Clients&FriendsMemo

SDNY Bankruptcy Court Interprets Section 546(e)'s Safe Harbors in Lehman-JPMorgan Dispute

May 3, 2012

On April 19, 2012, the U.S. Bankruptcy Court for the Southern District of New York granted in part and denied in part JPMorgan Chase, N.A.'s motion to dismiss an adversary complaint filed by Lehman Brothers Holdings Inc. ("LBHI") and its Official Committee of Unsecured Creditors. The Complaint seeks to recover approximately $8.6 billion in prepetition transfers made by LBHI to JPMorgan in the days leading up to LBHI's bankruptcy. JPMorgan filed a motion to dismiss the Complaint, arguing that it acted reasonably in requiring additional collateral at a time of great financial risk, and that the transfers that the Plaintiffs sought to unwind are immunized by the safe harbor protections of section 546(e) of the Bankruptcy Code.[1]

The Court ultimately dismissed twenty-two counts of the Complaint related to claims of preferential and constructively fraudulent transfers, on the grounds that section 546(e) protected the transfers from avoidance by the Debtors. The Court refused to dismiss the remaining twenty-seven counts, which related to, among other things, common law legal doctrines, turnover of estate property, and equitable subordination, finding that the safe harbors do not offer "fail safe protection against every cognizable claim" related to a covered transaction and are not an "impenetrable barrier" to all claims against a market participant.[2]

The Relationship Between JPMorgan and Lehman Brothers

JPMorgan was the principal clearing bank for Lehman Brothers Inc. ("LBI"), and performed clearing activities for LBI pursuant to a Clearance Agreement dated June 15, 2000. The Clearance Agreement remained unaltered until August 2008, when JPMorgan drafted a new set of documents that materially changed the clearance relationship between JPMorgan and the Lehman entities. These "August Agreements" included (i) an Amendment to the Clearance Agreement that added LBHI and several of its subsidiaries as parties to the Clearance Agreement; (ii) a Guaranty,

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1 Lehman Bros. Holdings Inc. v. JPMorgan Chase Bank, N.A. (In re Lehman Bros. Holdings Inc.), --- B.R. ----, 2012 WL 1355659 (Bankr. S.D.N.Y. April 19, 2012).

2 Id. at *32.

pursuant to which LBHI guaranteed payment of all obligations and liabilities owed to JPMorgan under the Clearance Agreement; and (iii) a Security Agreement that granted JPMorgan a lien on certain LBHI accounts at JPMorgan in which LBHI posted collateral.

On September 9, 2008, as LBHI's financial condition deteriorated, JPMorgan requested that LBHI execute another new set of documents. These "September Agreements" included (i) a further Amendment to the Clearance Agreement, which expanded the Lehman entities' obligations under the Clearance Agreement to all Lehman obligations of whatever nature to all JPMorgan entities, including clearance, trading, and derivatives obligations; (ii) a Guaranty that expanded LBHI's liabilities to include all obligations of Lehman entities to all JPMorgan entities; (iii) a Security Agreement that granted JPMorgan a lien on all of LBHI's accounts at JPMorgan or its affiliates; and (iv) an Account Control Agreement that perfected JPMorgan's security interest LBHI's posted collateral.

The parties executed the September Agreements on September 10, 2008. JPMorgan immediately requested additional collateral under the Agreements, although the Plaintiffs allege that it already held sufficient collateral to secure its risks. Between Tuesday, September 9, 2008 and Friday, September 12, 2008, LBHI posted approximately $8.6 billion in collateral with JPMorgan (the "Disputed Collateral Transfers"). LBHI filed a petition for relief under chapter 11 on Monday, September 15, 2008.

The Adversary Complaint

In the Complaint, the Plaintiffs asserted forty-nine separate claims, including claims seeking the avoidance and recovery of actually fraudulent transfers under section 548 of the Bankruptcy Code; claims seeking avoidance and recovery of constructively fraudulent and preferential transfers under sections 544, 547 and 548 of the Bankruptcy Code; claims under various common law legal doctrines; and claims under other sections of the Bankruptcy Code, including turnover of estate property under section 542, setoff under section 553, equitable subordination under section 510(c), and disallowance of claims under section 502(d). The Court dismissed the claims for recovery and avoidance of constructively fraudulent and preferential transfers made under the August and September Agreements, finding that the transfers are protected under section 546(e)'s safe harbors.

The Court's Application of the Safe Harbors of Section 546(e) of the Bankruptcy Code

Section 546(e) of the Bankruptcy Code expressly limits a debtor's or trustee's power to avoid a transfer as preferential under section 547(b) of the Bankruptcy Code or as constructively fraudulent under section 548(a)(1)(B) of the Bankruptcy Code. Specifically, section 546(e) exempts from avoidance "a transfer made by or to (or for the benefit of) a . . . financial institution [or] financial

participant . . . in connection with a securities contract, as defined in section 741(7) . . . that is made before the commencement of the case."[3]

Section 741(7) defines "securities contracts" as, among other things,

> (A)(i) a contract for the purchase, sale or loan of a security; . . . (v) any extension of credit for the clearance or settlement of securities transactions; . . . (x) a master agreement that provides for an agreement or transaction referred to in cause (i) [or] (v); . . .[and] (xi) any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in this subparagraph, including any guarantee . . . .[4]

As a threshold matter, the Court found that the recent Enron and Quebecor World decisions require courts to strictly interpret the language of the safe harbors, "even when the outcome may be prejudicial to the interests of the estate and its creditors."[5]

The key issue in the Court's application of the safe harbors was whether the August and September Agreements qualified as securities contracts under section 741(7). The Court first addressed the Clearance Agreement, as amended by the August and September Amendments, finding that it qualified as a securities contract because it was an "extension of credit for the clearance or settlement of securities transactions" under section 741(7)(A)(v). Moreover, the Court found that because subsection (v)'s definition of securities contract refers to securities transactions, each individual extension of credit by JPMorgan to LBI under the Clearance Agreement was a stand-alone securities contract. As a result, the Court found that the Clearance Agreement was also a securities contract because it was a master agreement under section 741(7)(A)(x). The Court then found that the August Agreements, the September Security Agreement and the September Guaranty met the definition of securities contract contained in section 741(7)(A)(xi), because they were credit enhancements related to other securities contracts.

Next, the Court addressed whether the grant and perfection of liens under the securities contracts constituted transfers for purposes of section 546(e). The Court found that courts generally agree that the grant of a lien and the perfection of a security interest are transfers for purposes of section 546(e). Thus, the Court found that the liens granted under the September Agreements were transfers pursuant to safe harbored securities contracts, and are exempt from avoidance under section 546(e). The Court also found that the Account Control Agreement's perfection of liens

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[3] 11 U.S.C. § 546(e). Notably, section 546(e) does not exempt from avoidance actually fraudulent transfers under section 548(a)(1)(A) of the Bankruptcy Code.

[4] 11 U.S.C. § 741(7)(A)(i)-(xi).

[5] Lehman Bros., 2012 WL 1355659 at *17. See also In re Enron Creditors Recovery Corp. v. Alfa S.A.B. de C.V., 651 F.3d 329 (2d Cir. 2011); Official Comm. of Unsecured Creditors of Quebecor World (USA) Inc. v. Am. United Life Ins. Co. (In re Quebecor World (USA) Inc., 453 B.R. 201 (Bankr. S.D.N.Y. 2011).

granted by other September Agreements was a safe harbored transfer. The Court found that even though the Account Control Agreement itself was not a securities contract, the perfection of liens granted by other securities contracts was a transfer in connection with protected securities contracts.

Another key issue addressed by the Court was whether the Disputed Collateral Transfers were transfers made in connection with safe harbored securities contracts. JPMorgan ultimately applied the Disputed Collateral Transfers to safe harbored contracts, but the Plaintiffs argued that the Disputed Collateral Transfers were not protected by section 546(e) because at the time the transfers were made, they "had nothing to do with" JPMorgan's exposure under the Clearance Agreement or any derivatives contracts.[6] In essence, the Plaintiffs argued that JPMorgan should not be permitted to retroactively sanitize the Disputed Collateral Transfers by applying them to safe harbored contracts. The Court disagreed, finding that section 546(e)'s requirement that a transfer be "in connection with" a securities contract does not contain a temporal requirement. Accordingly, the Court held that LBHI and the Committee could not avoid the Disputed Collateral Transfers because they were made in connection with safe harbored agreements.

Finally, the Court addressed whether LBHI could avoid obligations it incurred to JPMorgan under the August Guaranty and the September Guaranty. Section 546(e) does not mention the incurrence of obligations, thus the Plaintiffs argued that the Guarantees were not protected from avoidance. The Court agreed that section 546(e) clearly does not cover the incurrence of obligations, and that obligations are distinguishable from transfers because an obligation is merely a legal prerequisite for a possible future transaction, rather than a transaction. Although the Court found that the obligations that LBHI incurred under the Guarantees were not protected by the safe harbor, it found that the Plaintiffs' argument was a dead end. The liens and related collateral transfers made by LBHI pursuant to the Guarantees, which the Plaintiffs were ultimately seeking to avoid, were transfers in connection with a securities contract. Thus, the liens and collateral transfers were independently immune from avoidance, even if the obligations secured were not.

Because the Court determined that the relevant August and September Agreements were securities contracts, and that the collateral transfers at issue were made in connection with the August and September Agreements, the Court determined that the transfers were protected from avoidance under section 546(e)'s safe harbors. However, the Court found that the protection of the safe harbors did not extend to claims not specifically described in section 546(e). Thus, the Court did not dismiss the remaining twenty-seven counts relating to claims such as to common law legal doctrines, turnover of estate property, and equitable subordination.

[6] Id. at *23.

Conclusion

The Court's decision, which extends to nearly one hundred pages, is significant in that it sheds light on several issues of first impression. It also shows, however, that the safe harbors will not protect against every claim that could arise out of a trading relationship.

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