# MEMORANDUM OF LAW

DATE: March 15, 1994

TO: Raymond F. Day, Investment Officer

FROM: City Attorney

SUBJECT: Repurchase Agreements

## Question Presented

You recently sent us a memo requesting that we provide a memorandum of law that will confirm whether commercial paper used as collateral for a repurchase agreement can be liquidated in the same manner as U.S. Treasury securities in the event of bankruptcy of the counterparty to the repurchase agreement. We had provided a memo dated September 28, 1993 to Eugene Ruzzini in which we stated that commercial paper held as collateral could not be liquidated by the holder in the event of bankruptcy of the counterparty to a repurchase agreement ("repo") and would be treated as a secured loan. After receiving that memo, you told us that you had asked attorneys for Merrill Lynch to respond to the same question and that they provided a case, Securities Industry Association v. Board of Governors of the Federal Reserve System, 468 U.S. 137 (1984)("SIA"), in which the U.S. Supreme Court held that commercial paper is a security and not a loan.

## Discussion

Mr. Ruzzini's original memo of August 13, 1993 referred to the 1984 Amendments to the Bankruptcy Code which allowed a holder of repurchase collateral to liquidate that collateral if the other party to the repo defaulted. His specific question was whether there were any subsequent amendments to the Bank-ruptcy Code that would permit holders of repurchase agreements collateralized by commercial paper to immediately sell out the collateral if the other party defaulted.

We responded as indicated, whereupon you chose to raise the question with legal representatives of Merrill Lynch. Irrespective of their response to you, our advice on the subject follows and we urge you to consider it.

1. Definitions. We will define the relevant terms prior to further discussion of the issue. Repurchase Agreement is defined in the Bankruptcy Code, 11 U.S.C. Section 101(47):

"repurchase agreement" (which

definition also applies to a reverse
repurchase agreement) means an
agreement, including related terms,
which provides for the transfer of
certificates of deposit, eligible
bankers' acceptances, or securities
that are direct obligations of, or
that are fully guaranteed as to
principle and interest by, the United
States or any agency of the United
States against the transfer of funds
by the transferee of such
certificates of deposit, eligible
bankers' acceptances or securities
with a simultaneous agreement by such
trans-feree to transfer to the
transferor thereof certificates of
deposit, eligible bankers'
acceptances, or securities as
described above, at a date certain
not later than one year after such
transfers or on demand, against the
transfer of funds.

Commercial paper is defined in the SIA case you sent us: "`Commercial paper' refers generally to unsecured, short-term promissory notes issued by commercial entities. Such a note is payable to the bearer on a stated maturity date. Maturities vary considerably, but typically are less than nine months." SIA, 486 U.S. at 140, fn 1. Black's Law Dictionary (6th Ed. 1990) at page 271 defines commercial paper as: "Bills of exchange (i.e., drafts), promissory notes, bank-checks, and other negotiable instruments."

Security is defined in several different places in the United States Codes. The SIA case refers to the definition of security found in section 3(a)(10) of the Securities Exchange Act, 15 U.S.C. Section 78c(a)(10). Since we are concerned with securities in conjunction with repurchase agreements, we use the definition of security found in the same definition section as repurchase agreements in the Bankruptcy Code, 11 U.S.C. Section 101(49).

(49) "security" --

(A) includes --

(i) note;

(ii) stock;

(iii) treasury stock;

(iv) bond;
(v) debenture
(vi) collateral trust certificate;
(vii) pre-organization certificate
or subscription;
(viii) transferable share;
(ix) voting-trust certificate;
(x) certificate of deposit;
(xi) certificate of deposit for
security;
(xii) investment contract or certificate
of interest or participation in a
profit-sharing agreement or in an
oil, gas, or mineral royalty or
lease, if such contract or interest
is required to be the subject of a
registration statement filed with
the Securities and Exchange
Commission under the provision of
the Securities Act of 1933 (15 U.S.C.
77a et seq.), or is exempt under
section 3(b) of such Act (15 U.S.C.
77c(b)) from the requirement to
file such a statement;
(xiii) interest of a limited partner in
a limited partnership;
(xiv) other claim or interest commonly
known as "security"; and
(xv) certificate of interest or
participation in, temporary or
interim certificate for, receipt
for, or warrant or right to
sub-scribe to or purchase or sell,
a security; but
(B) does not include --
(i) currency, check, draft, bill of
exchange, or bank letter of credit;
(ii) leverage transaction, as defined
in section 761(13) of this title;
(iii) commodity futures contract or forward
contract;
(iv) option, warrant, or right to
subscribe to or purchase or sell
a commodity futures contract;
(v) option to purchase or sell a
commodity;

(vi) contract or certificate of a kind specified in subparagraph (A)(xii) of this paragraph that is not required to be the subject of a registration statement filed with the Securities and Exchange Commission and is not exempt under section 3(b) of the Securities Act of 1933 (15 U.S.C. 77c(b)) from the requirement to file such a statement; or

(vii) debt or evidence of indebtedness for goods sold and delivered or services rendered

2. Background. To better understand the complexities of this issue, some additional background is helpful. The court in Bevill v. Spencer Savings & Loan, 878 F. 2d 742 (3d Cir. 1989), a case regarding purchases of federal government securities and repurchase agreements, provided a comprehensive analysis of repurchase agreements and the reasons for the 1982 and the 1984 Bankruptcy Code amendments. The court explained that the 1982 amendments to the Bankruptcy Code

> did not "adequately protect liquidations of repos in the event of the insolvency of a dealer or other participant in the repo market, even though the principal objective of Public Law 97-222 the 1982 amendments was to prevent the insolvency of one commodities or securities firm from spreading to other firms and possibly threatening the stability of the affected market . . ."
>
> "The effective functioning of the repo market can only be assured if repo investors will be protected against open-ended market loss arising from the insolvency of a dealer or other counter-party in the repo market. . . . 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."

Id. at 747-748.

As if to emphasize the inadequacy of the 1982 Amendments, the October 1982 bench decision of the Bankruptcy Court of the Southern District of New York in Lombard-Wall Inc. v. Columbus Bank & Trust Co. (In re Lombard-Wall Inc.), No. 82 B 11556 (Bankr.S.D.N.Y. Sept. 16, 1982), held that "the holder of securities subject to a repurchase agreement was subject to the automatic stay provision of the Code, and that the holder was precluded from closing out its position with the debtor without approval of the court." Bevill at 748. This interpretation meant that the purchaser/lender in a repurchase agreement could not immediately liquidate securities it was holding despite the bankruptcy of the seller/borrower, because the interest of the seller/borrower would be considered the property of the bankrupt estate.

The "automatic stay" provision referred to by the Bevill court is found at section 362(a) of the Bankruptcy Code, which holds that filing of a bankruptcy petition operates as a stay of any act to obtain possession of or exercise control over property of the estate. As the court in Bevill noted, "the repo participant would be subject `both to the unexpected inability to liquidate securities it holds and to the risk of capital loss should unfavorable interest rate changes occur; these risks impair the qualities that are the essence of the appeal of repo agreements.'" Id., quoting Bankruptcy Law and Repurchase Agreements: Hearings on H. 2852 and H. 3418 Before the Subcommittee on Monopolies and Commercial Law of the House Comm. on the Judiciary, 98th Cong., 2d Sess. 72 (1984) (letter of Hon. Paul A. Volcker, Chairman, Federal Reserve, to Hon. Peter W. Rodino, Jr., Chairman, House Judiciary Committee).

To alleviate the uncertainties resulting from the 1982 Amendments and the Lombard-Wall holding, Congress passed the 1984 Amendments.F

We will be happy to provide copies of any authorities cited herein.

These amendments "provided not only that the repo participant could liquidate its securities, but also that it could keep the proceeds of that liquidation to the extent of its contract price." Bevill at 748.

The 1984 Amendments do not address whether commercial paper is a secured loan or a security, but rather create certain exemptions from the automatic stay and avoidance provisions of the Bankruptcy Code for margin payments, settlement payments, and liquidations of securities in connection with repurchase agreements as defined in 11 U.S.C. Section 101(47). In our view, only repos involving certificates of deposit, eligible bankers'

acceptances, and U.S. government and federal agency-issued or guaranteed obligations fall within the statutory definition, and therefore only repos of this type are eligible for the special treatment (exemption from stay and avoidance provisions) afforded by the Amendments.

> Repos involving other types of securities (including such widely traded securities as commercial paper) will, in light of Lombard-Wall, presumably be characterized as secured loans for bankruptcy purposes . . . . Repos involving securities other than certificates of deposit, eligible bankers' acceptances, or U.S. government and federal agency-issued or guaranteed securities do not, as explained above, fall within the definition of repurchase agreements. Repos covering commercial paper are perhaps the most significant type of ineligible repos.

Practicing Law Institute, Order No. A4-4135, "Repurchase Agreements After the 1984 Amendments to the Bankruptcy Code," November 1, 1985, Alisa F. Levin & John M. Donovan, 368 PLI/Comm 143 emphasis added.

3. Application. The above discussion outlines the reasons for our earlier opinion that commercial paper cannot be liquidated when used as collateral in a repurchase agreement. As we understand it, your concern has been the status of commercial paper in a repurchase agreement. We agree that in the SIA case you sent us, the Supreme Court held that commercial paper is a security. However, our reading of that case leads us to believe the Court was basing its decision on the particular facts of that case, which involved whether the Glass-Steagall Act (the Banking Act of 1933), prohibited commercial banks from selling third-party commercial paper. It is our interpretation that the holding in SIA that commercial paper is a security should be limited to the facts of that case. In its opinion, the Court stated that, "because commercial paper falls within the plain language of the Act, and because the inclusion of commercial paper within the terms of the Act is fully consistent with the Act's purposes, we conclude that commercial paper is a `security' under the Glass-Steagall Act . . . ." SIA at 140. Emphasis added.

The problem appears to be one of definition. As you know, language can be deceiving -- words must be interpreted based

upon the context in which they are used. In fact, the court in Bevill, 878 F. 2d at 750, felt so strongly about language interpretation that it quoted several other courts in its opinion:

> Impressive authorities have warned judges that they must ascertain meaning from more than the actual language of a statute. Cardozo wrote that "when things are called by the same name it is easy for the mind to slide into an assumption that the verbal identity is accompanied in all its sequences by identity of meaning." . . . Holmes told us: "A word is not a crystal, transparent and unchanged, it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used." . . . Learned Hand said, "it is one of the surest indexes of a mature and developed juris-prudence not to make a fortress out of the dictionary; but to remember that statutes always have some purpose or object to accomplish, whose sympathetic and imaginative discovery is the surest guide to their meaning."

Perhaps the confusion stems from the use of the term "commercial paper" in two different contexts. Courts have wrestled with the meaning of the term "commercial paper" in several cases.F

Cases which have held that promissory notes are securities include Reyes v. Ernst & Young, 494 U.S. 56 (1990); Tri-County State Bank v. Hertz, 418 F. Supp. 332 (M.D. Penn. 1976); Davis v. Avco Corporation, 371 F. Supp. 782 (N.D. Ohio 1974). Cases which have held that promissory notes are not securities include Holloway v. Peat, Marwick, Mitchell & Co., 900 F. 2d 1485 (10th Cir. 1990)(if maturity of not less than nine months); American Bank & Trust Co. v. Wallace, 702 F. 2d 93 (6th Cir. 1983); Oxford Finance Companies, Inc. v. Harvey, 385 F. Supp. 431 (E.D. Penn. 1974).

In Reves v. Ernst & Young, 494 U.S. 56, 61 (1990), the Supreme Court was asked to decide whether certain demand notes issued by the Farmers Cooperative of Arkansas

and Oklahoma were "securities" within the meaning of Section 3(a)(10) of the Securities Exchange Act of 1934, and held that

> in discharging our duty, we are not bound by legal formalism, but instead take account of the economics of the transaction under investigation. (See, e.g., Tcherepnin v. Knight, 389 U.S. 332, 336 citations omitted (1967) (in interpreting the term "security," "form should be disregarded for substance and the emphasis should be on economic reality.").

The court in Reves was asked to decide if stock is a security, and in so doing, commented on the inclusion of the term "notes" in the definition of security:

> "note" may now be viewed as a relatively broad term that encompasses instruments with widely varying characteristics, depending on whether issued in a consumer context, as commercial paper, or in some other investment context . . . . While common stock is the quintessence of a security, . . . and investors therefore justifiably assume that a sale of stock is covered by the Securities Acts, the same simply cannot be said of notes, which are used in a variety of settings, not all of which involve investments. Thus, the phrase "any note" should not be inter-preted to mean literally "any note," but must be understood against the backdrop of what Congress was attempting to accomplish in enacting the Securities Act.

Id. at 58.

The court in Llanos v. U.S., 206 F. 2d 852 (9th Cir. 1953) held that "promissory notes are securities under Securities Act as being evidence of indebtedness, . . . notwithstanding that they are not securities under other statutes."

In the Bankruptcy Code at issue, 11 U.S.C. Section 101(47), the court specified certain instruments as exempt from the Code's stay provisions, and commercial paper was not among those exemptions. We look to methods commonly used to interpret

legislation. Where specific terms are used by the legislative body, the usual statutory interpretation (known by its Latin term as expressio unius est exclusio alterius), is that the mention of one thing is the exclusion of another. Here, we assume that since the legislators specified certain instruments in the repo definition, they meant to include only those terms and exclude others not named.

Conclusion

Commercial paper is characterized as a security in the SIA case you provided; however, it is our opinion that such characterization should be limited to the facts of that case. Based upon the opinions of courts which have examined this issue, the question of whether commercial notes constitute a security is a question of fact and must be decided on a case by case basis. As noted above, the Court in SIA found that commercial paper is a security, stating that "commercial paper falls within the plain language of the Act. . ." Here, commercial paper is specifically not included in the plain language of the Bankruptcy Code; therefore the Code does not include commercial paper in its treatment of collateral for repurchase agreements.

Finally, we seriously question the propriety of posing questions such as this to the legal representatives of those very vendors who would propose to market and sell repurchase agreements. Our views on this subject are stated clearly above. We would urge you to take close note of our views.

We will be glad to discuss this further with you if you desire. We await your reply.

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