

Bank of America Ordered to Repay More than \$500 Million Seized from Lehman Accounts

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On November 16, 2010, the Bankruptcy Court in the Southern District of New York decided *Bank of America, N.A. v. Lehman Brothers Holdings, Inc., et al.*, 08-1753 (the "*BofA Proceeding*"). It (i) granted summary judgment for Lehman Brothers Holdings, Inc. ("LBHI"), Lehman Brothers Special Financing ("LBSF," collectively with LBHI and LBHI's other affiliates and subsidiaries, "Lehman") and Quinn Emanuel client, the Official Creditors Committee of LBHI and its affiliated debtors (the "Committee"), (ii) denied Bank of America's cross-motion for summary judgment, and (iii) directed Bank of America to return \$501.8 million plus interest to the debtors' estates for the benefit of creditors. The ruling should put all creditors on notice of the inherent risks in taking self-help measures against a debtor after a bankruptcy stay has issued.

Prior to LBHI's Chapter 11 filing, Bank of America served as one of Lehman's clearing banks. Lehman incurred intra-day overdrafts as funds came in and went out of the account. To the extent there were overdrafts during the business day, Bank of America was essentially extending unsecured credit to Lehman with the expectation that any overdrafts would be eliminated by the end of the business day.

In July 2008, one of Lehman's Bank of America accounts recorded a \$650 million overnight overdraft. Alarmed, Bank of America pressured LBHI to enter into a security agreement establishing a \$500 million fund solely dedicated to satisfying Lehman's overdrafts. LBHI acceded to the request, placing \$500 million in a special-purpose account for potential overdrafts. LBHI's \$500 million remained in its special-purpose account until November 10, 2008, when Bank of America, without first seeking relief from the Bankruptcy Court, seized the funds (plus accrued interest) and set them off against amounts that Lehman allegedly owed to Bank of America as a result of unrelated derivatives (swap) agreements.

Following the seizure, Bank of America instituted proceedings in the Bankruptcy Court seeking a declaratory judgment that its actions did not violate the stay or, in the alternative, retroactive relief from the automatic stay. LBHI cross-claimed that the setoff was improper, and the Creditor's Committee intervened in support of Lehman.

The court examined the terms of the security agreement that established the account in question and the intentions of the parties in establishing the account. Initially, Bank of America had demanded that LBHI deposit \$1 billion into an account pledged as collateral subject to the terms of a security agreement. Lehman responded by asking whether Bank of America would consider treating the account as a "vanilla" account with no specific pledge. Bank of America refused. From this initial position, the parties negotiated for four days, without ever discussing setoffs. In the end, the security agreement required that Lehman deposit \$500 million into an account to be used, according to the terms of the agreement, "solely in respect of overdrafts." The funds were not pledged as security against any other debts. In addition, the deposited funds could be withdrawn by Lehman only upon three days' written notice. Once deposited, neither Lehman nor Bank of America ever used the funds for any purpose before the November 10 setoff.

The court found that both the language of the security agreement and the conduct of the parties clearly reflected an intent to establish a special-purpose account. The security agreement expressly permitted the use of the funds "solely in respect of overdrafts." And, in addition to the three-day notice required for any withdrawal by Lehman, Bank of America placed the deposited funds on an "indefinite" hold. As a result, the court concluded that the parties created a special-purpose account thus making the funds ineligible for setoff under New York law. In reaching that conclusion, the court rejected arguments from Bank of America that the common-law setoff rights were preserved by boilerplate contract language reserving "all rights, powers and remedies given to [Bank of America] by virtue of any statute or rule of law." The court also rejected Bank of America's attempt to find refuge in the safe harbor provisions of the Bankruptcy Code, which permit a swap counterparty to exercise any right related to the swap agreement. 11 U.S.C. § 362(b)(7). It held that the right asserted under this provision must be a part of or related to the swap agreement. In this instance, the security agreement providing the right to set the dedicated funds off against overdrafts bore no relation to the terms of the swap agreement against which those funds were applied. In making those findings, the court emphasized the distinct bargaining advantage and "situational leverage" enjoyed by Bank of America throughout the entire episode. *BofA Proceeding*, No. 08-01753 at 34-35. Lehman, the court said, "found itself in [a] coerced position" *Id.* at 9.

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The court reserved most of its censorious language for Bank of America's "deliberately aggressive and calculated strategy" to circumvent the stay. *Id.* at 7. The opinion expressed the court's dismay that Bank of America "could have thought that taking the money was the right thing to do without first seeking permission from the Court." *Id.* at 44. Bank of America's actions "were surprising and, quite frankly, disappointing." *Id.* at 45. The court is still considering what sanctions Bank of America should face for its "calculated violation of the bankruptcy stay." *Id.*