

**BANK AND INSURANCE COMPANY
INSOLVENCY PROCEEDINGS**

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2009 New York City Bankruptcy Conference

Bank and Insurance Company Insolvency Proceedings

Section 109(b) of the Bankruptcy Code provides that a person may not be a debtor under Chapter 7 of the Bankruptcy Code if such person is a domestic insurance company, bank, savings bank, cooperative bank, savings and loan association, building and loan association, credit union or industrial bank or similar institution which is an insured bank as defined in section 3(h) of the Federal Deposit Insurance Act, except that an uninsured state member bank, or a corporation organized under section 25A of the Federal Reserve Act, which operates, or operates as, a multilateral clearing organization pursuant to section 409 of the Federal Deposit Insurance Corporation Improvement Act of 1991 may be a debtor if a petition is filed at the direction of the Board of Governors of the Federal Reserve System.¹ Under Section 109(d) of the Bankruptcy Code, only a railroad, a person that may be a debtor under Chapter 7 (except a stockbroker or a commodity broker) and an uninsured state member bank, or a corporation organized under section 25A of the Federal Reserve Act, which operates, or operates as, a multilateral clearing organization pursuant to section 409 of the Federal Deposit Insurance Corporation Improvement Act of 1991 may be a debtor under Chapter 11. Thus, all domestic insurance companies and most banks, savings and loans and similar organizations are subject to insolvency proceedings outside of Title 11 of the United States Code (the “Bankruptcy Code”).

A. Banks Insolvency Proceedings

Insolvencies for insured depository institutions are governed by the Federal Deposit Insurance Act² and are administered by the Federal Deposit Insurance Corporation (“FDIC”).

¹ In addition, a foreign insurance company, engaged in business in the United States or a foreign bank, savings bank, cooperative bank, savings and loan association, building and loan association or credit union that has a branch or agency in the United States cannot be a debtor under Chapter 7 of the Bankruptcy Code.

² 12 U.S.C. § 1821-25. To the extent that the bank or other similar lending institution is not an insured depository institution, the insolvency will be governed by applicable state law and typically occur under the auspices of the state banking commissioner, except in the rare circumstances described above where a bankruptcy filing is possible.

The insolvency process is initiated by the charter agency³ or by the institution's primary Federal regulatory agency.⁴ The FDIC will appoint itself as conservator or receiver or it can appoint a conservator or receiver for the insured depository institution if:

- a. its assets are less than its obligations to its creditors and others;
- b. there is substantial dissipation of assets or earnings due to
 - (1) any violation of any statute or regulation or
 - (2) any unsafe or unsound practice;
- c. it is in an unsafe or unsound condition to transact business;
- d. it willfully violates a cease and desist order which has become final;
- e. there is concealment of the institution's books, papers, records, or assets, or any refusal to submit the institution's books, papers, records, or affairs for inspection to any examiner or to any lawful agent of the appropriate Federal banking agency or state bank or savings association supervisor;
- f. it is likely to be unable to pay its obligations or meet its depositors' demands in the normal course of business;
- g. it has incurred or is likely to incur losses that will deplete all or substantially all of its capital and there is no reasonable prospect for the institution to become adequately capitalized without Federal assistance;
- h. there has been a violation of any law or regulation, or any unsafe or unsound practice or condition that is likely to
 - (1) cause insolvency or substantial dissipation of assets or earnings;
 - (2) weaken the institution's condition; or
 - (3) otherwise seriously prejudice the interests of the institution's depositors or the Deposit Insurance Fund;
- i. it consents to the appointment;
- j. it ceases to be an insured institution;

³ Chartering agencies are the Office of the Comptroller of the Currency ("OCC") for nationally chartered banks, the state bank regulator agencies for state chartered banks and thrift institutions and the Office of Thrift Supervision ("OTS") for Federal thrift institutions.

⁴ The primary Federal regulatory agent is the OCC for nationally chartered banks, the Federal Reserve for state chartered member banks, the FDIC for state chartered non-Federal Reserve member banks and the OTS for Federal thrifts.

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- k. it is undercapitalized and
 - (1) has no reasonable prospect of becoming adequately capitalized,
 - (2) fails to become adequately capitalized when required to do so,
 - (3) fails to submit an acceptable capital restoration plan, or
 - (4) materially fails to implement an accepted capital restoration plan;
- l. it is critically undercapitalized or otherwise has insufficient capital; or
- m. it has been found guilty of money laundering.

The FDIC, the Federal Reserve and other Federal regulatory agencies' first choice is to arrange for the sale of the troubled insured depository institution to another insured depository institution. If such a sale were to occur, the troubled insured depository institution will often be taken over by the FDIC on a Friday night, sold and reopen on Monday under the new owner. This avoids any claims by depositors and is generally beneficial to all of the institution's creditors. If no single insured depository institution is interested in acquiring the whole business of the troubled insured depository institution (even with the Federal Reserve or the FDIC agreeing to fund potential losses on specific loans or investments), the troubled insured depository institution may be sold in pieces or a portion may be sold through the use of a good bank/bad bank structure which was used in the early to mid 1990s.

If the insured depository institution is not sold to another insured depository institution, the charter is revoked. Typically, the senior managers are ousted and the shareholders no longer have control. There is also the ability for the FDIC to transfer certain assets and liabilities to a bridge bank, generally to effectuate the good bank/ bank structure. There is a stay, but only for a maximum of 60 days, for any litigation and there is no stay as to any setoff rights or other contractual rights or rights to enforce against collateral. However, the FDIC as receiver does have broad powers to disaffirm or repudiate contracts. Counterparties to disaffirmed or repudiated contracts have general unsecured claims for damages (absent having recourse to any

collateral). The FDIC or the person appointed by the FDIC unilaterally makes all decisions as receiver or conservator without any oversight by any Court. There is also no mechanism for creditors or shareholders to participate in the insolvency process, unlike under the Bankruptcy Code, other than to file claims. Moreover, the disallowance of claims is not subject to any judicial review.

There is a priority scheme applicable to an insured depository institution's insolvency. After first deducting the payment of the costs of the liquidation, receivership or conservatorship, holders of insured domestic deposits are paid in full by the FDIC up to the insurance limit.⁵ The FDIC then steps into their shoes. Holders of uninsured domestic deposits⁶ then share equally with the FDIC in any recoveries. Any excess recoveries are next distributed to holders of foreign deposits and general creditors and thereafter, to the shareholders.

To the extent that there is a bank holding company which owns the troubled insured depository institution, the FDIC may seek to recover funds from the bank holding company based on the "source of strength doctrine" whereby the Federal Reserve has asserted that a bank holding company has an obligation to support its subsidiary banks, even if they are insolvent. The validity of the doctrine has not been clearly resolved by the Courts.

When a bank or other insured depository institution is taken over by the FDIC, the holding company generally files for protection under the Bankruptcy Code. There are often disputes between the holding company and its creditors and the purchaser of the insured depository institution and/or the FDIC, as applicable, over what constitutes the assets and liabilities of the holding company versus the assets and liabilities of the insured depository

⁵ Domestic deposits refers to deposits held in domestic branches. Foreign deposits are deposits held at foreign branches.

⁶ This would typically be the portion of domestic deposits in excess of the insurance limit.

institution, intercompany claims and transfers which occurred between the holding company and the insured depository institution prior to the FDIC's takeover or to a sale, as applicable.

B. Insurance Company Insolvencies.

As described above, an insolvent insurance company cannot file for bankruptcy, although a holding company which owns an insurance company can file for bankruptcy. Thus, insurance company insolvency is a process conducted under applicable state law. The laws differ from state to state.⁷ For purposes of this analysis, we have primarily focused on New York law.

Under New York law, insolvency proceedings for insurance companies licensed to do business in New York are handled by the Superintendent of Insurance (the "Superintendent") and the New York Liquidation Bureau ("NYLB") which is a part of the Department of Insurance. The license of an insurance company may be revoked by the Superintendent for various reasons, including insolvency, impairment of required capital, insufficient surplus or the use of the practices that render its operation detrimental or its condition unsound with respect to the public or its policyholders.

The Superintendent can apply to the State Court for an order of liquidation for an insurance company, whether foreign or domestic, for various reasons, including, but not limited to, if the insurer is insolvent, has not submitted to examination by the Superintendent or has failed to make good on impairment of its capital or minimum surplus to policy holders.⁸ In a liquidation, the Superintendent or the NYLB takes possession of the property of the insurer,

⁷ For example, under some states, the insurance department can put a troubled insurance company under an order of supervision. Such an order subjects the troubled insurance company to more frequent reporting and examination and generally includes restrictions on taking certain actions, absent obtaining the consent of the insurance commissioner.

⁸ New York is one of the states which has adopted the Uniform Insurers Liquidation Act, NY CLS Ins. § 7408 - 7415 (2008). The majority of states have not adopted this legislation.

liquidates its business and distributes the proceeds of the liquidation in accordance with the priorities described below.

Alternatively, the Superintendent can apply to the State Court for an order directing him to rehabilitate a domestic insurer.⁹ The NYLB will be appointed by the State Court to act as the rehabilitator. The Court must determine that the rehabilitator's plan has a substantial likelihood of succeeding and returning the insurer to regulatory compliance within a two year period before it may issue an order of rehabilitation. As the rehabilitator, the NYLB will take possession of the property of the insurer and conduct its business. The NYLB may request advances from the property/casualty insurance fund or other applicable guaranty funds.¹⁰

The Superintendent may seek an injunction from the State Court to assist it in connection with a liquidation or rehabilitation but there is no automatic stay. Normally, creditors and policyholders have four months from the entry of a liquidation or rehabilitation order to file proofs of claim, unless the Superintendent requests a longer period and the State Court enters an order approving such longer deadline.

The priority of distribution on account of claims filed in a liquidation or rehabilitation is:

- (i) Class one. The costs of administration incurred by the liquidator or the rehabilitator;
- (ii) Class two. All claims under policies including the claims of the Federal or any State or local government for losses incurred, third party claims, claims for unearned premiums, and all claims of a security fund or guaranty association or the equivalent, except for claims under reinsurance contracts;

⁹ NY CLS Ins. § 7402.

¹⁰ The property/casualty insurance fund is maintained by the State of New York to pay coverage to insureds under property and casualty insurance policies if the insurer becomes insolvent. To the extent that the property/casualty insurance fund pays coverage to insureds on behalf of an insolvent insurer, it has a claim against the insolvent insurer. There is a payment limit of \$1,000,000 per claim. Life insurance and health insurance policyholders and holders of annuity contracts, in each case issued by a life insurance company, have recourse to a fund run by Life Insurance Company Guaranty Corporation ("LICGC"). LICGC is funded by assessments from its members. There is a recovery limit of \$500,000.

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- (iii) Class three. Claims of the Federal government not included in class two;
- (iv) Class four. Claims for wages owed to employees for services rendered in the year prior to commencement of the proceeding, not exceeding \$1,200 per employee, and claims for unemployment insurance contributions;
- (v) Class five. Claims of state and local governments not included in class two;
- (vi) Class six. Claims of general creditors including, but not limited to, claims arising under reinsurance contracts;
- (vii) Class seven. Claims filed late or any other claims other than claims under class eight or nine;
- (viii) Class eight. Claims for advanced or borrowed funds made pursuant to section 1307 of this chapter; and
- (ix) Class nine. Claims of shareholders or other owners in their capacity as shareholders.

Paul Hastings

Liquidations Under the Securities Investor Protection Act

Presentation for 2009 ABI-NYC Conference:
Alternative Liquidation Regimes under Banking,
Securities, Insurance and State Law

May 4, 2009

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A. Background – SIPA and SIPC PaulHastings

- ▶ **Securities Investor Protection Act (SIPA)**¹: In the late 1960s, a wave of broker-dealer failures caused a crisis of confidence among customers and investors, with both groups fearing that broker-dealers were unable to protect their investments or honor trade commitments. SIPA was enacted to protect customers from the risks associated with the failure of registered broker-dealers, and to boost investor confidence in the financial system.²
- ▶ **Securities Investor Protection Corporation (SIPC)**: To carry out its objectives, SIPA created SIPC, a non-profit private membership corporation whose members are all broker-dealers registered under the Securities Exchange Act of 1934.³ SIPC has a seven person Board of Directors, of which one Director is appointed by the Secretary of the Treasury, one Director is appointed by the Federal Reserve Board from amongst its own officers and employees, and five Directors are appointed by the President. SIPC functions as a party to liquidation proceedings of failed broker-dealers, and also establishes and administers a fund for the benefit of injured customers.⁴

¹15 U.S.C. §§ 78aaa-III (2007).

² See Harbeck, Stephen P., "The Securities Investor Protection Act," 12 PLI/Corp 457, 461 (2001).

³ See 15 U.S.C. § 78ccc (2)(A).

⁴ See 15 U.S.C. § 78ddd.

A. Background – Protected

Investors

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- ▶ **Customers:** SIPA sets out to protect all customers of failed broker-dealers, and defines the term “customer” to include any person who has a claim arising out of sales or conversions “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.”⁵ Therefore, persons who have deposited cash into an account with a broker-dealer for the purpose of purchasing securities are considered customers, while persons who have deposited cash for the purpose of earning interest are not covered by SIPA. It is important to note that dividends or proceeds from the sale of securities are also covered by SIPA.⁶

⁵15 U.S.C. § 78III(2).

⁶See Bloomenthal, Harold S. and Wolff, Samuel, “Securities Investor Protection Act,” Sec. & Fed. Corp. Law § 23:105 (2008).

B. Purposes of the SIPA Liquidation Proceeding

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- 1) To deliver customer name securities to or on behalf of customers;
- 2) To distribute customer property and otherwise satisfy net equity claims of customers;
- 3) To sell or transfer offices and other productive units of the debtor's business;
- 4) To enforce the rights of subrogation; and
- 5) To liquidate the business as promptly as possible.⁷

⁷15 U.S.C. § 78fff(a).

C. Summary of the SIPA Liquidation Process

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- 1) Determination of Broker-Dealer Failure: Since it is not a regulator, SIPC relies on the Securities Exchange Commission (“SEC”) or any Self-Regulatory Organizations (“SRO”) for warnings that a broker-dealer is approaching a point of failure. Based on such information, SIPC may commence a proceeding if:
 - i) The broker-dealer has failed or is in danger of failing to meet its obligations to customers, and the broker-dealer is insolvent within the meaning of Section 101(32) of the Bankruptcy Code or is unable to meet its obligations as they mature;
 - ii) The broker-dealer is the subject of any proceeding pending in any court or before any agency in which a receiver, trustee or liquidator for the broker-dealer has been appointed, or;
 - iii) The broker-dealer is not in compliance with, or cannot demonstrate compliance with the SEC’s regulations regarding financial responsibility or hypothecation of customer securities.⁸

⁸See 15 U.S.C. § 78eee(a)(3).

C. Summary of the SIPA Liquidation Process

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- 2) Case assessment: Before commencing a formal liquidation procedure, SIPC assesses the case to determine if liquidation is necessary and if the direct payment procedure is preferable to a formal liquidation proceeding. Direct payment is an expeditious and cost-efficient method for liquidation, and is permitted if:
- i) All claims are within SIPA limits;
 - ii) The aggregate of all claims is less than \$250,000;
 - iii) The direct payment process is more cost efficient than formal liquidation; and
 - iv) The failed broker-dealer has either consented to the direct payment or has had its registration terminated.⁹

⁹ See 15 U.S.C. § 78fff-4(a).

C. Summary of the SIPA Liquidation Process

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- 2) Case Assessment (cont'd):
- (a) Direct Payment Procedure:
- i) If SIPC determines that direct payment is warranted, notice is given by publication and mail to all persons who appear to have been customers of the broker-dealer within the last 12 months, and the customers' claims must then be received within 6 months of the notice. SIPC then directly satisfies all customers' claims by "delivery of securities or the effecting of payments to such customer(s)."¹⁰
 - ii) If SIPC determines that the amounts of the claims in question are too great for the direct payment procedure, it can revoke the use of direct payment with court approval. In such a circumstance, any claims that have already been paid at the time of commencement are given full effect in the formal liquidation proceeding.¹¹

¹⁰ 15 U.S.C. § 78fff-4(c).

¹¹ See 15 U.S.C. § 78fff-4(f).

C. Summary of the SIPA Liquidation Process

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- 3) Commencement: A SIPA proceeding is commenced when SIPC files an application for a customer protective decree in federal district court, an action which brings an automatic stay to all other bankruptcy cases that have been commenced, thus keeping the failed broker-dealer intact to ensure an equitable distribution of that debtor's property.¹² The court will issue this decree if:
- i) The debtor consents;
 - ii) The debtor fails to contest the application; or
 - iii) The court finds that any of the factors signaling a failure of the broker-dealer exist (see above section B(1) of this outline for list of these factors.)¹³

¹² See Don, Michael E. and Wang, Josephine, "Stockbroker Liquidations Under the Securities Investor Protection Act and Their Impact on Securities Transfers," 12 *Cardozo L. Rev.* 509, 518 (1990).

¹³ See 15 U.S.C. § 78eeee(b)(1).

C. Summary of the SIPA Liquidation Process

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- 4) Appointment of Trustee: If the order is approved, the court will appoint a disinterested trustee (such disinterestedness must be confirmed at a hearing) and attorney, as specified by SIPC. If the total liabilities appear to be more than \$750,000, and there appear to be more than 500 customers, the trustee may not be an employee of SIPC.¹⁴ After this appointment, the entire liquidation proceeding is removed to the district's bankruptcy court. The trustee is an independent fiduciary working in consultation with SIPC, and performs many roles.

¹⁴ See 15 U.S.C. § 78eee(b)(3).

C. Summary of the SIPA Liquidation Process

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- 4) Appointment of Trustee (Cont'd):
- a) Roles and Duties of a Trustee :
- i) Administration: The appointed trustee must notify customers by publication in a general circulation newspaper, or by mailed notice to each person who was a customer of the broker-dealer within 12 months of the filing date.¹⁵ The trustee also must take possession and control of debtor's property, manage the employees of the debtor, hire any additional necessary personnel (e.g. accountants), and margin and maintain the debtor's customer accounts.¹⁶
- ii) Investigation/Monitoring: The trustee must investigate the operations and financial condition of the broker-dealer, a process which may include depositing the directors and officers of the broker-dealer. The trustee is required to submit reports on these investigations to SIPC and any other party that the court specifies.¹⁷

¹⁵ See 15 U.S.C. § 78fff-2(a)(3).

¹⁶ See 15 U.S.C. § 78fff-1(a).

¹⁷ See 15 U.S.C. § 78fff-1(d)(4).

C. Summary of the SIPA Liquidation

Process

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- 4) Appointment of Trustee:
 - a) Roles and Duties of a Trustee (Cont'd):
 - iii) Settlement of Secured Debt: The trustee must determine whether it is necessary to pay off secured creditors in order to gain access to the securities which collateralize the debt. Upon its approval of such determination, SIPC will advance the necessary funds to the trustee for this purpose.¹⁸
 - iv) Satisfaction of Claims: The trustee is responsible for satisfying customers' claims, either through a sale of some or all of the broker-dealer's accounts to a healthy firm, or through a liquidation and distribution of the failed broker-dealer's accounts.¹⁹ Throughout this distribution process, the trustee must submit written reports to the court and SIPC updating the progress of the liquidation proceeding.²⁰

¹⁸ See 15 U.S.C. § 78fff-1 (b)(2).

¹⁹ See 15 U.S.C. § 78fff-1 (b)(1).

²⁰ See 15 U.S.C. § 78fff-1 (c).

C. Summary of the SIPA Liquidation Process

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- 5) **Customer Claims:** Customers are required to file a written statement of their claim with the trustee within 6 months of the notice. Customer claims seek the return of “customer name securities” and a share of the general “customer property.”
- i) **Customer Name Securities:** Customer name securities are those which were held for the account, and in the name, of a customer on the filing date by or on behalf of the debtor in non-negotiable form.²¹ Customers are entitled to a full return of these securities to the maximum extent practicable.²²
- ii) **Customer Property:** Customer property is the total amount of cash and securities, excluding all customer name securities, which is held by the debtor at the time of filing.²³ Customers are entitled to a pro rata share of this property based on their respective “net equity,” which is calculated as the net of the filing date value of a customer’s non-customer name securities plus any cash balance owed to the customer, corrected for any indebtedness of the customer to the debtor.²⁴

²¹ See 15 U.S.C. § 7811(3).

²² See 15 U.S.C. § 7811-1(b)(1).

²³ See 15 U.S.C. § 7811(4).

²⁴ See 15 U.S.C. § 7811(11).

C. Summary of the SIPA Liquidation Process

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6) Satisfaction of Claims: A key distinction between SIPA and the Bankruptcy Code is that the trustee under SIPA is tasked with distributing securities back to the customers rather than liquidating directly to cash.²⁵ Such satisfaction can be accomplished in two ways:

- i) Sale/Transfer of Accounts: The SIPC trustee can often simplify the liquidation process by finding a solvent firm to buy some or all of the failed broker-dealer's accounts. In such cases, the customers whose accounts are transferred will have immediate access to their securities and cash, and will thus have been made whole. SIPC must approve such a sale, and also may provide funds to secure any indemnification that is necessary to complete the transaction.²⁶

²⁵ See 15 U.S.C. § 78fff(a)(1).

²⁶ See 15 U.S.C. § 78fff-2(f).

C. Summary of the SIPA Liquidation Process

Paul Hastings

6) Satisfaction of Claims (Cont'd):

ii) Distribution of Cash and Securities: The trustee first returns all customer name securities back to the individual customers. In the case of a large broker-dealer, there are generally very few customer name securities, so the bulk of the distributed securities comes from the pooled customer property. From this pool, the trustee then ratably disburses the remainder of the customer property to the customers according to their net equity in the property. To the extent necessary, SIPC can, with court approval, advance the trustee funds to either buy and distribute securities or pay out cash in order to make the customers whole. Such advances are capped at \$500,000 per customer, of which only \$100,000 may be distributed as cash.²⁷ With regard to SIPC's recoupment of these advances, cash payments made by SIPC to the customers are given priority in recovering from customer property and the general estate over advances used to purchase securities.²⁸

Note: If customers' accounts exceed the SIPA limits, and there are insufficient funds in the brokerage to cover those accounts, the full distribution of SIPA funds to customers can take months or years to achieve.

²⁷ See 15 U.S.C. § 78fff-3(a).

²⁸ See 15 U.S.C. § 78fff-2(c).

C. Summary of the SIPA Liquidation Process

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- 7) Unsatisfied Claims and Administrative Expenses:
- i) Customers: Any customers whose claims still remain partially unsatisfied may recoup from the general estate along with the other unsecured creditors.²⁹
 - ii) Fees and Expenses of the Trustee: Costs and expenses associated with the administration of the estate, including funds advanced by SIPC to the trustee for the purposes of hiring additional personnel, are recouped from the general estate of the debtor to the extent that the estate has sufficient funds.³⁰

²⁹ See 15 U.S.C. § 78fff-2(c).

³⁰ See 15 U.S.C. § 78fff(e).

D. SIPA and the Bankruptcy Code

Paul Hastings

- ▶ Generally, SIPA liquidations are conducted in accordance with the Code, and the SIPA language itself notes that a liquidation proceeding under SIPA is to 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” to the extent that those chapters are “consistent” with SIPA.³¹ However, liquidations of broker-dealers specifically proceed according to subchapter III of Chapter 7³², and there are several key ways in which SIPA proceedings differ from liquidations under that subchapter.

³¹ See 15 U.S.C. § 78fff(b).

³² See 11 U.S.C. §§ 741-752.

D. SIPA and the Bankruptcy Code

Paul Hastings

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- a) Differences between SIPA and Subchapter III of Chapter 7 of the Bankruptcy Code:
- i) SIPA's liquidation provisions extend only to broker-dealers who are registered SIPC members.³³ As discussed above, even if such firms are already engaged in a liquidation under subchapter III, SIPC may step in and file for a protective decree if it determines that the protected class of customers can be better served by a liquidation under SIPA, and this filing will bring a stay to all actions under the Bankruptcy Code.³⁴ Examples of firms that are not eligible for SIPC membership are firms with their principal place of business outside of the United States or broker-dealers whose business consists solely of distributing shares in mutual funds/annuities, the sale of insurance, or rendering investment advisory advice.³⁵ Since such businesses are covered by the Code, the only option for their liquidation is to proceed under subchapter III of Chapter 7.

³³ See 15 U.S.C. § 78ccc(a)(2).

³⁴ See 15 U.S.C. § 78eee(3).

³⁵ See 15 U.S.C. § 78ccc(a)(2).

D. SIPA and the Bankruptcy Code

Paul Hastings

- a) Differences between SIPA and Subchapter III of Chapter 7 of the Bankruptcy Code (Cont'd):
- ii) Objective: Whereas the SIPC trustee seeks to restore securities to customers' accounts, subchapter III specifically mandates that the trustee in bankruptcy shall reduce all non-customer name securities to money "as soon as practicable."³⁶ As such, the form of recovery for customers of a firm being liquidated under subchapter III is limited to cash.

³⁶ 11 U.S.C. § 748.

D. SIPA and the Bankruptcy Code

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a) Differences between SIPA and Subchapter III of Chapter 7 of the Bankruptcy Code (Cont'd):

iii) Advances: As a result of the fund it maintains, SIPC is able to advance monies to customers in order to more quickly satisfy claims rather than making customers endure a lengthy bankruptcy liquidation proceeding before they can gain access to their money. Additionally, SIPC is able to advance the trustee such monies that are necessary to cover any long positions that need to be accounted for in a sale or transfer of accounts to a healthy broker.³⁷ Thus, the SIPC fund facilitates a quick return of securities and repayment of cash to investors which cannot be accomplished in a Chapter 7 liquidation. Therefore, those investors who qualify for customer status under SIPA would likely prefer that their failed broker-dealer be liquidated according to SIPA rather than under subchapter III of Chapter 7 of the Bankruptcy Code.

³⁷ 15 U.S.C. § 78fff(3).

E. Conclusion

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Overall, the guidelines for a liquidation proceeding under SIPA help ensure that customers receive securities in satisfaction of their claims to the maximum extent possible. Additionally, SIPA prioritizes the claims of customers above claims by the broker-dealer's general creditors. These customer safeguards are borne out of the widespread crisis of confidence among investors that initially necessitated the enactment of SIPA, and SIPA's liquidation procedures aim to encourage investing and trading by reassuring potential investors that their broker-dealer accounts will be protected by a disinterested and experienced organization.

SEC Receiverships

By: Arthur Steinberg and David Pauker¹

The Receiver's Appointment

Generally, when a corporation (and/or its principals) are alleged to have committed an ongoing violation of one of the federal securities statutes, the Securities and Exchange Commission (SEC) may request,² at the inception of its case, that the district court freeze the corporation's assets and appoint a receiver to assume control thereof. Federal Rule of Civil Procedure 66, federal common law as well as certain securities statutes authorize a court to appoint a receiver in such circumstance. The appointment of a receiver has been characterized as "an extraordinary remedy, available only upon a clear showing that a receivership is essential to protect the property from some threatened loss or injury pending a final disposition by the court."³

Courts have examined the following factors to determine whether the appointment of a receiver is warranted: "[i] the existence of a valid claim by the party seeking the appointment; [(ii)] the imminent nature of any danger to the property, to its concealment or removal, or its value; [(iii)] the adequacy of other legal remedies; [(iv)] the lack of a less drastic equitable remedy; [(v)] the plaintiff's probable success in the lawsuit and the risk of irreparable injury to the property; [(vi)] whether the defendant has engaged, or may engage, in any fraudulent actions

¹ Arthur J. Steinberg is a partner in the New York office of King & Spalding. David Pauker is a Managing Director with Goldin Associates, LLC. Monika Roth and Heath Rosenblat are associates with King & Spalding that assisted with the preparation of the article.

² While this article focuses on receiverships arising out of an SEC enforcement action, receivers are also appointed in other circumstances, such as, an enforcement action brought by the Commodity Futures Trading Commission to prevent an ongoing violation of federal statutes relating to the regulation of the commodity futures and option markets.

³ STEVEN BAICKER-MCKEE ET AL., FEDERAL CIVIL RULES HANDBOOK 1233 (2009 ed. 2008).

with respect to the property; [(vii)] the likelihood that appointing the receiver will do more good than harm; and [(viii)] whether the potential harm to the plaintiff outweighs the injury to others.⁴

Prior to commencing its case, the staff of the SEC will try and identify at least three receivership candidates to present to the Court for consideration, and the Court will thereafter make its selection. Oftentimes, but not always, the Court will make its selection from the list presented by the SEC. The SEC staff usually asks each receiver candidate to set forth in a letter, among other things, (a) its qualifications including relevant background experience, (b) that the candidate has no conflicts with respect to the matter, and (c) the proposed fee arrangement for the assignment. The staff of the SEC expects that the receiver candidate will agree to a fee arrangement that reflects the “public interest” aspect of the assignment. That letter is presented to the Court for its consideration in selecting the receiver.

In the Court order that appoints the receiver, the Court will set forth the purpose and powers of the receiver. For example, in the action brought by the SEC against Bernard L. Madoff and Bernard L. Madoff Investment Securities LLC (BMIS) alleging securities fraud for a multi-billion dollar Ponzi scheme, the receiver’s duties were defined to include all actions necessary to “(i) preserve the *status quo*; (ii) ascertain the extent of commingling of funds between Madoff and BMIS; (iii) ascertain the true financial condition of BMIS and the dispositions of investor funds; (iv) prevent further dissipation of the property and assets of BMIS; (v) prevent the encumbrance of property or assets of BMIS and the investors; (vi) preserve the books, records and documents of BMIS; (vii) respond to investor inquiries; (viii) protect the assets of BMIS from further dissipation; (ix) determine whether BMIS should undertake a bankruptcy filing; and (x) determine the extent to which the freeze should be lifted

⁴ *Id.* at 1233-34

as to certain assets in the custody of BMIS.”⁵ In order to effectuate the forgoing actions, the Court granted the receiver the power to take immediate possession and control of all of the assets and property of BMIS and other Madoff-related entities, have exclusive control of bank, brokerage firm and financial institution accounts, conduct business as required to preserve or maximize the value of the assets and property, locate assets conveyed to third parties or otherwise concealed and engage and employ persons, including accountants, attorneys and experts, to assist in the carrying out of the receiver’s duties.⁶

Accounting of Assets

The court order appointing the receiver generally will request that the receiver file a report within a specified time period (usually 60-90 days, if feasible) which identifies the company’s assets and liabilities. Depending on the case, the report may also include information as to (a) the location of the assets, (b) the state of the company’s books and records, (c) the status of any customer accounts managed by the company, and (d) any redemptions or other forms of “out of the ordinary” third party distributions made by the company.⁷ The court order usually will grant the receiver certain powers to expeditiously gather such information including the ability to serve subpoenas to seek document production and deposition testimony from third parties on shortened notice. This form of investigatory relief is similar to that granted to a bankruptcy trustee under Bankruptcy Rule 2004.

In some circumstances, the ability for the receiver to prepare the Court mandated report is impacted by an ongoing criminal investigation of the Company or its principals. Sometimes,

⁵ *SEC v. Madoff et al.*, 08 Civ. 10791 (LLS) (S.D.N.Y.). A copy of the Madoff Appointment Order is attached hereto as Exhibit A.

⁶ *Id.*

⁷ A copy of a Receiver report (with Exhibits A-H) filed in *SEC v. Shiv et al.*, is annexed hereto as Exhibit B. Arthur J. Steinberg, one of the authors of this article, was the receiver in this case.

documents have been seized by the federal authorities and it takes time for the receiver to retrieve them. In other situations, the U.S. Attorney's office is sensitive to certain information relating to the bad acts of the company being prematurely revealed before it has had an opportunity to complete investigation as to whether to formally charge the alleged perpetrators of the fraud. The receiver trying to complete his assignment for the Court needs to be sensitive to these competing government concerns, and timely raise those concerns to the Court for further clarification and refinement as appropriate.

The Differences Between A Receivership and a Bankruptcy Proceeding for the Company

A receivership case is generally conducted by the district court in accordance with the powers granted to the receiver under the appointment order. The creditors and investors are considered parties in interest but they generally don't have a formal seat at the table (as they do in a bankruptcy case). Unlike a bankruptcy case, there is no specific statute like the Bankruptcy Code that delineates the procedures to follow in various circumstances. That being said, in certain instances, bankruptcy procedures can be imported; for example, the receiver may move for a claim bar date order that is framed similar to what is done in a chapter 11 bankruptcy case. This type of order assists the receiver with ascertaining the creditor/investor pool and facilitating the development and administration of a distribution plan.

Typically, the order appointing a receiver will have an "injunction" provision preventing the company or receiver from being sued without further order of the court. This type of relief is the functional equivalent of the "automatic stay" provided for under section 362 of the Bankruptcy Code.

There are certain rights granted under the Bankruptcy Code to enhance creditor recoveries, such as the ability to recover a preference (unsecured transfer of the debtor's property made within 90 days of the bankruptcy petition) that are not available in a receivership case.

The law is a bit murky as to whether a receiver (as the representative of the company) can pursue fraudulent transfers under state law (which is a creditor remedy).⁸ And, the fraudulent transfer claim is one of the basis to recover third party transfers such as redemptions made while the company was insolvent.

Most receivership cases (as contrasted to bankruptcy cases) do not have creditors/investor committees compensated by the receivership estate, or specific periodic statutory reporting requirements and therefore, the cost of administration in a receivership is generally lower than in a bankruptcy case.

Also there is no equivalent analogue to Section 510(b) of the Bankruptcy Code in a receivership case; section 510(b) subordinates equity security fraud claims to the claims of unsecured creditors. As a consequence, investors who were defrauded in a receivership case may assert that they should be treated ratably with other creditors.

As a general matter, the imputation/*in pari delicto* doctrines will negatively impact a receiver's ability to sue third parties for aiding and abetting the company's fraud in the same way as it negatively impacts a trustee in bankruptcy. One New York State Court relying on a Ninth Circuit decision has tried to make a distinction between a trustee in bankruptcy and a receiver to assist a receiver in suing a third party for aiding and abetting the company's fraud, but that clearly is the minority view.⁹

⁸ See *Eberhard v. Marcu*, 530 F.3d 122, 133-34 (2d Cir. 2008).

⁹ See *Morgado Family Partners, LP v. Lipper*, 19 A.D.3d 262 (Supreme Court, Appellate Division, First Department, New York, 2005).

Distribution Plan

The order appointing the receiver generally will specify whether the receiver has the specific responsibility of developing the proposed plan of distribution. Generally, the receiver will work with the staff of the SEC in presenting the proposed distribution plan to the Court. Unlike a bankruptcy case, there is no disclosure statement describing the plan, or formal voting on the plan. In a receivership, the receiver's prior reports to the Court describe the Company's financial position and past problems, and the motion to the Court describes the plan and the underlying basis for the proposal made. Much of this information is similar to that contained in a bankruptcy disclosure statement. Creditors/investors receive notice of the plan being filed and usually have the right to comment/object to provisions of the plan. The perpetrator of the fraud and his/her family members generally are excluded from plan distributions, and frequently, the distribution plan will seek a pro rata distribution among creditor/investors. *Pro rata* distributions are utilized when the victims are "similarly situated with respect to their relationship to the defrauders."¹⁰ Furthermore, the "use of a *pro rata* distribution has been deemed especially appropriate for fraud victims of a "Ponzi scheme," in which earlier investors' returns are generated by the influx of fresh capital from unwitting newcomers rather than through legitimate investment activity[.]"¹¹ In these scenarios, "whether at any given moment a particular customer's assets are traceable is a result of the merely fortuitous fact that the defrauders spent

¹⁰ *SEC v. Credit Bancorp, Ltd.*, 290 F.3d 80 (2d Cir. 2002).

¹¹ *Id.*

the money of the other victims first.”¹² Constructive trust or creditor tracing claims are generally not favored to permit one creditor of a fraud to receive an enhanced distribution over another.

Assuming a *pro rata* distribution is appropriate, there is further issue as to whether the measuring stick should be based on the unpaid principal of the amounts originally invested or the capital account balance at the time of the receivership, which will reflect gains or losses. The proper guide post usually will be dependent on whether the gains and losses in the capital account were materially affected by the federal law violation of the company, as contrasted to typical market forces at work.

The procedural framework for administering the distribution is also included in the distribution plan. For example, the distribution plan will usually have provisions dealing with (a) how claims are allowed, (b) when distributions will be made, and (c) what happens with checks not cashed within a certain timeframe. The distribution plan will also provide for the accounting that will need to be filed with the Court, the dissolution of the corporate entities, the preservation (or lack thereof) of corporate records, the filing of tax returns, and the discharge of the receiver.¹³

Conclusion

In part, due to the pervasive nature of the fraud involved, SEC receiverships are generally liquidations for the benefit of the victims (creditors/investors). However, the receivership cases do not have the statutory framework of the Bankruptcy Code. Sometimes differences between the two regimes, makes a difference.

¹² *Id.* (quoting *SEC v. Credit Bancorp, Ltd.*, No. 99 CIV. 11395-RWS), see also, e.g., *CFTC v. Eustace*, 2008 WL 471574 (E.D. Pa. February 19, 2008); *SEC v. Merrill Scott & Associates, Ltd.*, 2007 WL 26981 (D. Utah Jan. 3, 2007); *Durham*, 86 F.3d 70.

¹³ A copy of the distribution plan approved in the Wood River case is annexed hereto as Exhibit C. Arthur Steinberg, one of the authors of this article was the receiver in this case. David Pauker, another one of the authors, was financial advisor to the receiver in this case.

