcy Code. See id. § 78fff-1(a) (1982).


135. See infra notes 139-41 and accompanying text.

136. See 11 U.S.C. § 362(d) (1982); 2 COLLIER, supra note 4, ¶ 362.01.

137. See infra notes 142-43 and accompanying text.

138. See infra notes 144-49 and accompanying text.

139. See 11 U.S.C. § 362(a)(3) (Supp. III 1982). This statute provides that when an application is filed under section 5(a)(3) of SIPA, see 15 U.S.C. § 78eee(a)(3) (1982), all proceedings concerning property of the estate are barred. See 11 U.S.C. § 362(a) (1982). While section 362(b)(7) of the Bankruptcy Code establishes the right of a REPO participant to set off any margin or settlement payment for a REPO, see id. § 362(b)(7) (Supp. III 1985), that section only applies to REPOS created with certain types of collateral securities such as certificates of deposit, United States guaranteed securities, and eligible banker’s acceptances. See id. § 101(35) (Supp. III 1985). In addition, while section 559 of the Bankruptcy Code, see id. § 559 (Supp. III 1985), seeks to protect a REPO participant’s right to liquidate collateral, that protection does not apply to proceedings under SIPA. See id.

140. See 2 COLLIER, supra note 4, ¶ 362.03, at 363-26. The stay is automatically created when the SIPA petition is filed. See 11 U.S.C. § 362(a) (1982). An affected party may, however, request a hearing to lift the stay, see id. § 362(d) (1982), and if that party can show it has an interest in property that would not be adequately protected unless the stay is lifted, or if he can show that the bankrupt does not have an ownership interest in the property in question, the stay will be lifted. See id. § 362(d) (1982).

141. See id. § 362(e) (1982). The statute requires a court to vacate the stay thirty days after a request for relief unless the court, after notice and a preliminary
Similarly, sections 550(a) and 542 of the Bankruptcy Code allow a SIPA trustee to force a creditor holding "estate property" to turn it over for use by the estate.\textsuperscript{142} Under section 542, if the SIPA trustee convinces the court that the REPO buyer's interest would remain adequately protected when the property is used,\textsuperscript{143} the SIPA trustee can regain possession of the securities.\textsuperscript{144}

Section 550(a) gives a SIPA trustee a right to repossess any property if he can invalidate the bankrupt's transfer of that property.\textsuperscript{145} Section 544 of the Bankruptcy Code allows a SIPA trustee to set aside transfers that can be voided under state law;\textsuperscript{146} section 548 of the Bankruptcy Code allows a SIPA trustee to set aside fraudulent transfers;\textsuperscript{147} and section 547 allows a SIPA trustee to set aside transfers that give preference to one creditor at the cost of other creditors.\textsuperscript{148} After a SIPA trustee sets aside transfers using these

hearing, see id. § 102(1) (1982) (definition of "notice and a preliminary hearing"), finds no reasonable likelihood that the party opposing relief will prevail at a full hearing. See id. § 362 (1982); 4 COLLIER, supra note 4, ¶ 362.08. While the party seeking relief from the stay must prosecute the action at the full hearing, the party supporting the stay has the burden of proof. Id. ¶ 362.08[2].

\textsuperscript{142} See 11 U.S.C. §§ 542(b) (1982); id. § 550(c). These sections make few exceptions. Property held by a REPO participant who, in good faith and without knowledge of the bankruptcy retransfers the property need not be turned over. See id. § 550(b).


\textsuperscript{145} See 11 U.S.C. § 550(a) (1982); 4 COLLIER, supra note 4, ¶ 550.02, at 550-12.

\textsuperscript{146} See 11 U.S.C. § 544(b) (1982). Section 544(a) is commonly called the strong-arm clause because it gives the trustee the status of a judicial lien creditor or a creditor holding an execution returned unsatisfied. See id. § 544(a). It gives the SIPA trustee the rights of a creditor who has gone to court and secured either an order placing a lien on the property of the bankrupt, or a writ of execution against the bankrupt's property which has not yet been satisfied. See H.R. Rep. No. 595, 95th Cong., 1st Sess. 370 (1977). Acting in that capacity, the SIPA trustee can bring state law claims to void transfers. See 11 U.S.C. § 544(b) (1982); 4 COLLIER, supra note 4, ¶ 544.01, at 544-3. Then, when transfers are voided, the trustee can assert ownership of the property involved. See id.

\textsuperscript{147} See 11 U.S.C. § 548(a)(1) (1982). The Bankruptcy Code allows a SIPA trustee to show that a transfer was fraudulent either by proving fraudulent intent, see id., or by showing that the transfer was made for less than reasonable value. See id. § 548(a)(2). Section 548 states that settlement payments in connection with REPO transactions are always made for reasonable value. See 11 U.S.C.A. § 548(d)(2)(C) (West Supp. 1986). A "settlement payment" is a payment of the repurchase price. 11 U.S.C. § 741(8) (Supp. III 1982). Therefore, § 548 effectively requires a SIPA trustee to prove that REPO participants who executed a repurchase intended to defraud creditors. See 1983 Senate Hearings, supra note 99, at 325.

\textsuperscript{148} See 11 U.S.C. § 547(b) (1982). Six elements establish a preference under
Code sections, he can assert his property right in the collateral and force the transferee to return the property to the estate.\footnote{149}

2. A SIPA Trustee’s SIPA Powers

A SIPA trustee can also use powers SIPA has granted him to compensate for deficiencies in the customer property fund.\footnote{150} Bankruptcy powers are generally sufficient to recover securities held for sale,\footnote{151} but SIPA provisions grant powers better equipped to deal

the Bankruptcy Code: (1) the property must be transferred; (2) the transfer must be for the benefit of a creditor; (3) the debtor must have been insolvent at the time; (4) the transfer must give the creditor more than the share he would receive as a creditor in the bankruptcy proceeding; (5) the transfer must occur within 90 days of insolvency; and (6) the transfer must be payment of an antecedent debt, and must diminish the debtor’s estate. \textit{See id.} § 547 (1982); 4 \textit{Collier}, \textit{supra} note 4, ¶ 547.01, at 541-11 to -12. The Bankruptcy Code considers a security interest to be a transfer for an antecedent debt if, after the transfer occurs, the two principals fail to make the transfer unassailable by complying with the procedures of state U.C.C. provisions. \textit{See 4 Collier}, \textit{supra} note 4, ¶ 547.44 at 547-137 to -139; U.C.C. § 8-321 (1978). This is called “perfecting” the transfer. \textit{See id.}

The Bankruptcy Code allows parties to wait ten days before they perfect. \textit{See 11 U.S.C.} § 547(e)(2)(A) (1982). If the parties fail to perfect within ten days, the Bankruptcy Code will not deem the security interest transferred until the transfer is perfected. \textit{See id.} § 547(e)(2)(B). If the parties never perfect, the Code deems the security interest transferred as of the time that the bankruptcy petition is filed. \textit{See id.} § 547(e)(2)(C). The rules for perfection are complex, and differ among states. For a discussion of perfecting a REPO, see Kraemer, \textit{Creation and Perfection of Security Interests in Securities Under the U.C.C., in Repurchase and Reverse Repurchase Agreements} (P.L.I. 1985) [hereinafter Kraemer].

The SIPA trustee can also avoid the claims of unsecured creditors filed under § 501 of the Bankruptcy Code, \textit{see 11 U.S.C.} § 501 (1982), but since this Note assumes that a REPO transaction creates a security interest, and is not an unsecured pledge, \textit{see supra} note 4, section 501 does not apply to REPO transactions as they are treated by this Note.

\footnote{149} \textit{See 11 U.S.C.} § 550(a) (1982); \textit{see also 4 Collier, supra} note 4, ¶ 550.02.

\footnote{150} \textit{See 15 U.S.C.} § 78fff-1 (1982) for a general statement of the powers and duties of a SIPA trustee. The specific powers at a trustee’s disposal are scattered throughout the Act. They are: (1) The power to pay or guarantee debts owed by the debtor subject to prior approval of SIPC, \textit{see 15 U.S.C.} § 78fff-1(b)(2) (1982); (2) the power to transfer or sell customer accounts, to margin those accounts for transfer, and to use SIPC funds to indemnify transferees against financial losses, \textit{see id.} § 78fff-2(f) (1982); (3) the power to purchase the securities needed to satisfy customer claims, \textit{see id.} § 78fff-2(d) (1982); (4) the power to complete open contractual commitments of the debtor, \textit{see id.} § 78fff-2(e) (1982); (5) the power to recover transfers that are void or voidable under the Bankruptcy Code, \textit{see id.} § 78fff-2(c)(3) (1982); (6) the power to avoid preferences as would a bankruptcy trustee; \textit{see id.} § 78fff-1(a) (1982); and (7) the power to forestall adverse judicial proceedings concerning the property of the estate. \textit{See id.} § 78eee(b) (1982).

\footnote{151} \textit{See supra} note 149 (discussing SIPA trustee powers under SIPA); \textit{supra} notes 134-41 (effect of filing SIPA petition).
with securities held as collateral for a margin loan, deposited for safekeeping with another broker or in the process of being transferred when a broker defaults.

The Securities Act treats securities for which a customer has fully paid differently than it treats securities a customer has bought on credit, or "margined." A broker can lend money to its customers and is permitted to speculate with securities that a customer has given as collateral for a margin loan. Securities regulations, however, require a broker to deliver margin securities as soon as a customer has fully paid for them. Therefore, a customer's equity in securities must always be protected.

SIPA goes one step further. Even after the speculating broker's insolvency, SIPA allows customers who bought securities on margin to repay the margin loan and free the securities from encumbrance. At that point, the SIPA trustee treats customers as if they had fully paid for the margin securities at the SIPA filing date. SIPA also protects a margin customer when his broker deposits securities with another broker for safekeeping.

152. See infra notes 155-60 and accompanying text.
153. See infra notes 162-74 and accompanying text.
154. See infra notes 175-85 and accompanying text.
156. Margined securities are often used by a broker to realize cash. See 2 L. Loss, SECURITIES REGULATION 1248 n.32 (1961). For example, the broker can use them as collateral for bank loans. See id. at 1244-48; see also 1970 HOUSE REPORT, supra note 107, at 2, reprinted in 1970 U.S. CODE CONG. & ADMIN. NEWS 5254, 5256. Securities regulations prohibit a broker from: (1) comingling the customer's margin securities with those of other customers without the customer's assent; (2) encumbering more than one customer's securities in the same loan, without the customer's consent; and (3) subjecting a customer's securities to any lien or claim of a pledgee in excess of the aggregate margin that the customer owes to the debtor. See 17 C.F.R. § 240.8c-1 (1986).
157. See id. § 240.15c3-3(l)(2) (1986).
158. See infra notes 162-74 and accompanying text.
159. See 1970 HOUSE REPORT, supra note 107, at 228 (statement of Phillip A. Loomis Jr., General Counsel, Securities and Exchange Commission) (securities laws are designed to protect customers' equity in margined securities, but Congress enacted SIPA to ensure that if those safeguards fail, customers are protected).
159. See 15 U.S.C. § 78fff-2(b)(2) (1982). Customers who have bought securities on margin are entitled to share in the "customer property" fund to the extent of
Securities regulations require a broker to possess or control securities whose purchase price has been fully paid, and that were deposited by, or on behalf of, a customer. In a SIPA liquidation, if a broker deposits its customers' securities with a second broker "for safekeeping," the SIPA trustee representing the depositing broker must reacquire the same or identical securities and return them to the depositing broker's customers. If those securities are subject to a lien, SIPA authorizes a trustee to pay or guarantee debts up to the market value of the securities encumbered, and if the market value of the customer's securities has become less than the debt owed on them, the SIPA trustee must default on repaying the loans and can use the principal to replace the lost collateral.

On the other side of the transaction, if it is the safekeeping broker who becomes insolvent, SIPA protects both individual investors and the market as a whole. SIPA protects individual investors from the risk of losing securities by requiring a SIPA trustee to return securities that were deposited with the insolvent broker either by an

their net equity in margined securities. See id. § 78fff-2(c)(1)(B) (1982). Net equity is computed by determining the dollar value of a customer's account at insolvency and subtracting the indebtedness of that customer. See id. § 78lll(11) (1982).

A customer may pay his margin, however, within a reasonable time from the date the customer receives notice of the SIPA proceeding, and will be treated as a fully paid customer. See id. § 78lll(11)(c) (1982). But, a customer cannot pay his margin more than 60 days after the SIPA trustee notifies him of the liquidation. See In re John Muir & Co., 28 Bankr. 947 (Bankr. S.D.N.Y. 1983).

161. See 17 C.F.R. § 240.15c3-3 (1986).
162. See id. § 240.15c3-3(a)(1) ("customer" means any person from whom, or on whose behalf, a broker or dealer has received, acquired, or held funds or securities).
164. See supra notes 128-32 and accompanying text.
165. See 15 U.S.C. § 78fff-1(b)(2) (1982); id. § 78fff-3(c)(1). The SIPA trustee, with SIPA approval, can use SIPC advances to pay or guarantee loans made to the insolvent broker-dealer if the market value of securities thus made available is not less than the debt. See id. The SIPA trustee apportions the freed securities to customer property in the same ratio that customer property held to the insolvent's assets in the lien, see id. § 78fff(d) (1982), and the SIPA trustee reimburses SIPC for those advances before it makes any other disbursements from the "customer property" fund. See id. § 78fff-2(c)(1)(A) (1982).
166. See id. § 78fff-1(b)(2) (1982).
167. See id. § 78fff-2(d) (1982). A SIPA trustee can use customer property to pay for securities needed to satisfy customers. See id. Customer property includes the proceeds of securities acquired or held for the account of a customer. See id. § 78lll(4) (1982).
168. See id. § 78fff-3 (1982). SIPC will advance up to $500,000 for the account of each customer for whom the insolvent broker failed to hold, as he should have,
individual investor or by a broker acting as an agent for an individual investor.\footnote{169}

This SIPA provision also protects the marketplace. Prior to SIPA, when a broker holding securities for another broker's customers became insolvent, the Bankruptcy Code considered deposited securities assets of the holding broker's estate in bankruptcy.\footnote{170} The customers of the depositing broker were entitled to claim those assets in a bankruptcy proceeding, but typically they received only a portion of the market value of their securities.\footnote{171} In such circumstances, claims for lost securities made by its customers could have placed the depositing broker in financial difficulties.\footnote{172}

SIPA negates the risk of customer claims by requiring that the securities and cash. \textit{See id.} The SIPA trustee may use this money to replace lost securities. \textit{See id.} \S\ 78fff-2(d) (1982). Yet the SIPA trustee may only do so if a "fair and orderly market" exists for the securities in question. \textit{See id.}

\footnote{169. See \textit{id.} \S\ 78fff-2(b)(2) (1982) (mandating return of customer property); \textit{id.} \S\ 78111(2) (1982) (defining customer property to include securities deposited by an agent); \textit{see also} 1970 \textit{HOUSE REPORT, supra} note 107, at 3, \textit{reprinted in} 1970 \textit{U.S. CODE CONG. \\& ADMIN. NEWS} 5254, 5256 (Congress intended to protect owners of securities held "for safekeeping"). A person who, as a principal or as an agent, directs the insolvent to hold securities for safekeeping is a "customer." \textit{See 15 U.S.C.} \S\ 78fff-2(b) (1982). Thus, acting through a "broker" does not destroy one's customer status. Similarly, a customer includes one whose account is cleared by a SIPC member on a fully disclosed basis for introducing brokers or dealers. \textit{See 17 C.F.R.} \S\ 300.200 (1986).

\footnote{170. Act of June 22, 1938, ch. 575, \S\ 1, 52 Stat. 869 (amending Bankruptcy Act of July 1, 1889 (codified at 11 \textit{U.S.C.} \S\ 96(c)) (\textit{repealed by} Bankruptcy Code of 1978, Pub. L. No. 95-598, 92 Stat. 2613); \textit{see also} J. \textit{HENDERSON, REMINGTON ON BANKRUPTCY} \S\S\ 2514-18 (2d ed. 1970); J. \textit{MACLACHLAN, HANDBOOK ON THE LAW OF BANKRUPTCY} 319-26 (1956) [hereinafter \textit{MACLACHLAN}].

\footnote{171. \textit{See MACLACHLAN, supra} note 170, at 323 (pre-SIPA law adopted theory that customers permitting stockbroker to exercise broad power over their securities subjected themselves to risk of loss); 116 \textit{CONG. REC.} H39343 (daily ed. Dec. 1, 1970) (remarks of Rep. Latta) (under bankruptcy law customers sometimes did not recover full value of their securities); \textit{see id.} at H39346 (statement of Rep. Staggers) (same).


Since Congress passed SIPA, the SEC has promulgated complex rules to assure that brokers maintain the physical possession or control of all securities a customer has fully paid for and all securities in a margin account when the value of those securities is greater than 140\% of the margin loan. \textit{See 17 C.F.R.} \S\ 240.15c3-3(b) (1986). In addition, brokers who hold customers' funds pursuant to the trading activity of those customers must deposit that cash in a "special reserve bank account" to insure that the broker cannot use it. \textit{See id.} \S\ 240.15c3-3(e) (1986). But these regulations expressly preserve a customer's pre-SIPA right to demand cash or securities that he has fully paid for. \textit{See id.} \S\ 240.15c3-3(l) (1985).}
trustee for an insolvent holding broker return securities in the holding broker’s possession that belong to the customers of a depositing broker.\footnote{\textsuperscript{173}} Thus, SIPA frees depositing brokers from the possibility that claims by their own customers for lost securities could cause financial difficulty.\footnote{\textsuperscript{174}}

Similarly, SIPA protects a dealer who contracts to sell or purchase securities to satisfy a customer order.\footnote{\textsuperscript{175}} When enacting SIPA, Congress recognized that some brokers contract to sell or buy securities at current market prices and provide that the securities need not be physically transferred until a later “settlement date.”\footnote{\textsuperscript{176}} Prior to SIPA, if a broker relied upon a contract with a second broker to satisfy a customer order, the SIPA trustee for the second broker could choose to dishonor the contract if the second broker became insolvent.\footnote{\textsuperscript{177}} At the point that the second broker breached, both the applicable regulations\footnote{\textsuperscript{178}} and the common law\footnote{\textsuperscript{179}} required the first


\textsuperscript{175} See \textit{1970 House Report}, supra note 107, at 8, \textit{reprinted in} 1970 U.S. Code Cong. & Admin. News 5254, 5263. “[T]he completion of such transactions will be in the interest of the public as well as investors. It is designed to minimize the disruption caused by a failure of a broker-dealer, precluding the domino effect of such failure.” \textit{Id.}


\textsuperscript{177} See MACLACHLAN, supra note 170, at 174.


\textsuperscript{179} See Lewis H. Ankeny, 29 S.E.C. 514, 516 (1949). A dealer impliedly represents that the transaction entered into for a customer will be consummated promptly unless there is a clear understanding to the contrary. \textit{See id.; see also}
broker to go out into the marketplace and complete the customer's order even if the market price of the security had changed since the customer had placed the order. If a broker did not complete a customer's order, he was liable to the customer for any loss caused either by an increase in the market price of securities that a customer sought to buy180 or a decrease in the price of securities that a customer sought to sell.181 Congress feared that such circumstances could force small dealers into bankruptcy, resulting in a "domino effect" that could cause the market to collapse.182

Congress wanted to prevent such "failures to receive" and "failures to deliver" from destabilizing the marketplace.183 Accordingly, SIPA requires a SIPA trustee to complete these types of contracts between the insolvent broker and another broker who is executing customer orders.184 In addition, SIPC can direct a trustee to complete any

Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1026 (6th Cir. 1979) (broker's delay in executing sale is actionable under Exchange Act of 1934 § 10(b) and Rule 10b-5).

180. See Galigher v. Jones, 129 U.S. 193, 199-201 (1889); McKinley v. Williams, 74 F. 94, 103 (8th Cir. 1896); In re Swift, 114 F. 947, 949 (D. Mass. 1902).


184. See 15 U.S.C. § 78fff-2(e) (1982). SIPC has adopted rules for contractual commitments which are outstanding on the filing date. See 17 C.F.R. § 300 (1986). The rules provide that the contract will be performed: (1) if the broker-dealer holding the outstanding contract was acting as an agent of a customer; or (2) if the insolvent broker-dealer fails to maintain his records on a specific identification basis and he had already transferred shares necessary to fill a firm customer order in a manner consistent with the special reserve requirement of 17 C.F.R. § 240.15c(3) (1986). See id. § 300.301 (1986).

Also, all such open contractual commitments must have a settlement date no more than 30 days before the filing date, or up to 5 days after, as long as the trade was made before the filing date. See id. Despite these regulations, SIPC may, after consulting with the SEC, direct the trustee to complete any open contractual commitment whatsoever in order to prevent a substantial detrimental effect on broker-dealers. See id. § 300.306. Also, with court approval, a trustee may, at any time, complete an open contractual commitment entered into for the benefit of a customer if this can be done with that customer's own securities in an account of the insolvent broker-dealer. See 17 C.F.R. § 300.307.
type of open contract whatsoever if such action is needed to "prevent a substantial detrimental impact upon the financial condition of one or more brokers or dealers." \(^1\)

3. Distribution of "Customer Property"

After the SIPA trustee uses all these methods to maximize the number of securities and the cash in the customer property fund, he then distributes the contents of that fund to customers. \(^2\) If the securities in the fund are insufficient to meet customer claims, the trustee allocates the securities available on a pro-rata basis \(^3\) and indemnifies each customer for up to an additional $500,000 worth of securities and cash. \(^4\)

SIPA does not indemnify customers for any loss in the market value of securities that occurs after the filing date. \(^5\) Instead, SIPA protects customers from market fluctuations by holding their securities for delivery. \(^6\) SIPA protects customers by requiring SIPC

\(^{185}\) See 17 C.F.R. § 300.306.
\(^{186}\) See id. § 78fff-2(b) (1982).
\(^{187}\) See id. § 78fff-2(b)(2).
\(^{188}\) See id. § 78fff-3(a) (1982). The money is made available whether or not the debtor's estate is sufficient to reimburse SIPC. See id. § 78fff-2(b)(1). Advances are limited to $500,000 for cash and securities in each customer's account, of which no more than $100,000 can be cash. See id. § 78fff-3(a)(1). For the purposes of this limit, securities are valued as of the time the SIPA petition is filed. See id. § 78fff-2(b).

\(^{189}\) See id. § 78fff(b) (1982) (SIPA values customer securities as of date SIPA petition is filed); see also SEC v. Aberdeen Sec. Co., 480 F.2d 1121, 1124 n.3 (3d Cir. 1973) (noting that problems caused by any loss in value between filing date and payment of claim should be solved by legislature, rather than courts); In re Weis Sec. Inc., [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,861 (Bankr. S.D.N.Y. Aug. 2, 1976) (investors who make claims for relief other than return of cash or securities are compensated as general creditors after "customer property" is distributed).

\(^{190}\) See 1978 Senate Hearings, supra note 25, at 4 (SIPA does not subject investors to the risk that the value of their securities will fluctuate by preventing them from making investment decisions until their claims are paid by trustee); 1978 Senate Report, supra note 25, at 2, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 764, 765 (principle underlying purpose of SIPA is to permit customer to receive securities rather than cash; this enables customer to pursue his investment objectives without being disturbed by forced sale of securities); See 1977 House Report, supra note 157, at 4 (same).
to advance money to a trustee. That money allows a trustee to: (1) buy securities needed to restore customers accounts to the position they should have been in at insolvency; and (2) pay or guarantee debts if doing so will free customer securities from liens.

V. The Sale/Loan Controversy in SIPA

SIPA was enacted to protect investors. Congress recognized that a broker is sometimes free to use his customer's securities and his customer's money. Therefore, courts administering SIPA proceedings should analyze the sale/loan question according to the practical effects on customers of adopting each classification, both when the insolvent issued the REPO with his customer's securities, and when the insolvent bought the REPO using his customer's money.

A. The REPO Transaction as a Contract for a Sale and a Subsequent Repurchase Under SIPA

If the court considers a REPO transaction a contract for sale and subsequent repurchase, then during the time between the sale and repurchase, the REPO participants are bound only by their duties under the contract. The REPO issuer has an obligation to return securities, and the REPO buyer is obligated to repurchase the

191. See 15 U.S.C. § 78fff-2(d) (1982); see also 1978 Senate Report, supra note 25, at 2, reprinted in 1978 U.S. Code Cong. & Admin. News 764, 765 (central feature of SIPA is grant of authority to trustee to purchase securities in open market or otherwise obtain them for purpose of restoring customer accounts to their filing date positions, allowing trustee to satisfy customer claims by delivering securities); see id. at 13, reprinted in 1978 U.S. Code Cong. & Admin. News 764, 776 (to increase extent to which customer claims for securities are satisfied with securities rather than cash, SIPA authorizes SIPA trustee to compensate for missing securities by purchasing shares).

192. See 15 U.S.C. § 78fff-1(b)(2) (1982); see also 1978 Senate Report, supra note 25, at 13 ("recovery of securities given ... as collateral for loans is an important means of facilitating the delivery of securities to customers").


196. See supra notes 85-88 and accompanying text.

197. See Gilmore v. State Bd. of Admin., 382 So. 2d at 862-63; see also First
The REPO buyer who purchased securities in good faith owns those securities.\textsuperscript{199}

1. The REPO Issuer’s Insolvency Under the Sale View

If the REPO issuer becomes bankrupt between the sale and the repurchase, the risk to his customers is that the REPO buyer will breach.\textsuperscript{200} A REPO buyer might be tempted to breach its contractual obligation to return securities if the underlying securities become more valuable than the price that the REPO issuer will pay upon repurchase, the risk to his customers is that the REPO buyer will and protects the REPO issuer’s customers who own the securities involved.

If a REPO buyer fails to return the securities or their value, SIPA allows a trustee to bring an action for breach of contract\textsuperscript{201} and use any recovery to compensate customers.\textsuperscript{202} In a breach of contract action, courts value securities at their highest market price between the time that they should have been delivered and the time it would take a reasonable buyer to purchase replacement securities.\textsuperscript{203} Damages for the breach, therefore, could not be cheaper but might be more expensive than the value of the securities on the repurchase.

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\textsuperscript{198} See In re Financial Corp., 1 Bankr. 522, 525 (W.D. Mo. 1979); Miller v. Schweickart, 413 F. Supp. 1062, 1067 (S.D.N.Y. 1976); see also Estate of Russell, 657 F.2d 668, 672 (5th Cir. 1981) (repayment not conditional).


\textsuperscript{200} See Gilmore v. State Bd. of Admin., 382 So. 2d 861, 862 (REPO buyer defaulted when REPO issuer became bankrupt); SEC v. Miller, 495 F. Supp. at 470 n.24 (risk of dishonor noted); STIGUM, supra note 55, at 25.

\textsuperscript{201} See 15 U.S.C. § 78fff-1 (1982). A SIPA trustee has the powers of a bankruptcy trustee. See id. A bankruptcy trustee can commence and prosecute any action or proceeding on behalf of the estate before any tribunal. See 11 U.S.C. § 323 (1982); BANK. R. 6009; 2 COLLIER, supra note 4, ¶ 323.02[4].

\textsuperscript{202} See 15 U.S.C. § 78ll(4)(D) (1982). Customer property includes the proceeds of customer property transferred by the insolvent broker. See id. The insolvent broker’s estate also owns any right of action the broker may have had under a contract. See 11 U.S.C. § 541(a)(1) (1982); 4 COLLIER, supra note 4, ¶ 541.10. The REPO buyer, however, can offset damages by the amount of the repurchase payment. See 11 U.S.C. § 546(f) (Supp. III 1985).

\textsuperscript{203} See generally Galigher v. Jones, 129 U.S. 193, 199-201 (1889); Schultz v. Commodity Futures Trading Comm’n, 716 F.2d 136, 140-41 (2d Cir. 1983); Clements v. Mueller, 41 F.2d 41, 42 (9th Cir. 1930); In re Swift, 114 F. 947, 949 (D. Mass. 1902). See Financial Corp., 1 Bankr. at 524-25 (damages for failure to execute a REPO contract governed by law of contracts).
date. Thus, any rise in the market value of underlying securities that might otherwise have encouraged a REPO buyer to breach his contract would instead provide incentive for the REPO buyer to honor his contract.

Therefore, when a REPO issuer becomes insolvent, customers who own securities that the REPO issuer used to issue the REPO will (at least in theory) receive their securities back. If the REPO buyer honors the REPO contract, the SIPA trustee for the REPO issuer distributes those securities to customers. If the REPO buyer dishonors the REPO contract, the SIPA trustee can bring an action against the REPO buyer for breach of contract, and use any recovery to buy replacement securities. Thus, SIPA protects the REPO issuer’s customers if the sale view is adopted.

2. The REPO Buyer’s Insolvency Under the Sale View

Conversely, if it is the REPO buyer that becomes insolvent between the time of the sale and the time of the repurchase, customers of the REPO issuer are protected. One section of the Bankruptcy Code should be incorporated into SIPA because it is consistent with SIPA’s policy of preventing market collapse. Section 546(f) of the Bankruptcy Code prohibits a SIPA trustee from breaching the REPO contract when his only motivation is that the market value of underlying securities has become greater than the repurchase price. The Bankruptcy Code prohibits a breach by requiring the SIPA trustee for a REPO buyer to accept repurchase payments from a good faith REPO issuer, and by prohibiting the SIPA trustee from preventing the REPO issuer from making such payments. The SIPA trustee for the REPO buyer can avoid accepting a repurchase payment only if the REPO participants entered into the REPO transactions intending to defraud creditors.

In addition to the protection afforded by the Bankruptcy Code, the open contract provisions in SIPA protect customers of the REPO

204. If the price declined since the delivery date, the REPO issuer would recover the highest market price between the delivery date and a reasonable time to replace. Thus, the issuer would recover the market price as of the time of the delivery date, and if the price rose during the period, the REPO issuer would be entitled to recover a greater amount. See Schultz, 716 F.2d at 140-41.
206. See supra notes 201-04 and accompanying text.
208. See id. § 362(b)(7) (Supp. III 1985).
209. See id. § 546(f) (Supp. III 1985); id § 548(a)(1); 4 COLLIER, supra note 4, ¶ 548.09[3], at 548-117.
issuer. SIPA regulations direct a SIPA trustee for the REPO buyer to honor certain types of open contractual commitments with the REPO issuer. Those regulations define the term “open contractual commitment” narrowly, but also provide that the SIPA trustee must complete contracts that fail to conform to the regulatory definition, if completion will “prevent a substantial detrimental impact upon the financial condition of one or more brokers or dealers.”

Through this provision, Congress created a safety net which can be used to prevent the collapse of the marketplace when a holding broker files for bankruptcy and is unable to return securities as it should.

Congress enacted the open contract provisions so that the financial resources of a depositing broker would not be drained either: (1) by his attempt to replace the deposited securities owned by his customers; or (2) by lawsuits brought by his customers based on his failure to make such replacements. Therefore, under the sale view, both the Bankruptcy Code and SIPA protect the REPO issuer’s customers when the REPO buyer becomes insolvent.

In 1986, a United States District Court in New Jersey held that a REPO is a contract for a sale and a subsequent repurchase for the purposes of SIPA. The court in In re Bevill, Bressler & Schulman Asset Management Corp. went even one step further, however, classifying a REPO participant as a SIPA “customer.”

The Bevill court’s classification thwarts congressional intent and
threatens to deplete the assets of SIPC. When Congress enacted SIPA, it intended to protect individual investors by affording them preferential status. Many REPO participants are institutions such as dealers. Therefore, if a court allows REPO participants to qualify as customers, it works against the intent of Congress by protecting dealers rather than individual investors.

Similarly, SIPA works by distributing securities to customers. If a court considers a REPO participant a SIPA customer, REPO participants will receive securities from an insolvent broker’s customer property fund. These distributions will drain first the insolvent broker’s customer property fund, and next the assets of SIPC.

B. The REPO Transaction as a Loan Under SIPA

If a court considers a REPO transaction a contract for a sale and a subsequent repurchase, only one participant owns the underlying securities at any one time. But, if a court considers a REPO a loan, both participants own interests in the securities. If a REPO is a loan, both parties have an ownership interest because the underlying securities are collateral. Although collateral ultimately belongs to the REPO issuer, it is encumbered by the REPO buyer’s security interest. The question of which party will get that collateral,


219. See infra notes 275-77 and accompanying text.


221. See supra notes 186-88 and accompanying text.

222. See infra notes 321-25 and accompanying text.

223. See infra notes 304-08 and accompanying text.

224. See Need for Legislative Action, supra note 10, at 829 n.8; Mitchell, supra note 10, at 6, col. 1; Portnoy, supra note 10, at 19, col. 2.

therefore, depends upon whether SIPA allows a secured creditor to keep collateral and, if so, whether the REPO issuer can defeat the REPO buyer's security interest. The answers to these questions, in turn, depend upon which REPO participant has become insolvent and when that insolvency has occurred.

If a court considers a REPO transaction a loan, and either party becomes insolvent, SIPA may subject the REPO participant and the REPO participant's customers to three risks: (1) the risk of fluctuation in the market price of underlying securities;226 (2) the risk of losing possession of the securities;227 causing (3) the risk of not having the anticipated numbers of securities available.228

1. The REPO Buyer's Insolvency Under the Loan View

Under the loan view, the REPO buyer holds collateral to secure repayment of the repurchase price.229 If the REPO buyer becomes bankrupt between the sale and the repurchase, the REPO issuer could lose his interest in the collateral.230 Upon the REPO buyer's bankruptcy, the REPO issuer is clearly protected by the Bankruptcy Code, but the REPO issuer may be at risk under SIPA.

Upon insolvency, the Bankruptcy Code would classify underlying securities as "cash collateral."231 The Code forbids a trustee to use or sell cash collateral unless he meets one of two conditions. The trustee must either: (1) obtain consent from the party in interest, in this case the REPO issuer;232 or (2) convince the court that the REPO issuer will be adequately protected after the use or sale.233 Courts will consider a creditor adequately protected only if the trustee gives him the "indubitable equivalence" of his interest in property.234 For example, a bankruptcy trustee could adequately protect a lienholder by giving him a replacement lien on other property of the estate.235

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226. See infra notes 244-53 and accompanying text.
227. See infra notes 254-57 and accompanying text.
228. See infra notes 258-59 and accompanying text.
229. See supra notes 66-78 and accompanying text.
230. See infra notes 236-41 and accompanying text.
231. See 11 U.S.C. § 363(a) (1982). "Cash Collateral" includes securities in which the estate and an entity other than the estate have an interest. Id.
232. See id. § 363(c)(2)(A) (1982).
233. See id. § 363(c)(2)(B) (1982). Section 361 of the Bankruptcy Code gives examples of the kinds of arrangements that provide adequate protection. See 11 U.S.C. § 361 (1982); see also In re American Mariner Indus., Inc., 734 F.2d 426, 428 (9th Cir. 1984); 2 COLLIER, supra note 4, ¶ 361.01, at 361-5.
234. See In re Murel Holding Corp., 75 F.2d 941, 942 (2d Cir. 1935) (Learned Hand, J.).
235. See, e.g., In re American Kitchen Foods, Inc., 9 Collier Bankr. Cas. 2d
When a SIPA trustee liquidates a REPO buyer, however, SIPA might not protect customers of the REPO issuer to the same degree that they are protected by the Bankruptcy Code. SIPA creates a class of creditors called “customers” whose claims enjoy priority over the claims of bankruptcy creditors. SIPA empowers a trustee to use property of the insolvent broker to purchase securities that the insolvent failed to hold for its “customers.” Therefore, if the REPO buyer failed to possess or control securities as required, a SIPA trustee may be able to use cash collateral, specifically securities underlying a REPO transaction, to satisfy customer claims.

For example, a broker is required to hold securities for which customers have fully paid. Assume that a broker speculates with his customers’ securities and loses them. He may try to replace the lost securities temporarily by purchasing securities through a REPO transaction. Assume further that the broker subsequently became insolvent while holding the securities subject to the REPO. Since a SIPA trustee can use the assets of a bankrupt REPO buyer’s estate to replace securities that the REPO buyer failed to hold for his customers, and since, under the loan view, the REPO buyer’s estate has an ownership interest in the underlying securities, a SIPA trustee may be able to use the securities underlying the REPO transaction to satisfy the claims of the REPO buyer’s customers.

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237. See 15 U.S.C. §§ 78fff-2(d) (1982). The SIPA trustee can use the customer property fund to purchase necessary securities in a fair and orderly market. See id. § 78fff-2(d). Customer property includes that property of the insolvent broker which is needed to cover shortfalls in customer accounts caused by the insolvent broker’s failure to comply with the applicable financial responsibility requirements of 15 U.S.C. § 78o(c)(3), and its attendant regulations. See id. § 78fff-2(d).

238. See id. § 78o(c)(3) (1982); 17 C.F.R. § 240.15c3-3(b)(1) (1986).

239. See 17 C.F.R. § 240.15c3-3. Section 15(c) of the Securities and Exchange Act requires brokers to comply with financial responsibility rules regarding the custody and use of customers’ securities. See 15 U.S.C. § 78o(c)(3) (1982). The applicable regulations require brokers to possess or control all securities that customers have fully paid for. See 17 C.F.R. § 240.15c3-3(b)(1) (1986). SIPA allows a SIPA trustee to use a broker’s assets to compensate the customer property fund for any shortfall due to the broker’s non-compliance with the above regulations. See 15 U.S.C. § 78fff-2(d) (1982). Using this money, a SIPA trustee can purchase securities needed to restore customer accounts to the positions they should have been in at insolvency. See § 78fff-2(d) (1982).


241. See supra notes 236-37 and accompanying text.
In such situations, a REPO issuer’s customers who own the securities could make claims only as bankruptcy creditors.\textsuperscript{242} They would be satisfied out of the bankrupt broker’s estate only after claims of all the REPO buyer’s customers had been satisfied.\textsuperscript{243} Therefore, if a court adopts the loan view, customers of REPO issuers could lose their securities when a REPO buyer becomes insolvent.

2. The REPO Issuer’s Insolvency Under the Loan View

Similarly, when it is the REPO issuer who becomes insolvent during the time between the sale and the repurchase, the SIPA trustee must avoid repurchasing the securities from the REPO buyer if their market value has diminished, but complete the REPO transaction if their market value has increased.\textsuperscript{244} Under the loan view, when a REPO issuer pays the repurchase price and receives the underlying securities, he is paying his debt and recovering collateral.\textsuperscript{245} SIPA does not allow a trustee to pay a debt unless doing so would free securities that are worth more than the payment.\textsuperscript{246} Therefore, when the market value of the underlying securities fluctuates, the insolvent REPO issuer’s estate cannot lose and the REPO buyer cannot win. The REPO buyer must honor the REPO contract when the value of the securities he is holding has increased, but must keep the securities if their value is diminishing.

Additionally, as the value of the collateral securities diminishes and a greater portion of the issuer’s debt becomes unsecured, SIPA prevents the REPO buyer from immediately cutting his losses by

\begin{footnotes}
\item[242] See infra notes 260-64 and accompanying text.
\item[245] See United States v. Erickson, 601 F.2d 296, 300 n.4 (7th Cir. 1979); SEC v. Miller, 495 F. Supp. 465, 467 (S.D.N.Y. 1980); Mitchell, supra note 10, at 6, col. 1.
\end{footnotes}
foreclosing and selling the collateral.\textsuperscript{247} SIPA's automatic stay prohibits a creditor from transferring any property in which the debtor's estate has an interest.\textsuperscript{248} To defeat the stay, a creditor must delay liquidation and show that he cannot adequately protect his interests unless he is allowed to transfer the property.\textsuperscript{249} Since SIPA was designed to avoid liquidating securities,\textsuperscript{250} and since Congress specifically decided to subject securities underlying REPO transactions in SIPA proceedings to the automatic stay,\textsuperscript{251} a court might refuse to read SIPA to incorporate a section of the Bankruptcy Code that allows REPO buyers to liquidate.\textsuperscript{252} In any case, the market rate of the collateral could continue to drop while the application is made.\textsuperscript{253}

In addition to losing equity, a REPO buyer might also lose possession of the underlying securities. Under the loan view, a trustee for a REPO issuer might recover the underlying securities without repaying the loan. A trustee can recover the securities either if the REPO buyer fails to perfect his security interest,\textsuperscript{254} or if the SIPA

\textsuperscript{247} Although § 559 of the Bankruptcy Code provides that a REPO buyer's right to liquidate cannot be stayed under the Code, see 11 U.S.C. § 559 (Supp. III 1985), that prohibition does not apply to stays under SIPA. See id.


\textsuperscript{249} See id. § 362(d)(1) (1982). The Code requires a hearing to determine whether a creditor's interest is adequately protected. See id. § 362(d); see also id. § 361 (1982) (examples of adequate protection). But see id. § 102(1)(B) (1982) (hearing need not be held if party in interest fails to make a timely request or if there is insufficient time); id. § 362(f) (Supp. III 1985) (court can grant relief from stay without hearing to prevent irreparable damage to interest in property).


\textsuperscript{251} See 11 U.S.C. § 559 (Supp. III 1985); see also 1983 Senate Hearings, supra note 99, at 326-36 (statement of Peter Sternlight, Executive Vice President, Federal Reserve Bank of New York).

\textsuperscript{252} See 15 U.S.C. § 78fff(b) (1982). The Bankruptcy Code is applicable to a SIPA proceeding only to the extent that it is consistent with SIPA. See id.

\textsuperscript{253} See, e.g., Miller, 495 F. Supp. at 473. A REPO participant with highly leveraged positions is subject to risk in the rapidly moving REPO market. See id. at 474.

\textsuperscript{254} See 11 U.S.C. § 550(a) (1982). If a REPO buyer fails to perfect within ten days a court would deem the underlying securities transferred not when the underlying securities change hands, but when the REPO buyer perfects. See id. § 547(e)(2) (1982). Since the REPO buyer pays the REPO issuer cash when the securities change hands, if the REPO buyer fails to perfect, a SIPA trustee can avoid the REPO as a transfer for an antecedent debt—the earlier cash payment. See id. § 544(b) comment 1; see supra note 147. The steps necessary for perfection are
trustee can convince a court that he can adequately protect the REPO buyer's interest when he uses or sells securities.\textsuperscript{255} As discussed above, Congress designed SIPA to allow a trustee to use all the insolvent broker's assets necessary to satisfy customer claims before the trustee satisfies the claims of any other creditors.\textsuperscript{256} Therefore, REPO buyers would be hard pressed to argue that adequately protecting their interest should take priority over satisfying the claims of customers.\textsuperscript{257}

If the REPO buyer fails to prove that he has a perfected security interest in the underlying securities, or if a trustee can show that the REPO buyer will nonetheless be adequately protected, a trustee can force the REPO buyer to turn underlying securities over to him.\textsuperscript{258} Then the REPO buyer will be unable to use the securities for the purpose that prompted him to enter into the REPO transaction, and he may be forced to borrow securities to replace those lost—which in turn would force him to incur additional cost. The
REPO buyer can avoid losing both the repurchase payment and the costs of borrowing replacement securities only if he reclaims the securities as a SIPA customer.\(^{259}\)

### 3. The REPO Participant as a SIPA Customer

The SIPA definition of "customer" includes those who, personally or through a broker acting as their agent, maintain accounts containing "securities"\(^{260}\) that the debtor receives, acquires or holds in one of three ways: (1) with a view to sale or pursuant to purchase; (2) for safekeeping; or (3) as collateral security.\(^{261}\) Therefore, to qualify as a customer, a REPO buyer must show that the transaction involved "securities"\(^{262}\) and that, in the transaction, he acted as an agent of one of his investors.\(^{263}\) Only a customer can retrieve securities entrusted to the debtor.\(^{264}\)

First, a court should not characterize a REPO, itself, as a "security" as that term is defined by SIPA.\(^{265}\) Only the underlying securities can qualify under SIPA's definition.\(^{266}\) When it amended the Bankruptcy Code in 1984, Congress last considered how to characterize a REPO transaction.\(^{267}\) Because SIPA's definition of "security" is virtually identical to the definition of "security" under the Bankruptcy Code,\(^{268}\) Congress' actions shed light on whether it

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\(^{260}\) See id. § 78llll(14) (1982).

\(^{261}\) See id. § 78llll(2); see also id. § 78fff-3(a)(5) (1982) (SIPC cannot advance money to pay claims of broker except those rising out of transactions with customers).

\(^{262}\) See infra notes 265-74 and accompanying text.


\(^{265}\) See Retail REPOs, supra note 218, at 2559-64; see also Lifting the Cloud, supra note 94, at 418-19 (discussing adverse consequences of courts treating REPO transactions as separate securities under Exchange Act).

\(^{266}\) See 15 U.S.C. § 78llll(4) (Supp. I 1983). Underlying securities could qualify as SIPA "securities" if they are notes, stocks, treasury stocks, bonds, debentures or evidences of indebtedness. Id. The REPO itself might only qualify if a court considers the REPO to be an investment contract, but investment contracts do not qualify as SIPC securities unless they are registered under the Exchange Act. See id.


intended courts to treat REPO transactions as securities under SIPA.

Congress declined to treat a REPO as a security for the purposes of the provisions of the Bankruptcy Code that apply to stockbrokers who are not members of SIPA.\textsuperscript{269} Congress handled REPO transactions by creating a new statutory framework applied only to those instruments.\textsuperscript{270} The framework paralleled the treatment of "securities contracts,"\textsuperscript{271} and, in fact, Congress anticipated that when a REPO fails to fit into the REPO sections, it could be treated under the securities contract sections.\textsuperscript{272}

Congress designed both the REPO and security contract sections to allow dealers to protect themselves from fluctuating market prices in transactions with other dealers.\textsuperscript{273} Congress believed that allowing dealers to take these protective measures would avoid a series of market failures when a dealer who has open securities positions with other dealers becomes bankrupt.\textsuperscript{274} In short, Congress created a new statutory mechanism rather than treating REPO transactions and other inter-dealer transactions as securities under the stockbroker provisions of the Bankruptcy Code. Therefore, it would be inappropriate to treat REPOS as "securities" under SIPA.

Similarly, in these types of inter-dealer transactions, the REPO participants are not acting on behalf of their customers, but are raising capital for their own needs.\textsuperscript{275} REPO transactions, therefore, lack the type of fiduciary characteristics that SIPA safeguards.\textsuperscript{276}

\begin{thebibliography}{9}
\bibitem{270} See 1983 Senate Hearings, supra note 98, at 323 (submission of Peter J. Sternlight, Executive Vice President, Federal Reserve Bank of New York); Levin & Donovan, supra note 30, at 154.
\bibitem{271} See S. REP. No. 65, 98th Cong., 1st Sess. 44 (REPO sections added to clarify that REPOS are to be treated as under Pub. L. No. 97-222, which proscribed treatment for securities contracts); see also 1983 Senate Hearings, supra note 25, at 328-29, 322-23, 335 (stating that proposed REPO amendments build upon Pub. L. No. 97-222).
\bibitem{272} See 1983 Senate Hearings, supra note 99, at 324 (statement of Peter J. Sternlight, Executive Vice President, Federal Reserve Bank of New York).
\bibitem{273} See 4 Collier, supra note 4, ¶ 741.07, at 741-50; see also 128 CONG. REC. S8133 (daily ed. July 13, 1982) (statement of Sen. Dole) [hereinafter Dole statement].
\bibitem{274} See H. REP. No. 420, 97th Cong., 2d Sess. 3 (1982); Dole statement, supra note 270, at S8133.
\bibitem{276} See 15 U.S.C. § 78ll(2) (1982). The Second Circuit has interpreted SIPA
Instead, REPO transactions display the characteristics of arms length financial dealings which SIPA does not protect.\textsuperscript{277} For these reasons, REPO participants cannot qualify as customers under SIPA.

\textbf{VI. The Legislative Purpose of SIPA Requires that REPO Transactions be Treated as Contracts for a Sale and a Subsequent Repurchase}

The argument that a REPO transaction is a loan,\textsuperscript{278} therefore, allows a SIPA trustee to add the underlying securities to the insolvent's estate if it is profitable to do so,\textsuperscript{279} but to avoid indemnifying the owners of securities underlying a REPO transaction.\textsuperscript{280} It is true that the loan approach works to maximize the insolvent's estate, lessening the possibility of a need to use SIPC funds and decreasing the risk that the insolvent's customers will lose securities.\textsuperscript{281} It does so, however, only by risking harm to the marketplace, increasing the risk that REPO participants will be rendered insolvent\textsuperscript{282} and

\begin{itemize}
  \item[277.] See Executive Sec. Corp., 556 F.2d at 99; Baroff, 497 F.2d at 284; 4 Collier, supra note 4, \S 741.02, at 741-16.
  \item[278.] See SIPC Amicus Memorandum, supra note 43, at 8-9 (SIPC argues "[a]lthough structured in apparent terms of purchase and sale, the [REPO] transaction is in reality a short-term loan").
  \item[279.] See supra notes 245-46 and accompanying text.
  \item[280.] In the ESM case, the SIPC argued that REPO participants are not "customers" under the Bankruptcy Code's stockbroker provisions, which are virtually identical to SIPA. See SIPC Amicus Memorandum, supra note 43, at 8. The SIPC also argued that even if REPO participants are considered "customers" under the Bankruptcy Code, they should not be considered "customers" under SIPA. See id. at 24-27.
  \item[281.] See supra notes 36-45 and accompanying text.
  \item[282.] See infra notes 291-96 and accompanying text.
\end{itemize}
causing investors to lose their securities or cash.\textsuperscript{283} Therefore, the loan view frustrates the secondary aims of SIPA while the sale view advances those secondary aims.

Courts determining how to treat REPO transactions in the SIPA context would do well to heed the comments of the Second Circuit in \textit{S.E.C. v. F.O. Baroff Co.}:\textsuperscript{284}

Judge Learned Hand has vividly admonished us not to be caught in the trap of language which seems, literally, too broad or too narrow to accommodate the patent legislative purposes. Securities legislation is no exception. This court has already heeded the caution in reading ... the Securities Investor Protection Act.\textsuperscript{285}

Classifying a REPO transaction as a contract for sale and subsequent repurchase will most effectively accomplish the goals Congress intended to achieve in enacting SIPA.

\textbf{A. The Aims of SIPA}

Congress intended SIPA: (1) to protect the market from a series of insolvencies among broker-dealers;\textsuperscript{286} (2) to protect a customer’s right to receive securities for which he paid in full;\textsuperscript{287} and (3) to increase the general public’s confidence in the securities industry.\textsuperscript{288} Courts can advance those goals by treating REPO transactions as contracts for a sale and a subsequent repurchase, but refusing to treat REPO participants as SIPA customers.\textsuperscript{289} Such a classification

\begin{footnotes}
\footnote{283. \textit{See supra} notes 239-43 and accompanying text.}
\footnote{284. 497 F.2d 280 (2d Cir. 1974).}
\footnote{285. \textit{See id.} at 282.}
\footnote{289. \textit{See supra} notes 260-77 and accompanying text.}
\end{footnotes}
REPO TRANSACTIONS

will protect REPO participants while assuring that the funds of the estate, and of SIPA, are not depleted.290

1. Protection of the Market

REPO transactions are as volatile as they are vital.291 According to the Senate Report to the Bankruptcy Amendments of 1984:

[REPO activity] is built upon transactions that are highly inter-related. A collapse of one institution involved in REPO transactions could start a chain reaction, putting at risk hundreds of billions of dollars, and threatening the solvency of many additional institutions.292

Congress was concerned with just such a "domino effect" when it enacted SIPA and dealt with it through the open contract provisions of the Act.293

SIPA can avert a series of market failures only by treating REPO transactions as "open contracts."294 If a court considers a REPO transaction a contract for a sale and a subsequent repurchase, SIPA allows a trustee to complete the REPO to avert a series of market failures.295 On the other hand, if a court considers a REPO transaction a loan, the trustee can complete the REPO transaction only

290. See infra notes 321-25 and accompanying text.
291. See 1983 Senate Hearings, supra note 99, at 310-12 (statement of Peter D. Sternlight, Executive Vice President, Federal Reserve Bank of New York); 1983 Senate Report, supra note 98, at 47.
292. See Volker Letter, supra note 93, at 305 (stating "failure of a major [REPO] market participant and the inability of other parties to liquidate their investment promptly could ripple outward through the securities market and cause an otherwise isolated problem to spread to other financial markets"); see also 1983 Senate Hearings, supra note 99, at 308 (statement of Thomas W. Strauss, Public Securities Association, "ripple effects . . . might seriously paralyze our securities and commodities markets should a large dealer go bankrupt with billions of dollars of outstanding obligations to investors and dealers, which in turn have billions of dollars of obligations outstanding to other investors and dealers"); S. Rep. No. 65, 98th Cong., 1st Sess. 47 (1983).
293. See 1970 House Hearings, supra note 115, at 266-27 (testimony of Phillip Loomis, General Counsel, Securities and Exchange Commission); see also SEC v. Barbour, 421 U.S. 412, 415 (1975) (Congress enacted SIPA to prevent "domino effect"); Ambassador Church, 679 F.2d at 612 (same).
295. See 17 C.F.R. § 300.306 (1986). The contracts to be completed need not conform to the definition of open contract in 17 C.F.R. § 300.300(c) (1986), or meet the requirements that otherwise dictate when an open contract will be closed out. See id. §§ 300.306 (1986). However, the SIPC must consult with the SEC before it makes any determinations under this section. See id.
if the market value of the underlying securities is greater than the repurchase price. Such a ruling would leave a SIPA trustee without the power to prevent a market collapse. Therefore, courts should refuse to treat REPO transactions as loans and should treat REPOs as contracts for the sale and subsequent repurchase of securities.

2. Protecting Customers' Rights to Receive Securities

In 1970, Congress attempted to insulate customers from fluctuations in the market value of securities that were in their account by requiring SIPA trustees to keep securities in the same form that they were in at insolvency, and to deliver them to customers. In 1979, however, Congress recognized that trustees could not deliver securities that the insolvent broker had improperly hypothecated, misappropriated, stolen or never purchased. Accordingly, Congress bolstered its support for the policy of returning securities to customers by giving the trustee the authority to purchase "customer securities" in the open market. This step made the assets in the customer property fund fungible to a large degree and insured that a SIPA

296. See infra note 244 and accompanying text.
A principle underlying purpose of the bill is to permit a customer to receive securities to the maximum extent possible instead of cash, in satisfaction of a claim for securities. By seeking to make customer accounts whole and returning them to customers in the form they existed on the filing date, the amendments not only . . . satisfy the customers' legitimate expectations, but also would restore the customer to his position prior to the broker-dealer's financial difficulties. This will enable the customer to pursue his investment objectives without being disturbed by the forced sale of securities . . .
Id. at 765.
trustee is able to deliver securities, as long as the aggregate value of the customer property fund remains sufficient to do so. Therefore, treating a REPO transaction as a sale and subsequent repurchase will assure that customers receive their securities, as long as that characterization does not deplete the customer property fund. As will be discussed presently, that fund will not be depleted when a court adopts the sale view.

3. Increasing the Confidence of the General Public

Congress also attempted to increase the general public’s confidence in the securities industry by creating SIPC. If REPO transactions are considered sales and subsequent repurchases, SIPA will protect both clients of REPO buyers and clients of REPO issuers. SIPC was designed to be a well funded insurer, to which all investors could look with confidence after suffering a loss.

SIPC advances money to the SIPA trustee without regard to the ability of the insolvent broker’s estate to repay SIPC. Therefore, SIPC funds could be depleted when the SIPA trustee either purchases securities to restore customer accounts or uses SIPC advances to reimburse customers for their securities lost. The customer property fund should contain all the assets necessary to reimburse SIPC. A SIPA trustee, however, can use the assets of the insolvent broker to

301. See infra notes 310-30 and accompanying text.
305. See H.R. Rep. No. 746, 95th Cong., 1st Sess. 22 (1977) (committee noted that phrase “fair and orderly market” was included in SIPA to assure that SIPC funds need not be expended if price of security needed to restore customer account is too high).
306. See 1978 House Hearings, supra note 297, at 70-71 (Hugh Owens, Chairman, SIPC, advocates raising amount of protection available to each individual customer and addresses concern that raising protection may deplete SIPC funds).
restore securities to the customer property fund when a broker failed to hold its customer’s securities. A SIPA trustee can then use the customer property fund to reimburse SIPC for advances. Therefore, SIPC funds are at risk only to the extent that the insolvent broker’s estate plus the customer property fund is insufficient to restore cash and securities to customers’ accounts.

B. The Customer Property Fund

Treating a REPO transaction as a contract for a sale and a subsequent repurchase will not deplete the customer property fund unless a court also deems a REPO participant a SIPA customer. Absent fraud or negligence, parties would not enter into a REPO transaction unless doing so was commercially reasonable. Each party receives a benefit from the bargain, and, upon insolvency, that benefit accrues to the customer property fund whether or not the parties breach the REPO agreement.

308. See 15 U.S.C. § 78fff-2(c)(1)(C) (1982). The disbursements from the customer property fund are made according to 15 U.S.C. § 78fff-2(c) (1982). SIPC is reimbursed both as the subrogee to the claims of customers, see id. § 78 fff-2(c) (1982), and for advances used to secure any debt under sections 78fff-2(f) and 78fff-3(c)(2). See id. § 78fff-2(c)(2) to (c)(3) (1982).
309. A SIPA trustee can void fraudulent transactions, see 11 U.S.C. § 548 (1982), and recover the property involved. See id. § 550(a) (1982). In addition, any property of the debtor which customers would receive as compensatory damages in a Rule 10b-5 securities fraud lawsuit is included in customer property. See 15 U.S.C. § 78lll(4)(D) (1982); see supra note 147 and accompanying text. Defrauded buyers receive their purchase price if they opt to rescind the contract, see A. Bromberg, Securities Fraud and Commodities Fraud § 9.1, at 226 n.2 (1984), or they may recover for out-of-pocket loss if they decide to sue under the contract for the breach. See id. at 226 n.3. In contrast, sellers can force a buyer to disgorge any profits made using a constructive trust theory. See id. at 227 n.8; see also infra notes 327-28 and accompanying text (discussing SIPA trustee’s power to bring action against insolvent broker’s officers for fraud).
310. Customer property is increased both by the property of the debtor that would be awarded to customers in a common law action of negligence, see 15 U.S.C. § 78lll(4)(D) (1982), and by securities that according to the net capital requirement, see id. § 78o(c)(3) (1982), the debtor should have possessed or controlled. See id. § 78lll(4)(A) (1982).
311. The courts have recognized the concept of “commercially reasonable” actions in the sale of collateral under the U.C.C. See U.C.C. § 9-504(3) (1978). A sale of collateral is commercially reasonable if the party acts in good faith, avoids loss, and makes an effective realization of the debt. See Old Colony Trust Co. v. Penrose Indus. Corp., 280 F. Supp. 698, 715 (C.D. Pa.), aff’d, 398 F.2d 310 (3d Cir. 1968); see also United States v. Willis, 593 F.2d 247, 259 (6th Cir. 1979).
312. See supra notes 56-59 and accompanying text.
313. See infra notes 314-20 and accompanying text.
A REPO issuer transfers his customer's securities in return for cash to use for a certain period of time. If a REPO issuer files for insolvency under SIPA, the value of the securities is protected. If the REPO contract is completed, the proceeds of investments the REPO issuer makes with the cash provided in the REPO, plus the collateral securities themselves, are included in the REPO issuer's customer property fund. Alternatively, if the REPO buyer breaches the contract, the REPO issuer could retain the cash and bring a breach of contract action for the REPO buyer's failure to deliver securities. The trustee can then add any damages recovered to the customer property fund.

Similarly, a REPO buyer can use its customers' cash to fund a REPO transaction. When the REPO is completed, that cash is returned with interest. If the REPO buyer becomes insolvent, both the principal and the interest become customer property; and if the REPO issuer fails to repurchase, the REPO buyer's trustee can foreclose, sell the underlying securities and bring a breach of contract action to recover any shortfall.

In contrast, if a REPO participant is considered a customer in his own right, the SIPC fund will be depleted. SIPA protects customers by returning securities and cash. Under the sale view, a REPO buyer does not buy a security, he obligates himself to return


315. See 15 U.S.C. § 78lll(4) (1982). SIPA's definition of customer property includes "...securities ... at any time received, acquired or held by or for the account of a debtor from or for the securities account of a customer, and the proceeds of any such property transferred by the debtor, including property unlawfully converted." See id. (emphasis added).

316. See supra notes 201-04.

317. See 15 U.S.C. § 78lll(4) (1982). Customer property includes the proceeds of securities held for customers but unlawfully converted. See id.; see also supra note 197 (estate includes value of contractual right of recovery).

318. See supra notes 57-59 and accompanying text.


320. See supra notes 201-04 and accompanying text.

a security on the repurchase date. This obligation means that a REPO buyer can retransfer the underlying securities as long as he satisfies his obligation to return securities in the future. This type of retransfer is a common practice in the REPO market.

For example, if broker A issued a REPO to broker B, broker B could retransfer the securities to broker C. If broker B becomes insolvent between the sale and the repurchase, broker A would have a customer property claim for the underlying securities and broker C would have a customer property claim for the repurchase price. In such a situation, broker A could claim securities that broker B was not obligated to hold. This example illustrates that when a court treats a REPO participant as a SIPA customer, the customer property fund of the insolvent broker, and therefore the funds of SIPC, will be depleted.

Therefore, absent fraud or negligence, unless a REPO participant is considered a customer, the assets in the customer property fund are not diminished by considering a REPO transaction as a contract for a sale and a subsequent repurchase. The customer property fund can be diminished, however, if the bankrupt broker had improperly used REPOS to generate cash or securities to cover bad proprietary investments. A SIPA trustee can bring legal actions against former officers of the bankrupt who were responsible for such fraudulent

322. *See supra* notes 85-86 and accompanying text.
323. *See supra* note 87.
324. *See Miller,* 495 F. Supp. at 471-72; *Oversight of Government Securities, supra* note 21, at 87,397 n.14; *see also* 1983 *Senate Hearings, supra* note 99, at 323 (statement of Peter J. Sternlight, Executive Vice President, Federal Reserve Bank of New York).
325. The SIPA trustee uses SIPC funds to reimburse customers for securities that are missing from the customer property fund. *See supra* notes 191-92 and accompanying text.
326. In *SEC v. Miller,* 495 F. Supp. 465 (S.D.N.Y. 1980), the court discussed various ways in which securities provided by REPOS are invested:

[R]epos are a very convenient way to leverage capital in order to take large positions in a security. And it is easy to see how a repo can be used to borrow against either a long or short position. Simply stated, “long” means taking the risks of owning, while “short” means taking the risks of owing. When a dealer wants to leverage long, he can buy a large amount of a security and finance nearly all of its purchase price by immediately “hanging it out” on repo—in other words, by borrowing the money and using the securities as collateral. Using repos to leverage short is slightly more complicated. The dealer sells securities he does not own, then lends the proceeds of the sale in a repo, receiving as collateral the same type of securities he has sold. He then delivers the collateral to the initial purchaser to complete the transaction.

*Id.* at 471-72 (footnotes omitted).
schemes\textsuperscript{327} and then add any damages recovered to the customer property fund.\textsuperscript{328} It is unreasonable to assume, however, that the trustee would be able to recover anything greater than a small portion of the money lost. It is entirely consistent with the purposes of SIPA to subject SIPC funds to that type of risk. Congress recognized that SIPC funds would be depleted when a broker misused assets acquired with a customer's cash or securities,\textsuperscript{329} but Congress nonetheless chose to indemnify customers.\textsuperscript{330} Consequently, treating REPO transactions

\textsuperscript{327} The property of the estate in bankruptcy includes any right of action the bankrupt corporation may have against its officers or directors for misconduct, mismanagement or negligence. See \textit{In re Burnett-Clark, Ltd.}, 56 F.2d 744 (2d Cir. 1932); \textit{In re Swofford Bros. Dry Goods Co.}, 180 F. 549 (W.D. Mo. 1910); 4 \textit{COLLIER, supra} note 4, ¶ 541.10. Thus, a bankruptcy trustee can prosecute a fraud claim against the former officers or directors of the bankrupt. 4 \textit{COLLIER, supra} note 4, ¶ 541.10; \textit{In re Plants & Faculties Co.}, 441 F.2d 275 (9th Cir. 1971); Bayliss v. Rood, 424 F.2d 142 (4th Cir. 1970).


\textsuperscript{328} A SIPA trustee can add any money so recovered to the estate of the debtor. See \textit{In re Burnett-Clark, Ltd.}, 56 F.2d 744 (2d Cir. 1932); \textit{In re Swofford Bros. Dry Goods Co.}, 180 F. 549 (W.D. Mo. 1910); 4 \textit{COLLIER, supra} note 4, ¶ 541.10. All property of the estate in bankruptcy can be added to the "customer property" fund to the extent that the insufficiency of the fund is attributable to non-compliance with 15 U.S.C. § 78o(c)(3). 15 U.S.C. § 78llll(4) (1982).

\textsuperscript{329} See 1978 Senate Hearings, \textit{supra} note 25, at 4. In 1977, SIPC Chairman Owens brought problems with SIPA to Congress' attention:

[C]ustomers generally expect to receive what is in their accounts when the member stops doing business. But in many instances that has not always been possible because securities have been lost, improperly hypothecated, misappropriated, never purchased, or even stolen. When there are valid claims for more stock than is on hand, under the present statute the claimant will receive only a pro rata portion of the securities he claims.

\textit{Id.}

Congress responded by providing protection for such losses. See Securities Investor Protection Act Amendments of 1978, Pub. L. No. 95-283, 92 Stat. 249. Similarly, Congress broadened the class of stockbrokers to which SIPA applies. SIPA originally covered only organizations that maintained customer accounts, but was changed to include all firms that handled "customer securities" when the possibility of loss or misappropriation exists. See \textit{Securities Investor Protection: Hearings before the Subcomm. on Commerce and Finance of the Comm. on Interstate and Foreign Commerce}, 91st Cong., 2nd Sess. 72-73 (1977) (statement of Hugh F. Owens, Chairman, SIPC).

\textsuperscript{330} The House Committee stated that a major aim of SIPA was to "establish immediately a substantial reserve fund which would provide protection to customers of broker-dealers . . . ." H.R. REP. No. 1613, 95th Cong., 2d Sess. 5254, 5257 (1970).
as contracts for a sale and a subsequent repurchase is consistent with Congress' mandate.

VII. Conclusion

A court should not allow a SIPA trustee to classify a REPO transaction as a loan arrangement in order to assert his statutory powers, and then refuse to protect the owners of securities underlying those same REPO transactions as "customers." A court should treat a repurchase agreement as a contract for a sale and a subsequent repurchase. This classification will allow REPO participants to liquidate the collateral securities, if doing so would be economically advantageous and would deplete neither the "customer property" fund nor the assets of SIPC. In addition, characterizing a REPO transaction as a contract for a sale and a subsequent repurchase will enable SIPC to prevent a series of market failures by closing out open REPO contracts. Therefore, the sale characterization will insure market stability, customer protection and maximum economic gain.

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