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Insolvency doesn't justify rewriting agreement to weaken creditor's rights

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In history's largest Chapter 11 case, a U.S. District Court has delivered a victory to the secured lender whom Lehman Brothers Holdings Inc. had accused of illegally accelerating its fall by squeezing billions of dollars of collateral out of the teetering investment bank shortly before it toppled into bankruptcy.

By substantially granting the lender's motion for summary judgment on Lehman's complaint in *Lehman Brothers Holdings Inc. v. JP Morgan Chase Bank, N.A.*, No. 11-cv-6760, 2015 WL 5828216 (S.D.N.Y. Sept. 30, 2015), the court vindicated a fundamental premise of debtor-creditor relations: Sophisticated parties will be held to their agreements, and parties do not violate those agreements by enforcing them aggressively, even harshly, to protect their own interests.

Chase acted as a clearing bank for Lehman Brothers Inc. (LBI), Lehman's broker/dealer subsidiary, pursuant to a "clearing agreement," under which Chase-financed LBI's securities trading business by lending billions of dollars to LBI on a daily basis; those overnight loans were to be repaid each day and were collateralized by securities owned by LBI and pledged to Chase.

During the months before Lehman's bankruptcy, Chase lost confidence in the value of those securities and told LBI that it could not lend without additional collateral from multiple Lehman entities. During the week before Lehman's Chapter 11, Chase obtained $8.6 billion in additional collateral — including virtually all of Lehman's unencumbered cash — which Chase ultimately applied to Lehman's outstanding obligations.

The key terms of the clearing agreement were that all loans by Chase were payable on demand; Chase had discretion to refuse to lend at any time, so long as the refusal was "with notice," and LBI could transfer to third parties securities previously pledged as collateral to Chase only if the value of the remaining collateral held by Chase fully secured all of its outstanding advances to LBI.

Notwithstanding these provisions, Lehman argued that (a) ceasing to lend only "with notice" meant that Chase had to give LBI as much as a year's warning before cutting LBI off; (b) absent lengthy notice, Chase was obligated to continue lending to LBI, and, because (in Lehman's view), Chase's collateral was never worth less than the full amount of Chase's outstanding loans to LBI, Chase's demands for additional collateral were improper attempts to become oversecured, at the expense of LBI and other creditors, and (c) even if the express terms of the clearance agreement permitted Chase's actions, those actions had violated Chase's implied obligation of good faith and fair dealing to LBI.

Secured creditors won an important victory with the decision in Lehman Brothers.

Lehman sought disgorgement of the entire $8.6 billion of collateral, plus additional damages, while Chase moved for summary judgment in its favor on all counts.

In ruling for Chase on most counts, the court rejected Lehman's key assumptions: That courts should relieve contracting parties of the harsh consequences of their own deals and that, just when a borrower's financial weakness makes a lender's negotiated protections most important, it is somehow unfair for the lender to then insist upon those protections.

The court first rejected Lehman's reading of the "notice" requirement. Because LBI's very existence depended so critically on its clearing banks extending billions of dollars in credit every day, Lehman argued that the only reasonable reading of the clearing agreement would require Chase to provide Lehman with as much as a year's notice — and, therefore, to keep funding Lehman for that same period — before withholding credit, even though Lehman was collapsing as Chase watched.

The court disagreed, holding that contracting parties know how to provide for a specific notice period. Because none was specified here, Chase, upon exercising its discretion to stop extending credit, was required only to tell Lehman of that decision.

Moreover, the clearance agreement explicitly made all loans payable "on demand," a fact that underscored the completely discretionary nature of Chase's extensions of credit.

Although Lehman might have preferred months of lead time before Chase ceased to lend, the court held that such notice "is not the notice that Lehman bargained for, and the [c]ourt is not in a position to enhance Lehman's contractual rights after the fact."

The court similarly rejected Lehman's argument that Chase had violated the clearance agreement by demanding more collateral than was necessary to keep its loans to LBI fully secured. Relying again on the text of the clearing agreement (and not on any disputed collateral values), the court found that the "full collateralization" requirement was a right bargained for to protect Chase; it did not "create a right for Lehman to impose a cap on its collateral obligations ...."

In short, the court declined to "rewrite the parties' contractual text ... to provide Lehman with language more beneficial than what it negotiated."

Lehman then appealed to equity: Whatever the express terms of the clearance agreement, Lehman complained, the implied covenant of good faith and fair dealing prevented Chase from threatening to cut Lehman off absent billions in additional collateral.

But the court rejected Lehman's argument: "That [Lehman] is now dissatisfied with the bargain [it] struck and believe[s] that [Chase] behaved badly in enforcing its terms is of no moment ... Put simply, a party does not breach an agreement by behaving as the instrument permitted."

Secured creditors won an important victory with the decision in Lehman Brothers. Faltering borrowers, and worried lenders, may both assume that courts addressing an insolvent borrower's rights are so debtor-friendly that they will override a lender's contractual rights, in order to do what, in hindsight, seems "fair."

To the contrary, after closely examining all of their rights and obligations under their agreements, lenders should not hesitate to enforce them. Lehman Brothers made clear that courts should and will enforce unambiguous agreements made by experienced parties, and that, while such enforcement might be painful for the debtor and other creditors, it is neither illegal nor unfair.