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Clear Contractual Terms Beat Equitable Principles — Again

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Bankruptcy courts in the U.S. are widely viewed as favorable fora for debtors, trustees and creditors committees to pursue creative and difficult causes of actions against deep-pocket lenders and others in an attempt to augment the resources available for distributions to creditors. In yet another case, however, the U.S. District Court for the Southern District of New York (after withdrawing the litigation from the bankruptcy court), recently dismissed many of the claims asserted by the Lehman debtors against JPMorgan Chase Bank NA, which were based on the alleged inequitable conduct of JPM.

The court held that a creditor could not be held liable for (aggressively) protecting its own interests when the plain language of the relevant documents permitted the actions taken by the creditor. The decision was issued in Lehman Brothers Holdings Inc v. JPMorgan Chase Bank NA, No. 11-cv-7670 (RJS) (S.D.N.Y. Sept. 30, 2015) and arose out of an adversary proceeding initiated by Lehman Brothers Holdings Inc. (LBHI) and its affiliated debtors (collectively, the “debtors”) against JPM.

The debtors advanced multiple causes of action and theories against JPM, alleging that JPM improperly and unfairly appropriated value from the debtors (thus harming their creditors) in the months leading up to LBHI’s bankruptcy filing by allegedly strong-arming the debtors into providing it with additional collateral and protections. The court, however, entered summary judgment against LBHI on nearly all counts because it found that the written contracts between JPM and LBHI expressly permitted JPM’s purportedly inequitable actions. The facts, as described herein, are based on the facts and allegations contained in the court’s opinion.

Background

At all relevant times, JPM served as the primary bank and credit provider to Lehman Brothers Inc. (LBI),

a wholly owned subsidiary of LBHI that provided broker-dealer services to investors. Specifically at issue in the action was JPM's role as a clearing bank in LBI's tri-party repurchase transactions, or "tri-party repos" transactions whereby one party sells an asset to another party with a promise to repurchase that asset at a specified future time, and a third-party clearing bank acts as an intermediary between the parties. JPM acted as a clearing bank in LBI's tri-party repos and provided credit support for the transactions by allowing LBI to borrow cash throughout the day. JPM's obligations were defined by a clearance agreement between LBI and JPM's predecessor in interest. As further detailed below, the clearance agreement was amended and supplemented numerous times in the months leading up to LBHI's bankruptcy filing.

In June 2008, in response to request from the Federal Reserve to JPM to limit its exposure to the clearance market, JPM negotiated with LBHI for a pledge by LBHI of an additional $5 billion in securities collateral to secure JPM's advances of intraday credit to the debtors. In August 2008, as the debtors' financial condition worsened, the parties entered into amendments and supplemental agreements regarding the clearance agreement that provided for a guaranty of LBHI's obligations, granted JPM a lien over LBHI's accounts, and required LBHI to post collateral to guarantee the debtors' intraday trading obligations to JPM. On Sept. 9, 2008, LBHI's stock had declined precipitously and JPM required an additional "broad-based" pledge of collateral the next day for JPM to continue providing credit to the debtors. By Sept. 12, 2008, LBHI had pledged an additional $1.7 billion in money-market funds and $6.9 billion of cash collateral to JPM to induce it to continue lending.

LBHI filed for bankruptcy on Sept. 15, 2008. The debtors filed a motion on Sept. 16, 2008, requesting a "comfort order" that the automatic stay did not bar JPM from providing post-petition credit to the debtors under the clearance agreement and related contracts. The request was based in part on the need to continue the business pending a sale to Barclays Capital Inc. The sale closed on Sept. 22, 2008. In October 2008, JPM applied funds from the debtors' accounts to satisfy obligations under the clearance agreement and related contracts, and in partial satisfaction of other obligations from the debtors to JPM.

In September 2010, the debtors filed an adversary complaint against JPM in the bankruptcy court, seeking damages and a return of the $8.6 billion in collateral that JPM received from LBHI in September 2008. The action was removed from the bankruptcy court and came before the district court on JPM's motion for summary judgment and the debtors' motion for partial summary judgment.

Opinion

The debtors' principal argument against JPM was that JPM had improperly used its leverage as primary lender to the debtors while the debtors were financially distressed to appropriate value for itself, specifically by refusing to extend credit to the debtors unless LBHI provided additional security for the loans. The court noted that this allegation rested "on the fundamental premise that [JPM] was obligated to extend credit to Lehman under its credit agreement and that, therefore, [JPM]'s demands, conditioning extensions of credit on obtaining additional collateral, were wrongful."

The clearance agreement, however, provided that JPM could "solely at [its] discretion, permit [LBI] to use funds," that all loans by JPM would be payable on demand, and that JPM could "at any time decline to extend such credit at [its] discretion, with notice[.]" The court found that this language plainly gave JPM the right, in its discretion, to refuse to extend credit to LBI, therefore entitling it to refuse to continue to make loans to LBI in September 2008 without additional security.

The Notice Element

The debtors argued that the requirement that JPM give "notice" of its refusal to extend credit meant that JPM had to give commercially reasonable notice, which could have meant months or even a year's notice that JPM intended to stop lending. The court rejected the debtors' argument and held that a mere requirement to give "notice" without any defined notice period (such as a set number of days or months) "unambiguously means 'accompanied by notice at any time before the noticed event occurs,'" especially given that temporal notice periods were specified elsewhere in the clearing agreement.

Nevertheless, the debtors argued that the implied covenant of good faith and fair dealing obligated JPM to refrain from insisting on additional security for its loans that would worsen the debtors' financial distress. The court noted that established New York state law generally does not apply the implied covenant of good faith and fair dealing when an implied obligation would be inconsistent with other contract terms; thus, JPM could not be obligated to lend to the debtors when the clearance agreement expressly provided it with discretion to stop lending. The court further noted that "lender liability" claims such as the implied obligations asserted by the debtors had been largely discredited by the Second Circuit as contrary to parties' written intent. Especially where both parties are sophisticated, courts have become increasingly hesitant to second-guess the terms the parties bargained for.

Hell or High Water Clauses

The debtors challenged the enforceability of one the September agreements that provided for a guaranty of LBHI on the basis that the guaranty was supported by insufficient consideration from LBHI and had been signed by an individual without authority to bind LBHI. JPM argued that LBHI's arguments were foreclosed by a waiver clause in the agreement, referred to as a "hell or high water clause" under New York law, which stated that LBHI's obligations under the agreement were absolute and unconditional regardless of "any lack of validity or enforceability" of the loan documents, and further provided that LBHI "irrevocably waiv[ed] the right to assert such defenses, setoffs our counterclaims in any litigation[.]"

Although the debtors argued that the hell or high water clause was unenforceable against them because the clause did not specifically waive a challenge based on lack of consideration or authority, the court noted that hell or high water clauses are enforced whenever (1) both parties are sophisticated and (2) their terms are clear and unambiguous. JPM and LBHI were both sophisticated parties represented by counsel when drafting the documents, and a waiver of "all defenses" such as the one LBHI granted in its hell or high water clause is considered clear and unambiguous of the parties' intent to waive a specific claim such as for insufficient consideration or lack of authority.

Ratification

In addition to finding that the hell or high water clause validly waived LBHI's claims against the enforceability of the September guaranty agreement, the court also held that the debtors had ratified the September agreements by their conduct before the bankruptcy court. As above, the day after filing for bankruptcy, LBHI sought a comfort order from the bankruptcy court stating that the automatic stay did not apply to JPM's ability to advance post-petition credit to the debtors under the clearance agreement and related documents. By accepting the benefits of its credit arrangements with JPM and seeking to enforce them, the court deemed LBHI to have ratified the validity of the agreements under the principle that a party's actions (or even inaction) can indicate that they consent to the contract's validity and enforceability.[1] The court reasoned that LBHI could have argued before the bankruptcy

court that the agreements were unenforceable, but chose instead to accept the benefits of JPM's credit. Thus the court also held that LBHI's actions in bankruptcy court waived any claim for breach of contract or breach of any implied covenant.

Fraudulent Inducement

Another of the debtors' key claims was that JPM had fraudulently induced LBHI to enter into supplemental agreements and amendments to provide additional security to JPM under the clearance agreement. There was a dispute over the circumstances of the September agreements between LBHI and JPM, as LBHI's witnesses insisted that LBHI only posted an additional $5 billion in collateral on Sept. 12, 2008, on the promise of JPM to return the cash by close of business on that same day, while JPM's witnesses insisted that it had never made the promise.

In order for LBHI to prevail on a fraudulent inducement claim, it would have had to show that it had reasonably relied on JPM's promise in posting the collateral. Even though the occurrence of the promise was a disputed material fact, the court once again granted summary judgment for JPM by deferring to the written language of the parties' agreements. The security agreement at issue stated that funds held as collateral by JPM could be returned only upon a three days' written notice, and thus, the provision could not have been modified orally. The court, relying upon precedent holding that a party cannot reasonably rely on an oral modification to an agreement where the agreement requires written modification, held that LBHI could not have reasonably relied on JPM's alleged promise because the security agreement would not have allowed JPM to orally amend the three-day notice period for return of securities.

Actual Fraud

The debtors also claimed that the transfers to JPM should be undone because LBHI had fraudulently transferred the additional collateral to JPM. The bankruptcy court had already dismissed LBHI's claims of preferential or constructively fraudulent transfer, so LBHI could only avoid the transfers by demonstrating that they were made with an actual intent to defraud creditors under 11 U.S.C. § 548. The debtors made two arguments to support their claim that LBHI had an affirmative intent to defraud creditors: first, that JPM's intent to increase its recovery at the expense of the debtors' other creditors should be imputed to LBHI, and second, that there were sufficient circumstantial badges of fraud to indicate that LBHI had fraudulent intent.

Regarding the first argument, courts do not impute a creditor's intent to a debtor in a fraudulent conveyance action unless the creditor has "actual control" over the debtor, which implies an insider relationship.[2] Here, the court found that the debtors did not even allege that JPM actually controlled LBHI and that any such claim would have failed because creditors do not exercise actual control over a debtor merely by virtue of having financial leverage over them.

Next, the court rejected the claim anchored on the alleged badges of fraud. The court rejected LBHI's claim that JPM having leverage over the debtors was a badge of fraud, since leverage alone is insufficient circumstantial evidence to establish fraudulent intent. The debtors' other three alleged badges of fraud — inadequate consideration, lack of arm's-length relationship, and the haste and secrecy of the transfers — fared no better. The court found that LBHI received sufficient consideration for the transfers because JPM was not obligated to continue lending, and its decision to do so during a critical time constituted consideration for the transfers. Furthermore, the negotiations between JPM and LBHI demonstrated that the deal was arm's-length; JPM might have been a tough negotiator, but

this was different from a transfer based on a close, insider relationship between debtor and creditor. Lastly, the court held that the transfer was not done “in secrecy” as it had never been misrepresented to the public, and that under the circumstances JPM was justified in insisting on haste as a condition of its extension of credit.

The court entered summary judgment for JPM on the majority of the claims asserted in the complaint, excepting only claims for avoidable setoff, violation of the automatic stay and equitable subordination due to the existence of material factual issues in dispute.

Implications

The LBHI decision is in line with recent Second Circuit decisions in which courts have been unwilling to find ambiguity in a contract in order to consider equitable arguments and defenses regarding a creditor’s conduct.[3] Especially where contract parties are sophisticated, courts give weight to the fact that each provision in the contract was likely heavily negotiated and that each word was chosen for a specific purpose.

Although bankruptcy courts are courts of equity and often import equitable standards, the court in LBHI was unwilling to deviate from the credit documents even when considering LBHI’s claims under the Bankruptcy Code. In light of this trend, potential challenges in bankruptcy cases regarding fraudulent prepetition transfers or other claims based on the creditor’s inequitable actions may not survive dismissal if the underlying credit documents authorized the creditor’s conduct. As the court so plainly stated, “regardless of whether [JPM]’s refusal to extend credit ‘propelled [Lehman] downhill,’ [JPM] merely exercised the rights enumerated in the contract between the parties,” and “a party does not breach an agreement by behaving as the instrument permitted.”

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[1] See, e.g., VKK Corp. v. Nat’l Football League, 244 F.3d 114, 122 (2d Cir. 2001) (party will be deemed to ratify a contract or release if the party does not “promptly repudiate” it).

[2] See, e.g., Nisselson v. Softbank AM Corp. (In re Marktext Holdings Corp.), 361 B.R. 369, 398 (Bankr. S.D.N.Y. 2007) (dismissing claim of actual fraudulent conveyance where contracting parties had adversarial relationship).

[3] See, e.g., Security Plans Inc. v. CUNA Mut. Ins. Soc., 769 F.3d 807, 817 (2d Cir. 2014) (refusing to find breach of implied covenant of good-faith and fear dealing where contract expressly condoned defendant’s action and granted it broad discretion to use its business judgment).

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