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Lehman Decision Transmutes Structured Finance Investors into General Unsecured Creditors

Leo T. Crowley and Margot P. Erlich*

The U.S. Bankruptcy Court for the Southern District of New York recently ruled that Lehman Brothers Holdings Inc. cannot subordinate securities fraud claims filed by holders of mortgage-backed securities under Bankruptcy Code Section 510(b) even though a Lehman Brothers affiliate and co-debtor was the depositor of, and considered the issuer for securities law purposes of, the mortgage-backed securities. The authors of this article discuss this very significant ruling and its consequences.

Recently, in a case of first impression, the Honorable Judge Shelley Chapman, U.S. Bankruptcy Judge for the Southern District of New York, ruled that Lehman Brothers Holdings Inc. ("LBHI" and together with its affiliated debtors, the "Debtors") cannot subordinate securities fraud claims filed by holders of mortgage-backed securities ("MBS") under Bankruptcy Code Section 510(b) even though an LBHI affiliate and co-debtor, Structured Asset Securities Corporation ("SASCO") was the depositor of, and considered the issuer for securities law purposes of, the MBS.[1]

The ruling is very significant and, as discussed below, problematic. MBS represents just one type of structured finance vehicle. Diversified financial conglomerates issue enormous volumes of those and many other types as well, e.g., credit card receivables, auto loans, student loans, etc. The essence of a structured finance vehicle is that the sponsor engages in a "true sale" of financial assets to a special purpose vehicle, typically a trust, which acquires the financial assets and in exchange transfers to the sponsor certificates evidencing ownership interest in the trusts assets. The sponsor then sells the securities in the capital markets either through a public offering or private placement. The structure has clearly delineated characteristics on which all parties rely:

- the investors in the structured finance vehicle ("certificate holders") have exclusive rights to the financial assets in the vehicle, to the exclusion of creditors of the sponsor and the sponsor's affiliates;

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[1] *In re Lehman Brothers Holdings, Inc., et al.*, No. 08-13555 (Bankr. S.D.N.Y. July 28, 2014).

- certificate holders have no recourse to the sponsor, the sponsor's affiliate or any of their assets; with limited exceptions their recourse is to the financial assets in the pool. These limited exceptions involve breach of contract claims for breaches of representations and warranties as to the characteristics of the financial assets contributed to the pool. The proceeds of such claims would go directly into the pool and represent another type of financial asset available for distribution to certificate holders; and
- creditors of the sponsor and the sponsor's affiliates have no recourse to assets in the pool, such assets having been sold.

The securities laws treat the sponsor entity known, as the "depositor" of the financial assets into the pool, as the "issuer" of the securities. The depositor is the sponsor or sponsor affiliate that is the actual transferor of the financial assets into the pool.

FACTS IN LEHMAN

Between May 2006 and November 2007, Federal Home Loan Bank of Pittsburgh ("FHLB") purchased MBS associated with six different non-debtor trusts (the "Trusts"). The MBS represented an ownership interest in a trust fund that consists primarily of pools of mortgage loans. In the case at hand, LBHI either originated the mortgage loans or purchased such loans from third party originators.[2] These mortgage loans were transferred to SASCO and deposited into the Trusts. The Trusts did not have any reporting obligations, employees, officers or directors and thus SASCO, as the depositor of the mortgages into the Trusts, was the "issuer" of the MBS for federal securities law purposes.[3] SASCO as depositor was therefore responsible for the accuracy of the prospectuses under which the MBS were sold.

FHLB filed two claims in the LBHI case seeking damages stemming from alleged material misrepresentations and omissions in the registration statements, prospectuses, prospectus supplements and other related offering documents prepared by and distributed by the Debtors in connection with the marketing of the MBS purchased by FHLB in purported violation of the securities law.[4] LBHI objected to these claims, arguing that they should be subordinated under Bankruptcy Code Section 510(b) which provides that claims "arising from the rescission of a purchase or sale of a security of the

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[2] *Id.*

[3] *Id.*

[4] *Id.*

debtor or an affiliate of the debtor, for damages arising from the purchase or sale of such security . . . shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security."[5]

All parties appeared to agree that the FHLB claims involved a security and were for damages arising from the purchase or sale of a security but vehemently disagreed on whether such security was "of the debtor or an affiliate of the debtor" for purposes of Section 510(b).

The Debtors urged the court to focus on the term "issuer" and because SASCO is the issuer for securities law purposes (the very law upon which FHLB's claims were based), the MBS are therefore securities "of a debtor."[6] Alternatively, the Debtors argued that, even if the MBS are not direct securities of the debtors but rather are deemed securities of the Trusts, since the Trusts are affiliates of the Debtors, the MBS should be deemed securities of an affiliate of the Debtors.[7] Additionally, the Debtors argued that subordination of these claims comports with Section 510(b)'s policy of preventing holders of securities fraud claims against a debtor from bootstrapping their way to parity with unsecured creditors as it would preclude FHLB's efforts to receive a recovery not only from the pool of mortgage loans for which it bargained (and to which it is entitled) but also from the Debtor's assets from which its general unsecured creditors could seek a recovery.[8]

FHLB responded to the Debtors' arguments by arguing that the Trusts issued the MBS and are the "issuing entity" and the offering materials clearly state that the MBS represent interests in the Trusts only and will not represent interests in, or obligations of, the sponsor, the depositor, or any of their affiliates. Therefore, for purposes of Section 510(b), FHLB argued that the MBS are not securities of the Debtor.

The court ultimately agreed with FHLB and found that, while the MBS are

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[5] 11 U.S.C. 510(b).

[6] *In re Lehman Brothers Holdings, Inc., et al.*, No. 08-13555 (Bankr. S.D.N.Y. July 28, 2014).

[7] *Id.* The court did not fully address the "affiliate" point, other than in a footnote, where it stated the Trusts were not affiliates of the Debtors under Section 101(2)(C) of the Bankruptcy Code and cited the *Washington Mutual* court's finding that the "Debtors have not adequately proven that the Pooling and Servicing Agreements constitute an operating agreement under the plain meaning of the statute" in support thereof. *Id.* (quoting *In re Wash. Mut., Inc.*, 462 B.R. 137, 145-146 (Bankr. D. Del. 2011)). There is an open issue as to whether a servicing agreement is an "operating agreement." The consequence of that would be that the recipient of services, i.e. the trust, would be a debtor "affiliate." Given the broad powers and responsibilities allocated to servicers this is a viable issue for future litigation.

[8] *Id.*

debt securities, they are not securities of the debtor or an affiliate of the debtor and therefore do not fit into the statutory framework of Section 510(b).[9] Because the obligations underlying the MBS are tied to the mortgage loans owned by the Trusts and FHLB does not have any direct (or indirect) right to demand repayment from any of the Debtors, the court would not agree that FHLB's claims should be subordinated.

Although the court's decision did not hinge one way or another by its characterization of the MBS as "debt," such characterization is highly questionable. Generally an MBS transaction is in effect a single business which consists of owning, and gradually liquidating, underlying mortgages. MBS have no maturity, and the certificate holders have no contractual right to sue for their principal. To the extent one wanted to analogize them to traditional corporate securities, they are more akin to preferred stock having a fixed dividend yield (payment of which is subject to conditions) and a liquidation preference as principal comes in and the underlying mortgages are either repaid, or liquidated through foreclosure or borrower bankruptcy. Although a number of cases have characterized such securities as a "bond,"[10] that is not an accurate characterization.

In overruling the Debtors' objection to FHLB's claims, the court primarily focused on the plain language of Section 510(b), which Judge Chapman stated does not include the term "issuer" nor does it refer to securities "issued by" or "sold by" the debtor.[11] Therefore, the court held that "if Congress had intended to include the terms 'issuer' or 'issued by' in Section 510(b), it would have done so explicitly. Stated differently, the Court declines to conclude that the word 'of' means 'issued by.'"[12] Additionally, the court found that the fact that SASCO was deemed the issuer of the MBS for securities law purposes was irrelevant and does not mean that creditors could look to that entity for repayment.[13]

LEGISLATIVE INTENT/POLICY ISSUES

While the court did not feel it was necessary to resort to the intent and legislative history behind Section 510(b), it nonetheless found that if the court

[9] *Id.*

[10] *E.g.*, *CW Capital Asset Mgmt., LLC v. Chicago Properties, LLC*, 610 F.3d 497, 499 (7th Cir. 2010).

[11] *In re Lehman Brothers Holdings, Inc., et al.*, No. 08-13555 (Bankr. S.D.N.Y. July 28, 2014).

[12] *Id.*

[13] *Id.*

were to look at such intent, the outcome would be the same. According to the court, "Section 510(b) was added to the Bankruptcy Code to ensure that shareholders, who have bargained to receive the benefit of the proceeds of a company in exchange for bearing the corresponding risk of loss, cannot, upon the company's bankruptcy filing, elevate their claims for illegality in the issuance of the company's stock to the level of unsecured creditors."[14] By its terms, however, Section 510(b) is not limited to equity securities and there is no dispute that it is applicable to other types of securities, including, e.g., debt securities. However, there is no requirement in Section 510(b) that the security in question be shares of stock or bonds or notes. And no one has seriously questioned that the MBS are in fact securities. The court reasoned that because FHLB received no beneficial interest in the profits of a Debtor and the MBS were not tied to the performance of any Debtor but rather to the underlying performance of the pooled mortgage loans owned by the Trusts, FHLB held no position in the Debtors' capital structure and the inherent risk of bootstrapping from one position in the capital structure to another was not present.[15]

The court was overly influenced by the fact the MBS holders did not have recourse to a debtor, and cited a decision in the Washington Mutual case likening the situation to that of a debtor selling third-party securities of, e.g., Apple stock.[16] First, of course, here the Debtors structured the MBS and received all of the proceeds of their sale, with the purpose and effect of taking the financial assets off of their balance sheet in a transaction the very design of which was to limit recourse as described above.

Second, there is no condition in Section 510(b) that the security entails potential recourse against a debtor or debtor affiliate in order for it to be a security "of the debtor or of an affiliate of the debtor." The court created such a condition but that cannot be squared with the Bankruptcy Code. Consider a situation in which a plain vanilla security (stock or bond) is issued by a non-debtor affiliate in circumstances in which the security by its nature never will represent an equity or debt claim against a debtor, e.g., an affiliate of which some of the equity is publicly held. The Bankruptcy Code's definition of affiliate includes any entity in which 20 percent or more of the voting equity is held by a debtor. The value of the securities in question could have fallen, whether or not due to the bankruptcy of the debtor, and the security holder may feel that it has a securities fraud claim against the debtor-affiliate. There is no doubt that under the plan language of Section 510(b) that such claim would

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[14] *Id.*

[15] *Id.*

[16] *Wash. Mut., Inc.*, 462 B.R. at 147.

be subordinated. It would make no difference that the security, if equity, did not represent an ownership interest in any debtor and, if debt, did not represent a debt claim against any debtor. So it cannot be the case that, as the Lehman ruling indicated, Section 510(b) is only triggered if the securities in question are tied "to the financial wherewithal" of a debtor, or entitled to receive a payment stream from a debtor, or "tied to the performance" of a debtor.[17] No such limitation is stated in the Code.

Third, when the "issuer" of the security is a debtor as is the case here, there is a heightened risk of securities law liability. Issuers have strict liability under Section 11 of the 1933 Act for materially false or misleading statements in a prospectus, unlike others such as underwriters who may have a due diligence defense.

While complex financial products marketed by Wall Street today (such as MBS) may not have been in existence when the seminal article by John J. Slain and Homer Kripke was published in 1973[18] or when the Bankruptcy Code was enacted in 1978 does not mean that the legislative history and policy concerns behind Section 510(b) should be read so narrowly. The Slain and Kripke article (which the legislative history behind Section 510(b) largely endorses) begins with stating that while the absolute priority rule (i.e. in bankruptcy cases, stockholders seeking to recover their investments cannot be paid before creditor claims are satisfied in full) is widely accepted in legal and commercial communities, there is nonetheless a class of cases not subject to this rule. In such cases, when a dissatisfied investor attempts to rescind a purchase of stock or subordinated debt by proving such purchase violated securities laws, that investor's claim either shares *pari passu* with, or is preferred to, general unsecured creditors. Such rescission claims have two characteristics in common, according to Slain and Kripke: (i) they disappoint a general unsecured creditor's expectation that its claim will be paid ahead of equity claims; and (ii) they assume that interests protected by securities regulations should take precedence over all other interests normally taken into account when dealing with claims against a troubled company.

While the examples used in the Slain and Kripke article focused on a rescinding stockholder, they fully acknowledged that the discussion was equally applicable to holders of subordinated debentures and to other creditors whose

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[17] *In re Lehman Brothers Holdings, Inc., et al.*, No. 08-13555 (Bankr. S.D.N.Y. July 28, 2014).

[18] *The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Between Securityholders and the Issuer's Creditors*, 48 N.Y.U. L. Rev. 261 (1973) ("*Slain and Kripke*").

debt securities are contractually subordinated.[19] Thus the authors did not intend for their concerns to be limited and narrow in scope.

According to the legislative history of Section 510(b), the law with respect to rescinding security holders was dramatically changed by the 1937 case of *Oppenheimer v. Harriman National Bank & Trust Co.,* where the Supreme Court unanimously held that a plaintiff stockholder's claim (which rescission claim was based on reliance upon a misrepresentation by the bank's officer) was allowable as a general unsecured claim; thus allowing the shareholder to be treated like any other holder of an unsecured nonpriority claim.[20] Many lower court cases thereafter followed the exception carved out of the absolute priority rule in *Oppenheimer* without regard to the impact such rulings would have on general unsecured creditors. Since *Oppenheimer* involved a relatively small isolated claim of $12,000, the Supreme Court may not have anticipated the possibility that rescission type claims in subsequent cases would be so large as to dilute materially the value of assets available for distribution to creditors.[21] The purpose of Section 510(b) is to preclude such outcomes in the future.

CONSEQUENCES OF LEHMAN RULING

Similar concerns arise when the possible impacts of the *Lehman* case are analyzed. There are trillions of dollars of structured finance vehicles such as MBS in the market. In the context of a major financial conglomerate, the amount of potential securities fraud claims by certificate holders could swamp a bankrupt's estate. To take one example, in the three years ended December 31, 2007 affiliates of Washington Mutual Inc. had sold approximately $340 billion of structured finance securities, most of which were MBS.[22] In the case of Lehman, in the years 2005 and 2006 alone it securitized approximately $280 billion of residential mortgage loans.[23] If securities fraud claims in respect of the hundreds of billions of dollars of MBS and other structured finance vehicles could compete on a *pari passu* basis with real creditors who actually extended financial or trade credit in reliance on balance sheets that did not contain liabilities for the structured finance vehicles, such claims could substantially dilute the recoveries of real creditors.

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[19] *Slain and Kripke* at 268.

[20] 301 U.S. 206 (1937).

[21] *Slain and Kripke* at 271.

[22] As reported in note 6 to the annual financial statements of Washington Mutual Inc. for the years ended December 31, 2006 and 2007.

[23] As reported in the Lehman Brothers Holdings Inc. Form 10-K for the year ended December 31, 2007, at p. 41.

The legislative history behind Section 510(b) found that the authors of the Slain and Kripke article concluded that "allocation of assets in a bankruptcy case is a zero-sum situation, and that rules of allocation in bankruptcy should be predicated on allocation of risk. The two risks to be considered are the risk of insolvency and the risk of an unlawful issuance of securities."[24] Furthermore, "while both security holders and general creditors assume the risk of insolvency, Slain and Kripke conclude that the risk of illegality in securities issuance should be borne by those investing in securities and not by general creditors. Placing rescinding shareholders on parity with general creditors shifts the risk of an illegal stock offering to general creditors."[25]

Applying these principles in the structured finance context, there are two competing bodies of creditors. The first consists of those who actually extended trade or financial credit to a debtor, presumptively (especially in the case of a financial creditor) in reliance on a balance sheet that does not reflect structured finance liabilities and as to which the only disclosed liability is the contingent one for repurchase of financial assets for breach of a representation or warranty. The other class consists of certificate holder investors who bought an investment, a central attribute of which was that it had exclusive rights to assets in a segregated pool, but no general claim on the assets of the sponsor. Slain and Kripke correctly focus on reasonable investor expectations. The likelihood that real creditors would have expected to have to share their recoveries with those who bargained for sequestered assets, but not a balance sheet claim against the sponsor, is remote. Conversely, the investors in MBS knew the following:

- they had no recourse to the sponsor's balance sheet;
- the sponsor or its affiliate was the "issuer" of the securities and therefore at a minimum they had a serious risk of subordination under Section 510(b); and
- they retained exclusive rights to the assets which were sold in the true sale to the securitization pool, a large benefit not available to general unsecured creditors.[26]

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[24] H.R. Rep. No. 95-595, at 195 (1978) *reprinted in* 1978 U.S.C.C.A.N. 5963, 6156.

[25] *Id.*

[26] In *Nationsbank, N.A. v. Commercial Fin. Serv.*, 268 B.R. 579, 592 (Bankr. N.D. Cal. 2001), the court in discussing Section 510(b) generally, stated that one policy reason for that section is to shift the risk of fraud and insolvency by requiring "subordination of claimants who voluntarily assume the risk of fraud and insolvency by purchasing a security in order to obtain potential benefits beyond those of a general unsecured creditor . . . the expectation of a purchaser of a security can include . . . benefits unavailable to general unsecured creditors." In the case of MBS, certificate holders obtain an enormous benefit—the true sale of assets from the

And all parties knew (or could have ascertained) that the volume of outstanding MBS potentially dwarfed the on-balance sheet liabilities of the sponsor. In this context, to say that the MBS investors can assert a *pari passu* claim for securities fraud against the sponsor, while retaining their ownership of the assets in the pool, puts them in a position akin to a secured creditor with a deficiency claim, asserted in the form of a securities fraud claim. No one bargained for that outcome, and that outcome if generally accepted would be a game changer in future insolvencies of financial services companies.

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sponsor's balance sheet into a separate entity whose assets are available only to them.