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United States District Court for the Southern District of New York Largely Dismisses Lehman's $8.6 Billion "Slush Fund" Claims Against JPMorgan

If you wish to receive more information on the topics covered in this publication, you may reach out to your regular Shearman & Sterling contact person or any of the following:

Fredric Sosnick
New York
+1.212.848.8571
fsosnick@shearman.com

Douglas P. Bartner
New York
+1.212.848.8190
dbartner@shearman.com

Joel Moss
New York
+1.212.848.4693
joel.moss@shearman.com

Solomon J. Noh
London
+44.20.7655.5795
solomon.noh@shearman.com

Ned S. Schodek
New York
+1.212.848.7052
ned.schodek@shearman.com

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On September 30, 2015, the United States District Court for the Southern District of New York (the "District Court") denied the motion of Lehman Brothers Holdings Inc. ("LBHI," and collectively with all of LBHI's subsidiaries, "Lehman") and its Official Committee of Unsecured Creditors (together, "Plaintiffs") seeking damages and the recovery of $8.6 billion from Defendant JPMorgan Chase Bank, N.A. ("JPMorgan") for the benefit of Lehman's creditors.[1] Instead, the District Court granted summary judgment in favor of JPMorgan on all but six of Lehman's claims and left standing various counterclaims asserted by JPMorgan. Although the outcome was widely anticipated in the market given that the Lehman Examiner previously concluded that Lehman had but one colorable claim against JPMorgan that was "not strong," it is a blow to the Lehman estates nonetheless and comes on the heels of a recent decision upholding a Loss calculation by Intel Corporation in respect of a failed transaction under an ISDA Master that Lehman had disputed [Read our memo on the Intel decision here].

Background

JPMorgan served as the primary bank and credit provider for broker/dealer Lehman Brothers Inc. ("LBI"), a wholly owned subsidiary of LBHI. JPMorgan was the agent for LBI's

[1] *Lehman Brothers Holdings Inc. and The Official Committee of Unsecured Creditors of Lehman Brothers Holdings Inc. v. JPMorgan Chase Bank, N.A. (In re Lehman Brothers Holdings Inc., et al.)*, Bk. No. 08-13555 (the "Bankruptcy Case"), Adv. No. 10-03266 (the "Adversary Proceeding"), No. 11-cv-6760 (S.D.N.Y. Sept. 30, 2015).

triparty repurchase agreements, or "triparty repos."[2] In light of Lehman's precarious financial situation, in August and September of 2008, JPMorgan required Lehman to enter into a series of agreements whereby JPMorgan obtained additional collateral from Lehman to secure Lehman's obligations to JPMorgan. Pursuant to these agreements, between September 9 and 12, LBHI posted approximately $1.7 billion in money-market funds as collateral to JPMorgan. LBHI also deposited $6.9 billion of cash collateral into an LBHI demand deposit account (the "Cash Account"), which funds were moved by JPMorgan out of the Cash Account and into an account maintained on JPMorgan's general ledger (the "GL Cash Account").

On September 15, 2008, LBHI filed a Chapter 11 petition in the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court"). In October, JPMorgan applied approximately $1.9 billion off the $6.9 billion GL Cash Account to claims related to various derivatives contracts, secured lending agreements and repurchase agreements that it had with Lehman. It then applied the remaining funds in partial satisfaction of other Lehman obligations to JPMorgan.

On January 20, 2009, at the request of various parties in interest, the Bankruptcy Court approved the appointment of an Examiner in the LBHI bankruptcy cases. The Examiner was charged with, among other things, investigating transactions and transfers among the debtors and pre-chapter 11 lenders and financial participants. Following his investigation, on March 11, 2010, the Examiner published an exhaustive multi-volume report describing his findings, including a detailed analysis of Lehman's dealings with, and potential claims against, JPMorgan. The Examiner ultimately concluded that the majority of Lehman's potential claims against JPMorgan were not supported by the evidence,[3] but found that "the evidence may support the existence of a colorable claim – but not a strong claim – that JPMorgan breached the implied covenant of good faith and fair dealing by making excessive collateral requests to Lehman in September 2008."[4]

On September 15, 2010, Plaintiffs commenced an adversary proceeding against JPMorgan seeking damages as well as the return of the $8.6 billion in collateral under various legal theories, essentially arguing that JPMorgan took unfair advantage of Lehman in extracting virtually all of Lehman's remaining liquidity and establishing a "slush fund" for its own use, ensuring that JPMorgan would be paid ahead of other creditors during Lehman's insolvency. JPMorgan filed a

[2] In the triparty repo market, a third party clearing bank acts as an intermediary between two parties engaging in a repurchase transaction – broker/dealers and outside investors. In such transactions, the clearing bank settles the repos at the end of the day by simultaneously transferring securities from the broker/dealer's accounts to the outside investors' accounts, and the cash from the outside investors' accounts to the broker/dealer's accounts. The outside investors hold the securities overnight, and on the morning of the next trading day, the clearing bank unwinds the repo, returning the securities to the broker/dealer and transferring cash (at the repurchase price plus interest) to the outside investors.

[3] Specifically, the Examiner concluded that: (i) the evidence did not support a colorable claim for economic duress due to the lack of evidence of an express unlawful threat by JPMorgan; (ii) there may be a technical claim that the agreements were invalid for lack of authority, but there are substantial defenses to such claim; (iii) the evidence did not support a claim that JPMorgan fraudulently induced the agreements, as regardless of the disputed issue of fact regarding inducement, Lehman counsel could not reasonably have relied on any such representation; and (iv) JPMorgan was not legally required to return the collateral to Lehman, because Lehman failed to provide JPMorgan with written notice for return of collateral as required under the agreements. Bankruptcy Case ECF No. 7531.

[4] *Id.*

motion to dismiss the complaint, and subsequently filed counterclaims alleging that LBHI fraudulently induced JPMorgan to continue extending credit to LBI after LBHI's bankruptcy filing.

On April 19, 2012, the Bankruptcy Court granted JPMorgan's motion to dismiss with respect to 20 of Plaintiffs' 49 claims, finding that claims based on preference liability or constructively fraudulent transfers were foreclosed by the Bankruptcy Code's safe harbors, which operate to, among other things, protect transfers associated with financial contracts from avoidance.[5] Plaintiffs filed a motion to dismiss JPMorgan's amended counterclaims. Judge Sullivan withdrew the reference[6] to the District Court after receiving notice that JPMorgan intended to move for summary judgment.

The District Court's Analysis

The District Court found that Plaintiffs' allegations rest on the fundamental premise that JPMorgan was obligated to extend credit to Lehman. In analyzing the governing agreements' express and implied terms, however, the District Court concluded that the agreements unambiguously permitted JPMorgan to cease extending credit to LBI, even without a notice period.[7] Moreover, the District Court found that the agreement provided JPMorgan with the right to decline to extend credit at any time, at its discretion, and that intraday credit from JPMorgan would be payable on demand, further clarifying the parties' intent to ensure that any extension of credit would occur at JPMorgan's discretion.

The District Court also was unpersuaded by Plaintiffs' arguments to the effect that the agreements offered JPMorgan the right to be fully – and not over – collateralized with respect to its clearance activities, finding that the language at issue simply operated to protect JPMorgan in the event of a default, and did not impose a cap on the amount of collateral that JPMorgan could obtain from Lehman. Likewise, the District Court rejected Plaintiffs' argument that an obligation to provide commercially reasonable notice and refrain from obtaining collateral in excess of its exposure arises independently from the implied covenant of good faith and fair dealing, given that such an obligation would be inconsistent with the terms of the contractual relationship and, therefore, cannot be implied.

The District Court further found that as a matter of New York law, JPMorgan retained its lien over the collateral deposited in the Cash Account, even after transferring it to JPMorgan's GL Cash Account, despite "foot fault" arguments by Plaintiffs to the contrary. In addition, the District Court refused to invalidate certain of the agreements in question for lack of consideration and lack of authority, as argued by the Plaintiffs, finding that Plaintiffs had ratified the agreements and that a so-called "hell or high water clause"[8] barred Lehman from asserting such defenses. The District Court noted

[5] *In re Lehman Bros. Holdings Inc.*, 469 B.R. 415 (Bankr. S.D.N.Y. 2012).

[6] District courts have original but not exclusive jurisdiction over all civil proceedings arising under title 11. Under this grant of authority, district courts "refer" these proceedings to bankruptcy courts. However, under certain circumstances, a district court is required or has discretion to withdraw the reference from the bankruptcy court and adjudicate the matter.

[7] The District Court dismissed Plaintiffs' contention that "with notice" obligated JPMorgan to provide commercially reasonable notice of "several months or a year," instead holding that where a notice period was not defined, notice can be provided at any time before the event occurs.

[8] A hell or high water clause generally makes a party's obligations absolute and unconditional.

that "hell or high water clauses" have been found to be enforceable by the Second Circuit, and the fact that the clause had not been heavily negotiated did not change the result.[9]

Finally, with respect to claims based on fraud, the District Court was not persuaded that JPMorgan fraudulently induced LBHI to extend collateral, as any oral promise by JPMorgan to return the collateral could not alter the plain terms of the contract to the contrary. Moreover, the District Court further found that there was insufficient evidence of actual intent on the part of LBHI to defraud creditors. On the latter, the District Court noted that the fact that JPMorgan had strong financial leverage over Lehman, as alleged by Plaintiffs, was insufficient to prove Plaintiffs' claim; instead, the analysis must turn on *actual control* of Lehman, which Plaintiffs did not allege. Rather, the District Court observed that JPMorgan's insistence on additional collateral to support substantial lending activity presented Lehman with a difficult decision; it did not prove that JPMorgan served as Lehman's decision-maker.

Although the District Court rejected the majority of Lehman's claims, the decision does not fully resolve the adversary proceeding. The District Court held that judgment regarding Plaintiffs' argument for equitable subordination of JPMorgan's claims as a result of JPMorgan's alleged "outrageous and inequitable" conduct was premature. The District Court also found that genuine issues of fact remain regarding Plaintiffs' claims of voidable setoff[10] and violation of the automatic stay.[11]

Further, the District Court left JPMorgan's counterclaims intact, finding that there was a genuine issue of material fact regarding whether Lehman actually made misstatements regarding the LBHI-Barclays deal, and whether those statements induced reliance on the part of JPMorgan. The District Court also denied summary judgment on JPMorgan's counterclaims alleging (i) that LBHI aided and abetted Barclays' fraud, and (ii) that LBHI aided and abetted LBI's fraud in procuring credit from JPMorgan with the intention not to repay JPMorgan's advances.[12] Finally, the District Court determined that summary judgment with respect to whether Plaintiffs' claims of willful misconduct foreclosed JPMorgan's indemnification claims was premature.

Discussion

While Lehman retains its appellate rights and the District Court did not dismiss all of Lehman's causes of action, Lehman clearly faces a difficult path forward given the limited number of counts remaining. With the benefit of a more extensive factual record, the District Court might well conclude that JPMorgan is protected by the Bankruptcy Code's safe harbors from Lehman's voidable setoff and automatic stay claims. The decision also suggests that Lehman faces an uphill battle on

[9] Interestingly, the District Court was in part persuaded by Second Circuit authority to the effect that where parties are sophisticated, the court should not second guess boilerplate provisions or stock language. This is contrary to one of Judge Peck's decisions in another Lehman adversary proceeding in which he disregarded language he deemed to be boilerplate for purposes of his analysis. *In re Lehman Bros. Holdings Inc.*, 439 B.R. 811, 818 (Bankr. S.D.N.Y. 2010).

[10] Plaintiffs claimed that because Lehman was insolvent in the days leading up to its bankruptcy, the transfers should be avoided as wrongfully made for the purpose of obtaining a setoff right, or designed to otherwise improve JPMorgan's credit position with respect to LBHI.

[11] Plaintiffs claimed that JPMorgan violated the automatic stay when it applied funds comprising the collateral under the agreements to set off its own claims against the LBHI estate arising from other agreements between the parties.

[12] The District Court found that a factual question remains regarding whether the corporate officers were acting in their capacity as LBI or LBHI employees when they committed the alleged fraud.

its equitable subordination claims as the District Court went out of its way to remark that "no reasonable juror could conclude that [JPMorgan] acted as an insider of Lehman" and observed that "[b]ecause an ordinary creditor does not owe a fiduciary duty to the debtor, it is unusual for a court to subordinate claims out of such arms-length dealings." Further, the District Court preserved JPMorgan's counterclaims, which, if successful, could effectively negate any remaining claims upon which Lehman is able to prevail.[13]

The outcome, however, cannot have been a surprise to the creditor community given the Examiner's conclusion five years ago that Lehman didn't have strong claims against JPMorgan. Further, it hardly marks the end of the JPMorgan/Lehman saga, as there are, among other things, separate litigations between the parties with respect to the propriety of JPMorgan's derivative close-out calculations and claims by Lehman that JPMorgan didn't liquidate collateral in a commercially reasonable manner.

In terms of next steps, creditors have long speculated as to whether Lehman and JPMorgan would be able to reach a consensual global resolution of all their outstanding claims. In its concluding line, the District Court seems to be asking the parties to consider just that, ordering that they submit a joint letter to the Court by October 16, 2015, not only as to counsel's availability for trial but also as to "the prospects for settlement."

13 JPMorgan has argued that "if, as a result of being required to return any of the $8.6 billion in collateral or pay damages to LBHI, JPMorgan is unable to recover the full amount of its loans or is otherwise prejudiced, the harm that JPMorgan suffered as a direct and proximate result of LBHI's fraudulent misconduct will entitle JPMorgan, among other things, to recover as an administrative expense of the LBHI estate any portion of the more than $25 billion of loans under the Clearance Agreement that has not been paid in full." Adversary Proceeding ECF No. 63.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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