

## Litigation Alert

### Bankruptcy Court Rules That "Soft Dollar" Claims Are Not Protected By SIPA

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In *In re Lehman Brothers, Inc.*, the bankruptcy court for the Southern District of New York recently ruled — as a matter of first impression nationwide — that bankruptcy claims based upon commission credits held in soft dollar accounts (“Soft Dollar Claims”) do not qualify for treatment as customer claims for purposes of the Securities Investor Protection Act of 1970, 15 U.S.C. §78aaa et seq. (“SIPA”).<sup>1</sup> Consequently, Soft Dollar Claims will no longer qualify for the enhanced protection afforded to customer claims by SIPA: guaranteed and prioritized payment. Rather, customers with Soft Dollar Claims instead will be deemed to hold general unsecured claims for breach of contract due to the debtor’s failure to apply the credits as promised. This less favorable treatment of Soft Dollar Claims likely will result in a devaluation of the underlying debt. Accordingly, Institutional investors should be wary overvaluing Soft Dollar Claims in the future.

#### Overview of Soft Dollar Credits and Arrangements

Although not specifically defined in any rule or statute, the term “soft dollars” generally refers to credits paid in connection with “an agreement or understanding by which a discretionary money manager receives research or other services from a broker-dealer in addition to transaction execution, and does so in exchange for the brokerage commissions from transactions for discretionary clients’ accounts.”<sup>2</sup> These credits have become a means for dealing with a unique problem faced by money managers: accounting for the difference between the commission rate actually paid to a broker-dealer for executing a trade and the rate otherwise payable for best execution of that trade. That spread is accumulated and held as a credit, for the benefit of the money manager, that is available only for purposes of paying for brokerage and research services.

In 1975, the Securities and Exchange Commission (“SEC”) ended fixed brokerage commissions and implemented the present system of negotiated rates.<sup>3</sup> The advent of competitive rates, however, caused money managers concern about the risk of exposure to claims for breach of fiduciary duty in the event that commissions charged to a client’s account were greater than the lowest commission available for a particular transaction.<sup>4</sup> To address this concern, Congress enacted Section 28(e) (the “Soft Dollar Safe Harbor”) in the Securities Acts Amendments of 1975.<sup>5</sup> The Soft Dollar Safe Harbor protects the money manager by providing that it is not a breach of fiduciary duty to have paid a higher

<sup>1</sup> See *In re Lehman Brothers Inc.*, No. 08-01420, slip op. (Bankr. S.D.N.Y. Jul. 10, 2012) [hereinafter Opinion].

<sup>2</sup> Thomas P. Lemke & Gerald T. Lins, *Soft Dollars & Other Trading Activities* § 1:1 (West 2011–12).

<sup>3</sup> See SEC Office of Compliance, Inspections and Examinations, Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisors, & Mutual Funds § II(C) (September 22, 1998), available at <http://sec.gov/news/studies/softdolr.htm> [hereinafter Inspection Report].

<sup>4</sup> See Use of Commission Payments by Fiduciaries, Exchange Act Release No. 34,12251, 41 Fed. Reg. 13678, 13679 (March 24, 1976).

<sup>5</sup> See Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934, Exchange Act Release No. 34,54165, 71 Fed. Reg. 41978, 41980 (July 18, 2006).



commission than another broker-dealer would have charged provided that the money manager determines in good faith that the commission paid is “reasonable in relation to the value of the brokerage and research services provided by such broker-dealer.”<sup>6</sup>

In order for a money manager to be protected by the Soft Dollar Safe Harbor, however, soft dollar commission credits for brokerage and research services may only be used in the manner described in Section 28(c).<sup>7</sup> The SEC has made this point emphatically, by noting that the use of soft dollar commission credits in a manner inconsistent with the Soft Dollar Safe Harbor “may constitute a breach of fiduciary duty as well as a violation of specific provisions of the federal securities laws . . . .”<sup>8</sup>

## The *In re Lehman Brothers, Inc.* Decision

In *In re Lehman Brothers, Inc.*, a contingent of money managers (the “Soft Dollar Claimants”) asserted customer claims against the debtor based upon soft dollar credit balances held in their accounts as of the SIPA liquidation filing date.<sup>9</sup> The SIPA trustee (the “Trustee”) determined that soft dollar credits are not customer property pursuant to SIPA, denied customer treatment for these Soft Dollar Claims, and classified them as general unsecured claims.<sup>10</sup> The Soft Dollar Claimants objected to the Trustee’s determination.<sup>11</sup> The court, however, agreed with the Trustee’s determination, and held that Soft Dollar Claims are general unsecured claims which do not receive protection as customer claims for purposes of SIPA.<sup>12</sup>

In making this determination, the court concluded that the Soft Dollar Claims did not qualify as customer claims because the Soft Dollar Claimants did not “fit within the narrow definition of a ‘customer’ with respect to . . . the soft dollar credits held in their [] accounts.”<sup>13</sup> In order to qualify as a “customer,” the court explained, “cash must have been deposited with the broker-dealer for the purpose of purchasing securities,”<sup>14</sup> yet “nothing in the [Soft Dollar Safe Harbor] permits the soft dollar commission credits to be used to purchase securities, and none of the services set forth in Section 28(e) fall within SIPA’s definition of a security.”<sup>15</sup> To the contrary, the court observed that the soft dollar accounts “were designated for a particular purpose — research — and under no circumstance could these account balances be applied to the purchase of securities.”<sup>16</sup> Instead, the court concluded that the Soft Dollar Claims “are really breach of contract claims . . . based on a breach of the contractual obligation of [the debtors] to provide research services to its customers.”<sup>17</sup>

## Implications of the *In re Lehman Brothers, Inc.* Decision

The *In re Lehman Brothers, Inc.* decision effectively downgrades and devalues Soft Dollar Claims in the bankruptcy context. Soft Dollar Claims previously enjoyed two significant benefits from being characterized as customer claims: (1) guaranteed payment, up to \$500,000 for each account, by the Securities Investor Protection Corporation (“SIPC”); and (2) prioritized payment within the distribution hierarchy.<sup>18</sup> As general unsecured claims, however, holders of Soft

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<sup>6</sup> Id.

<sup>7</sup> See Interpretive Release Concerning Scope of Section 28(e) of the Securities Exchange Act of 1934 and Related Matters, Exchange Act Release No. 34,23170, 51 Fed. Reg. 16004, \*2 (April 23, 1986).

<sup>8</sup> Id.

<sup>9</sup> See Opinion, at 8.

<sup>10</sup> See id.

<sup>11</sup> See id.

<sup>12</sup> See id., at 3.

<sup>13</sup> See id., at 10.

<sup>14</sup> See id., at 11.

<sup>15</sup> See id., at 12.

<sup>16</sup> See id., at 12.

<sup>17</sup> See id., at 17.

<sup>18</sup> See 15 U.S.C. § 78fff-1(b); 15 U.S.C. § 78fff-2(b)-(c); 15 U.S.C. § 78fff-3(a).

Dollar Claims no longer will be entitled to guaranteed payment by SIPC, and only will be paid after customer claims and expenses related to the debtor's liquidation.<sup>19</sup> Consequently, the reclassification of Soft Dollar Claims will result in a devaluation of this debt, and institutional investors should be wary overvaluing Soft Dollar Claims in the future.

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<sup>19</sup> See 15 U.S.C. § 78fff-2(c)(1).