BANKRUPTCY LAW360

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Phone: +1 212 537 6331 | Fax: +1 212 537 6371 | customerservice@portfoliomedia.com

When Brokers Go Broke

Friday, Apr 11, 2008 --- As the subprime crisis worsens, more stockbrokers can expect to face the intricacies and special quirks that attend brokerage bankruptcies, say Charles M. Oellermann and Mark G. Douglas of Jones Day.

By almost every estimate, the fallout from the subprime mortgage/investment disaster has proved to be worse than anticipated, numbering among its casualties over 50 mortgage lenders as well as venerable 85-year old Wall Street icon Bear Stearns Cos. Inc.

Once the fifth largest securities firm in the U.S., Bear Stearns provisionally agreed to be acquired by JP Morgan Chase & Co. (with up to $30 billion in Federal Reserve emergency financing) on March 24, 2008, at the bargain basement price of $1.2 billion, or $10 per share, only a week after expressing outrage at JP Morgan's initial offer of only $240 million ($2 per share) and 10 days after its market value had been pegged at $4.1 billion.

There was a good deal of speculation as Bear Stearns' affairs unraveled at lightning speed that the company might seek bankruptcy protection in a effort to stave off billions of dollars in margin calls.

However, although Bear Stearns is a global investment banking firm, a significant percentage of its business involves prime brokerage clearing services to hedge funds and other investors. It is, in fact, the third largest prime brokerage firm in the U.S., behind Goldman Sachs Group Inc. and Morgan Stanley.

To the extent that Bear Stearns' respective business entities are considered "stockbrokers" (defined generally to include any securities broker), those entities would be ineligible for relief under Chapter 11 of the Bankruptcy Code. As a result, the alternative would be liquidation under either Chapter 7 or the Securities Investor Protection Act of 1970 ("SIPA").

The potentially disastrous consequences of liquidating Bear Stearns' brokerage assets for customers and creditors (including trade counterparties to credit default swap contracts carrying an outstanding value of over $2.5 trillion), as well as the inability to stay the liquidation of many of those contracts even if a bankruptcy were filed, provided the principal impetus for the Federal Reserve's decision to provide emergency loans backing the JP Morgan acquisition/bailout.

An increasing number of broker-dealers will be forced to consider their options, as the inevitable onslaught of litigation and federal investigations

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ensue regarding the subprime investment scandal. Creditors and customers of U.S. broker-dealers will similarly be keenly interested in the likely ramifications of a broker's meltdown.

In anticipation of those concerns, a short primer on stockbroker liquidation proceedings may be instructive.

Federal Regulation Of Stockbrokers

As a consequence of the financial mayhem that precipitated the Great Depression, the securities industry is among the most heavily regulated sectors in the U.S., with the Securities and Exchange Commission ("SEC") presiding over enforcement of the Securities Act of 1933 and the Securities Exchange Act of 1934 (the "1934 Act").

Those statutes were designed to restore investor confidence in U.S. capital markets by providing investors with more reliable information and clear rules of honest dealing. The SEC's enforcement mandate includes the obligation to regulate securities brokers, transfer agents and clearing agencies as well as U.S. securities self-regulatory organizations ("SROs"), such as the New York and American Stock Exchanges and the National Association of Securities Dealers, which operates the NASDAQ system.

That mandate, however, does not include the responsibility to preside over the liquidation of a securities broker. The history of federal legislation governing stockbroker liquidations in the U.S. extends back to the Bankruptcy Act of 1898 and before. The modern legislative framework is contained principally in two related statutes: SIPA and subchapter III of Chapter 7 of the Bankruptcy Code.

SIPA And SIPC

Following a period of great expansion in the 1960s, the U.S. securities industry hit hard times, leading to the failure or instability of a significant number of brokerage firms. The resulting crisis in customer and investor confidence and the prospect that capital markets might fail altogether as solvent brokers were dragged down by failing brokers unable to honor trade commitments prompted Congress to enact SIPA in 1970. The law was substantially revamped in 1978 in conjunction with the enactment of the Bankruptcy Code.

A SIPA proceeding is commenced against a broker-dealer when the Securities Investor Protection Corporation ("SIPC"), a nonprofit corporation whose members include most interstate broker-dealers, files an application for a protective decree regarding one of its members in federal district court.

The court will issue a protective decree if the broker-dealer consents or fails to contest the petition, or if the court concludes that the broker-dealer:

(i) is insolvent (on a balance sheet basis) or unable to meet its obligations as

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they mature;

(ii) is the subject of a proceeding pending in any court or before any federal or state agency in which a receiver, trustee or liquidator has been appointed;

(iii) is not in compliance with the financial responsibility or securities hypothecation requirements of the 1934 Act, SEC rules or applicable SRO rules; or

(iv) is unable to prove that it is in compliance with such rules.

If the district court issues a protective decree, it appoints a trustee to oversee the broker-dealer's liquidation and refers the case to the bankruptcy court.

SIPA affords limited financial protection to the customers of registered broker-dealers.

A "customer" is any person who has a claim "on account of securities received, acquired, or held by the debtor in the ordinary course of its business as a broker or dealer from or for the securities accounts of such person for safekeeping, with a view to sale, to cover consummated sales, pursuant to purchases, as collateral security, or for purposes of effecting transfer."

The term also includes "any person who has deposited cash with the debtor for the purpose of purchasing securities."

SIPA liquidations generally involve customer claims and the claims of general unsecured creditors, such as vendors or judgment creditors. The former are satisfied out of a customer estate (a fund consisting of customer-related assets, such as securities and cash on deposit) while the latter are paid from the general estate (any remaining assets).

The value of a customer's account, or its "net equity," is the measure of its preferred SIPA customer claim. "Net equity" is the total value of cash and securities owed to the customer as of the petition date, less the total value of cash and securities owed by the customer to the debtor as of the petition date.

SIPC advances funds to the trustee as necessary to satisfy customer claims, but limited to $500,000 per customer, of which no more than $100,000 may be based on a customer claim for cash. SIPC is subrogated to customer claims paid to the extent of such advances. Those advances are repaid from funds in the general estate prior to payments on account of general unsecured claims.

As noted, the bankruptcy court presides over a SIPA case, and the case proceeds very much like a Chapter 7 liquidation, with certain exceptions.

SIPA expressly provides that to the extent consistent with its provisions, "a

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liquidation proceeding shall be conducted in accordance with, and as though it were being conducted under Chapters 1, 3, and 5 and Subchapters I and II of Chapter 7 of Title 11."

This means, for example, that the automatic stay precludes the continuation of most collection efforts against the debtor or its property (but, as described below, not the exercise of certain rights under financial or securities contracts).

Similarly, the SIPA trustee has substantially all of the duties of a bankruptcy trustee as well as a bankruptcy trustee's powers, including the "strong arm" and avoidance powers and the ability to assume and assign executory contracts. Customers and creditors are required to submit proof of their claims against the debtor.

Stockbroker Liquidation Under Chapter 7

Chapter 7 of the Bankruptcy Code incorporates provisions separate and apart from (albeit similar to) SIPA that govern stockbroker liquidations. These provisions, which are contained in Subchapter III of Chapter 7, were enacted to address the lack of uniformity in rules and procedures governing intrastate stockbrokers who are not subject to the SEC's financial responsibility rules.

Stockbroker liquidations under Chapter 7, as opposed to SIPA, are relatively rare. Once SIPC commences a SIPA proceeding against a broker-dealer, any pending Chapter 7 case with respect to the debtor is automatically stayed, and will be dismissed upon completion of the SIPA liquidation case.

One important distinction between SIPA and Chapter 7 stockbroker liquidations is that a SIPA trustee is required to distribute securities to customers to the greatest extent possible in satisfaction of their claims, while a Chapter 7 trustee is entrusted with converting securities to cash as quickly as possible (except for securities specifically registered to particular customers) and delivering the cash to creditors, including customers, in satisfaction of their claims.

Thus, SIPA presumes that customers prefer their securities, while Chapter 7 presumes that they prefer cash.

Notably, in both SIPA and Chapter 7 cases, commencement of the case does not stay any exercise of the contractual rights of a creditor to liquidate, terminate, accelerate or net out obligations under a financial or securities contract, or to foreclose on any cash collateral pledged by the debtor. Disposition of or foreclosure on securities collateral, however, may be enjoined.

Outlook

As noted, the Bankruptcy Code precludes relief to a securities broker under any chapter other than Chapter 7. Recourse to Chapter 11 is precluded

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because the complexities of Chapter 11 are incompatible with the narrow purpose for which the special stockbroker liquidation provisions in Chapter 7 were designed – the protection of customers.

Notable attempts have been mounted to circumvent that proscription, but with limited success. For example, Drexel Burnham Lambert Group Inc. filed for Chapter 11 protection in 1990, but only after selling its brokerage operations, which were ultimately liquidated.

Commodities broker Refco Inc. filed for Chapter 11 in 2005, notwithstanding a similar ban on commodity broker Chapter 11 filings, contending that it should be permitted access to Chapter 11 because its substantial brokerage activities were carried out by an offshore vehicle. The bankruptcy court ruled otherwise, and the Refco affiliate that was a registered commodities broker was liquidated in Chapter 7 while Refco's remaining operations and assets were ultimately liquidated in Chapter 11.

Thus, few options are available to stock or commodity brokers intent upon obtaining a breathing spell while they attempt to sort out financial problems brought on by the subprime disaster. More likely than not, escalating liabilities will propel many brokers toward either SIPA or Chapter 7, both of which are geared more toward protecting customers than creditors.

– By Charles M. Oellermann and Mark G. Douglas, Jones Day

Charles Oellermann is a partner in the Columbus, Ohio office and Mark Douglas is the firm's restructuring practice communications coordinator and managing editor of the Jones Day Business Restructuring Review.

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