King & Spalding

Client Alert

Financial Restructuring Practice Group

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Second Circuit Finds that Barclay's Bought Lehman's Assets Free and Clear of FirstBank's Claims

On March 29, 2016, the Second Circuit Court of Appeals ruled that FirstBank Puerto Rico ("**FirstBank**") could not recover from Barclays Capital Inc. ("**Barclays**") the securities ("**Securities**") pledged by it, in connection with a pre-bankruptcy interest rate swap with a Lehman affiliate ("**LBSF**"). The Securities were first sold by LBSF to Lehman Brothers Inc. ("**Lehman**") pursuant to a contractually authorized pre-bankruptcy transaction, and thereafter sold by Lehman to Barclays, free and clear of liens/claims, pursuant to a Bankruptcy Court authorized sale. The Second Circuit's short decision affirmed the District Court,[1] which had affirmed the Bankruptcy Court.

The Second Circuit also confirmed: (a) it is the Bankruptcy Court that should resolve this type of bankruptcy sale-related dispute in the first instance; (b) that FirstBank violated the injunction in the Bankruptcy Court's Sale Order when it sought to side-step the Bankruptcy Court and commenced litigation against Barclays; and (c) the attorneys' fee sanctions assessed against FirstBank.

Background

In 2008, FirstBank pledged the Securities to LBSF as collateral for an interest rate swap. LBSF then sold the Securities to Lehman pursuant to a repurchase agreement. The LBSF agreement with FirstBank permitted this type of transaction, which resulted in FirstBank relinquishing its' rights to the Securities as against Lehman (or its' transferees), and retaining contractual rights against LBSF. The Securities were thereafter sold by Lehman to Barclays pursuant to a repurchase agreement, and eventually the sale to Barclays was confirmed through a Section 363 "free and clear" Sale Order of the Bankruptcy Court.

After the sale, in discussions between FirstBank and Lehman, FirstBank was told that (i) the Securities were no longer under Lehman's control, (ii) LBSF was crediting a portion of the value of the Securities against the net termination amount owed by FirstBank to LBSF under the interest rate swap, and (iii) FirstBank would need to file a claim against the LBSF bankruptcy estate for the value of the excess Securities that was not credited against the interest rate swap obligation owed by FirstBank. Lehman also told FirstBank that if it wanted to argue that it should become

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senior to the other creditors with respect to the value of the Securities, it would need to file a motion with the Bankruptcy Court. FirstBank did not file any motion or proof of claim with the Bankruptcy Court against LBSF or Lehman. Instead, FirstBank filed an action in the District Court against Barclays, which, in turn, requested that the District Court refer the case to the Bankruptcy Court since it concerned an interpretation of the Bankruptcy Court's Sale Order. The District Court ultimately referred the case to the Bankruptcy Court for further proceedings. Barclays filed a motion for summary judgment in the Bankruptcy Court, arguing that the Sale Order's "free and clear" language prevented FirstBank from pursuing its claim for the Securities against Barclays.

The Bankruptcy Court agreed with Barclays. It found that (a) FirstBank's claims against Barclays were really for money damages associated with LBSF's default under the interest rate swap agreement; (b) Barclays was protected by the creditor shield in the Sale Order; (c) FirstBank should have filed a claim against LBSF; and (d) FirstBank was in civil contempt for prosecuting the adversary proceeding in the District Court against Barclays in violation of the Sale Order.

On appeal, the District Court affirmed the Bankruptcy Court finding that when LBSF sold the Securities to Lehman, FirstBank lost all rights to the Securities as against Lehman (and its subsequent transferees); the Securities became Lehman's property. The District Court enforced the "free and clear" provision of the Sale Order and upheld the sanctions against FirstBank finding that the good faith purchaser (Barclays) needed to be protected as contemplated by the Sale Order.

The Second Circuit's Decision

The Second Circuit, in affirming the District Court, held that LBSF's sale of the Securities to Lehman cutoff FirstBank's property interests in the Securities. It also held that since the Securities were transferred to Barclays as part of its purchase of assets in the bankruptcy sale, the appropriate venue to litigate this dispute was the Bankruptcy Court – and not the District Court. Finally, the Second Circuit affirmed the order requiring FirstBank to pay Barclays' reasonable attorneys' fees in defending the litigation that was pursued by FirstBank in violation of the Sale Order.

Conclusion

The important takeaway points from this case are: (a) Bankruptcy Court Sale Orders with "free and clear" provisions will be enforced; (b) the Bankruptcy Court is the appropriate forum to resolve disputes relating to its Sale Orders; (c) parties that violate the injunction in the Sale Order can be sanctioned; and (d) strategic decisions to pursue the purchaser instead of the debtor-seller can backfire.

[1] *In re Lehman Bros. Holding Inc*., 526 B.R. 481 (S.D.N.Y. 2014), *as corrected* (Dec. 29, 2014) *aff'd sub nom. In re Lehman Bros. Holdings, Inc*. (2d Cir. Mar. 29, 2016).