Client Alert

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Second Circuit Court of Appeals Looks at "Commercial Reality" in Deciding Lehman / Barclays Dispute

In a closely watched dispute impacting creditors of the Lehman Brothers, Inc. ("LBI") bankruptcy estate, on August 5, 2014, the U.S. Court of Appeals for the Second Circuit ruled that while "ambiguities" existed in the expedited sale of Lehman's brokerage business to Barclays Capital, Inc. ("Barclays") during the financial crisis in September 2008, transaction documents supported Barclays' position that it had title to certain disputed assets. While the ruling should not impact prior distributions received by creditors, it may affect future payouts to creditors and already appears to have negatively impacted trading of LBI debt.

At issue was title to the $4 billion of "margin assets" (cash that had been maintained by LBI in accounts at various financial institutions as collateral in connection with its exchange-traded derivative business) and $1.9 billion of "clearance box assets" (unencumbered securities held in LBI's clearance box accounts at The Depository Trust & Clearing Corporation ("DTCC")).

The LBI trustee argued that LBI was entitled to the margin assets because "cash" was treated as an "Excluded Asset" under the asset purchase agreement. The LBI trustee also argued that LBI was entitled to the clearance box assets, notwithstanding conflicting language in the "Clarification Letter" previously filed by the parties with the bankruptcy court in response to certain issues raised with respect to the transaction, because the parties and DTCC had executed a letter ("DTCC Letter"), which suggested that the relevant accounts of LBI constitute "Excluded Assets" under the asset purchase agreement.

In February 2011, U.S. Bankruptcy Judge James Peck ruled that Barclays was entitled to the LBI clearance box assets but not the margin assets.

In July 2012, U.S. District Judge Katherine Forrest partially reversed Judge Peck, ruling that Barclays was entitled to both categories of assets.

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The Second Circuit examined the terms of the asset purchase agreement along with the Clarification Letter that was filed with the bankruptcy court immediately following the September 2008 sale hearing.

Upholding the District Court's decision, the Second Circuit noted that "ambiguities and loose ends were inevitable" given the "urgency under which this deal was executed." But nonetheless, the Second Circuit did not find any ambiguity with respect to the margin assets. The bankruptcy court ruled that the margin assets were not sold as a result of the asset purchase agreement's exclusion of "all assets primarily related to . . . derivatives contracts" and the general exclusion of "cash" from the sale assets. However, while the asset purchase agreement and the Clarification Letter showed that, despite the emphasis in documents and court hearings that "no cash" should be involved, the Second Circuit ruled that it was clear that "cash" meant unencumbered cash and not cash that was collateral with LBI's exchange-traded derivative business. The Second Circuit observed that a buyer such as Barclays might have otherwise deemed the purchase commercially unacceptable. The Court stated: "It would be highly unusual for a buyer to purchase LBI's ETD business in its entirety but not the collateral that allowed that business to exist, particularly in a time of economic crisis when the value of the underlying assets, e.g., options and futures, would be extremely volatile."

With respect to the clearance box assets, the Second Circuit ruled that these assets were also sold to Barclays. The Second Circuit supported its ruling by applying the maxim in contract interpretation that the "specific governs the general." Specifically, the Court tracked the bankruptcy court's finding that the Clarification Letter, which was submitted after the DTCC Letter, contained more detail than the DTCC Letter, including a schedule to the Clarification Letter that identified individual clearance box assets. The Court concluded that the specificity of that schedule trumped the generality of the DTCC Letter, which had no such schedule. To the extent any ambiguity remained in the DTCC Letter, such ambiguity was to be resolved by the extrinsic evidence, which was comprised of (i) the parties' course of conduct in itemizing the clearance box assets in the schedule to the Clarification Letter as well as an email written by DTCC's outside counsel to the effect that DTCC agreed to accept a $250 million guarantee from Barclays in return for a relinquishment of the clearance box assets and (ii) deferring to the commercial reality of the transaction, which "saw DTCC incur losses far below the $250 million guarantee provided by Barclays, who took on the lion's share of the risk," meaning that, in the Second Circuit's view, Barclays would likely never have agreed to guarantee DTCC's losses if it could not reap the benefit of owning the clearance box assets.

Given the chaos of the financial crisis and the expedited nature of the sale, it is not entirely surprising that ambiguities and uncertainties existed in

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connection with the LBI transaction. Market participants can take comfort in the Second Circuit's examination of the context and "commercial reality" of the transaction, at least as one component of the analysis, in deciding the dispute.

For more information regarding the LBI / Barclays decision and its implications, please contact the Olshan attorney with whom you regularly work or either of the attorneys listed below.

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