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Editorial Office
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Avoiding Collateral Damage: Whose Pledged Assets Are They Anyway?

By Les Jacobowitz, Brooke Fodor, Megan (Woodward) Daily, Justin A. Kesselman, Alan S. Dubin, Matthew R. Bentley, and Malia K. Benison*

In this article, the authors discuss the practice of repledging.

The practice of repledging (sometimes referred to as "rehypothecation") is utilized in, among others, loan, swap, and brokerage transactions. In connection with troubled financing institutions, it may be a classic example of borrowing from Peter to pay Paul and was a focus during the 2008 financial crisis with the bankruptcy of Lehman Brothers. Following the recent collapses of FDIC-insured Silicon Valley Bank, Signature Bank, First Republic Bank, Heartland Tri-State Bank, and Credit Suisse, an in-depth analysis of this common practice deserves renewed attention.

REPLEDGING

In a typical secured transaction, a borrower pledges an asset (in most cases this involves securities, although it is possible that the pledged asset can be trade receivables or other collateral) to a lender as collateral to secure a loan.[1] The borrower retains ownership rights to the asset unless there is a default, in which event the lender is entitled to sell or retain the collateral.

What many borrowers fail to appreciate, however, is that despite the borrower's pre-default retention of ownership rights to the collateral, many standard loan documents permit the lender to further pledge the borrower's collateral, to secure the lender's own obligations to a third-party lender, and to facilitate the lender in making a new loan to a third-party borrower. This repledging could occur at any time, even prior to a default.

Moreover, if a lender repledges the borrower's collateral, and the lender thereafter becomes insolvent, then the borrower's only rights could be as an

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[*] The authors, attorneys with ArentFox Schiff LLP, may be contacted at les.jacobowitz@afslaw.com, brooke.fodor@afslaw.com, megan.daily@afslaw.com, justin.kesselman@afslaw.com, alan.dubin@afslaw.com, matthew.bentley@afslaw.com and malia.benison@afslaw.com, respectively. 2023 Summer Associates Denny Peixoto and Alexis Mozeleski assisted in the preparation of this article.

[1] Although these principles apply to real estate transactions, use of real estate as collateral is less likely to trigger repledging concerns. However, this caveat is inapplicable to receivables, securities and general intangibles, which are often pledged alongside real estate in the same transaction.

unsecured creditor vis-à-vis its own collateral in the lender's bankruptcy or receivership proceeding.

A WORD ABOUT NOMENCLATURE

This article refers to the borrower as "Borrower," the lender as "Original Lender," the bank swap counterparty as "Original Co-Lender" (who is most often the same as, or an affiliated entity of, Original Lender), and the third-party beneficiary of lender's repledge of the borrower's collateral as "Bank Lender."

REPLEDGING IMPACT

While the original example of repledging that we provided above was of a lender using property pledged as collateral by a borrower to secure the lender's obligations to a third-party, repledging can occur in a variety of different contexts (e.g., (1) a broker, as Original Lender, utilizing securities posted as collateral by the broker's client, as Borrower, (2) a swap provider, as Original Co-Lender, typically securing its obligations to a third-party with the same assets pledged to Original Lender).

Regardless of the types of parties involved, however, repledging is a practice that is completely legal, minimally regulated, and one to which Borrowers routinely consent through execution of standard documentation. However, this likely will only surface as an issue for a borrower when its lending institution is having liquidity issues as potentially occurred in Spring 2023 with certain troubled banks.

STANDARD DOCUMENTATION REGARDING REPLEDGING

Many standard documents (e.g., customer agreements with brokers, loan agreements with lenders, swap agreements with swap bank counterparties) permit repledging without restriction.

For example, the standard documentation for over-the-counter derivative transactions permits Original Co-Lender to repledge without Borrower's consent, and to repledge the pledged collateral before Borrower's default. The standard documentation also provides that if Borrower's pledged collateral is repledged, Original Co-Lender may retain the proceeds for its own use (as opposed to applying them to Borrower's obligations to Original Lender and Original Co-Lender). In addition, standard documentation sometimes permits (or does not prohibit) the repledge of Borrower's collateral in an amount greater than the amounts due to Original Lender.

WHY SHOULD BORROWERS CARE?

In a repledging scenario where Original Lender or Original Co-Lender becomes insolvent, Borrower would become an unsecured creditor, and may receive pennies on the dollar, on its own collateral, in any related bankruptcy proceeding of such lender.[2]

While being unaware of the potential pitfalls of repledging is, at least practically, of little consequence while financial institutions remain stable, the recent bank failures bring repledging into renewed focus.

LESSONS OF LEHMAN

In light of the banking failures of Silicon Valley Bank, Signature Bank and First Republic (as well as Credit Suisse), the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) proposed guidance and rules for larger banks to:

- Develop “living wills” to ensure their orderly liquidation;
- Issue unsecured long-term debt to, among other things, cushion any bank liquidity runs; and
- Enhance bank capital requirements.

This article now discusses the consequences and strategies for Borrowers when Original Lender or Original Co-Lender repledges their collateral and subsequently enters bankruptcy or other insolvency proceedings.

TYPES OF LENDER INSOLVENCIES

When Original Lender or Original Co-Lender becomes insolvent and collapses, it generally will commence a formal process to liquidate its assets for the benefit of creditors. Lenders other than banks may file for bankruptcy under Chapter 7 or Chapter 11 of Title 11 of the U.S. Code (the Bankruptcy Code). Insolvent banks are not eligible for bankruptcy and instead are placed in receivership and liquidated by the FDIC.

Under either regime, it is critical for parties doing business with the failed Original Lender or Original Co-Lender to understand the nature of their exposure and the process for protecting their interests.

SECURED VERSUS UNSECURED CLAIMS

The Bankruptcy Code creates a comprehensive priority scheme for the distribution of a debtor’s property to creditors on account of their claims. Claims secured by a debtor’s property are entitled to be paid in full up to the value of that property.

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[2] A similar analysis would be applied to the bankruptcy of not just Original Lender, but also any subsequent Bank Lender.

In contrast, unsecured creditors receive payments after the satisfaction of all secured creditors, based upon proportionate shares of the unencumbered assets less the amount of the costs of administering the bankruptcy. This often results in the unsecured creditors receiving only relatively small recoveries.

Similarly, in an FDIC receivership, secured creditors are entitled to be paid from their collateral; then administrative expenses of the receivership are paid; then uninsured bank deposits are paid; and finally, general unsecured claims are paid.

LIQUIDATING ORIGINAL LENDER OR ORIGINAL CO-LENDER COLLATERAL

The process for liquidating Original Lender's or Original Co-Lender's assets, which would include collateral pledged to them, typically moves quickly and has significant consequences for creditors with a claim to, or interest in, the property. Debtors frequently commence Chapter 11 bankruptcy cases with a proposal to sell their assets free and clear of any liens, claims, or interests pursuant to Section 363 of the Bankruptcy Code. These transactions are attractive to acquirers of distressed assets because the process moves quickly (21 days' notice unless shortened by the bankruptcy court) and cannot be unwound so long as the bankruptcy court finds that the acquirer acted in good faith.

A free-and-clear sale can have dramatic implications for other parties claiming an interest in the property. As discussed above, in a transaction in which Original Lender has not repledged collateral pledged to it by Borrower, unless Borrower defaults and loses its collateral by foreclosure, Borrower has the right to the return of its collateral once it has paid the obligation secured by the collateral.

However, once Original Lender repledges Borrower's collateral to Bank Lender, if Original Lender cannot pay its obligation secured by the repledged collateral, Original Lender will generally be unable to reclaim the repledged collateral from Bank Lender.[3] At that point, Borrower will only have a contractual right to reclaim its collateral from Original Lender and will not have

[3] This analysis applies in particular to collateral that is marketable securities, including securities that are in securities accounts over which Original Lender has "control" (a Uniform Commercial Code concept).

For example, brokers with discretionary investment authority have control over the clients' securities. Borrowers that pledge marketable securities to Original Lenders often do so in a manner that grants control to the Original Lenders. The Bank Lenders to which the Original Lenders repledge the Borrowers' collateral do not know, and have no diligence obligation to determine, whether the repledged collateral is actually owned by, or only controlled by, the Original Lenders. Since the Original Lenders have control, the Bank Lenders are generally

the right to demand the return of its collateral from Bank Lender. If, at that time, Original Lender is in bankruptcy or receivership, Borrower's contractual claim against Original Lender for the return of its collateral will most likely be converted into a general unsecured claim against Original Lender, leaving Borrower exposed to substantial potential losses.

The bankruptcy cases of Lehman Brothers shine a harsh light on these risks, while also providing a roadmap for future Borrowers facing similar circumstances.

THE LEHMAN TRILOGY

On September 15, 2008, Lehman Brothers, Inc. (Lehman Operating Co.) and certain affiliates commenced the largest bankruptcy case in United States history (and exacerbated the Great Recession), reporting assets and liabilities in excess of $600 billion. Four days later, the bankruptcy court entered an order approving the sale of most of Lehman Operating Co.'s assets (the Sale Order), including approximately $63 million in pledged securities (the Swap Collateral), to Barclays. After the sale, FirstBank Puerto Rico (FirstBank) filed a lawsuit against Barclays for damages and the return of Swap Collateral that it alleged Lehman Operating Co. had no right to sell.

Earlier Repledging

In 1997, FirstBank pledged the Swap Collateral to secure its obligations under an interest rate swap agreement (Swap Agreement) with Lehman Brothers Special Financing, Inc. (Lehman Swap Provider). The obligations of Lehman Swap Provider under the Swap Agreement were guaranteed by Lehman Brothers Holdings, Inc. (Lehman Parent). The Swap Agreement provided that, if Lehman Swap Provider defaulted under the Swap Agreement, it was contractually obligated to return the Swap Collateral to FirstBank. It also afforded Lehman Swap Provider the right to repledge the Swap Collateral, which meant that, if Lehman Swap Provider did default under the Swap Agreement after having repledged the Swap Collateral, it would be obligated to reacquire the Swap Collateral, or substitute comparable collateral, in order to return it to FirstBank.

This pattern occurs in the ordinary course of a swap provider's business, when the collateral pledged to it consists of marketable securities but can be disrupted by bankruptcy or other similar proceedings.

Bankruptcy Filings

Lehman Swap Provider repledged the Swap Collateral to Lehman Operating Co. under a repurchase agreement that granted Lehman Swap Provider the

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entitled to assume that the Original Lenders have the power to transfer complete ownership of the repledged marketable securities.

right to repurchase the Swap Collateral from Lehman Operating Co. However, when Lehman Swap Provider defaulted under the Swap Agreement with FirstBank, it did not repurchase the Swap Collateral from Lehman Operating Co.

Shortly after Lehman Swap Provider defaulted under the Swap Agreement, Lehman Operating Co. and Lehman Parent filed for bankruptcy. The bankruptcy court approved, on an expedited basis, Lehman Operating Co.'s free-and-clear sale of the Swap Collateral to Barclays. The bankruptcy court acted so quickly because of the worldwide implications of Lehman Brothers' bankruptcy. Notice of the sale was not provided to FirstBank. FirstBank sent a notice of default to Lehman Swap Provider but did not demand the return of the Swap Collateral until after the Sale Order had been approved and the Swap Collateral had been sold to Barclays – neither of which FirstBank was aware of. Lehman Swap Provider then filed for bankruptcy.

Court Rulings

In a series of decisions, the bankruptcy court ruled that FirstBank was not entitled to an order requiring Barclays to return the Swap Collateral, even though, as against Lehman Swap Provider, FirstBank was entitled to the return of the Swap Collateral.[4] By having agreed to the repledging provision in the Swap Agreement, FirstBank had also agreed that, once Lehman Swap Provider repledged the Swap Collateral to Lehman Operating Co., FirstBank lost its property interest.

As a result, FirstBank could not sue Barclays for the return of the Swap Collateral or damages because (i) FirstBank had no remaining interest in the Swap Collateral and no contractual relationship with Barclays, and (ii) Barclays was a good faith purchaser with no diligence obligations and was otherwise barred by the Sale Order, even though FirstBank did not receive notice of the sale since the Swap Collateral had already been repledged by Lehman Swap Provider to Lehman Operating Co. (and likely was not required under the underlying documents to receive notice of the original repledge to Lehman Operating Co.).

Under the bankruptcy court's orders, FirstBank had valid breach of contract claims against Lehman Swap Provider because of its failure to (i) fulfill its payment obligations under the Swap Agreement, and (ii) reacquire and return the Swap Collateral to FirstBank. These breach of contract claims amounted to

[4] See In re Lehman Bros. Holdings Inc., 492 B.R. 191 (S.D.N.Y. Bankr. 2013); In re Lehman Bros. Holdings Inc., 526 B.R. 481 (Bankr. S.D.N.Y. 2014); In re Lehman Bros. Inc. (S.D.N.Y. Bankr. Nov. 23, 2015).

approximately $61 million, based on the value of the Swap Collateral in excess of FirstBank's remaining obligations under the Swap Agreement. But these were determined to be general unsecured claims against the bankruptcy estates of Lehman Swap Provider and Lehman Parent (as guarantor under the Swap Agreement).

Unfortunately for FirstBank, it did not file proofs of claim in the bankruptcy proceedings against either Lehman Swap Provider or Lehman Parent. Instead, FirstBank filed a proof of claim in Lehman Operating Co.'s liquidation proceeding under the Securities Investor Protection Act (SIPA) as a customer entitled to return of deposited funds. The bankruptcy court held – correctly – that a "customer" under the SIPA does not include a swap counterparty, basing its decision on the principle that a customer is an investor that entrusted its marketable securities to a broker-dealer to make investments on the customer's behalf. Consequently, FirstBank was not entitled to any SIPA recovery.

RISK MITIGATION IN LIQUIDATION OF ORIGINAL LENDER OR ORIGINAL CO-LENDER

Although Lehman Brothers was an anomaly in terms of size, scope, and speed, the risks inherent in repledging remain ever present and require swift action when Borrowers are faced with a troubled Original Lender or Original Co-Lender in bankruptcy or an FDIC receivership. Borrowers with rehypothecation provisions in their financing agreements can protect themselves by following the principles discussed below during insolvency proceedings.

Stay Informed

Upon any signs of banking or lender failure, Borrowers should determine:

- Who are the right debtors (lender and guarantor)?
- What is happening in the bankruptcy case of the debtor and its affiliates?
- Where is the collateral?
- Is there a proposed sale of collateral?
- How will the collateral be affected?

Move Quickly

Bankruptcy or receivership sales can happen within a month of filing. Importantly, upon the onset of significant liquidity concerns, Original Lender and Original Co-Lender have every incentive to conduct 'fire sales' of their assets, as well as all Borrower collateral pledged to them.

Although the sale in Lehman Brothers occurred more quickly than the typical case, the trend in Chapter 11 has been for Section 363 sales to occur

early in the case and on an expedited timeline. It is imperative for interested parties to become involved at the outset and to object to relief that may prejudice their rights and interests – even if they have not received all of the notice and information to which they might technically be entitled.

Borrowers should remember that, since FirstBank was not a creditor of Lehman Operating Co., the bankruptcy court determined that FirstBank was not entitled to notice that Lehman Operating Co. was selling the Swap Collateral free and clear to Barclays. Although it is not certain that FirstBank would have been able to block the sale in that case, there may be circumstances where a Borrower would be able to improve its position by timely seeking relief from the bankruptcy court – for example, if there has been fraudulent or unfair conduct by a pledge recipient such as, potentially, Lehman Operating Co. Indeed, the bankruptcy court permitted Lehman Parent to pursue misconduct claims against its operating bank and swap counterparty in another litigation arising from the Lehman Brothers bankruptcy.

Once a sale of repledged collateral is approved, however, it becomes extremely difficult (if not impossible) to unwind.

File Claims Timely (Against the Correct Parties)

Sometimes it is unclear whom is the proper party to pursue, particularly in the face of a web of debtors with a byzantine and complex corporate structure.

Repledging makes matters more difficult by clouding the location and ownership of Borrower's collateral – an issue FirstBank faced for several months in trying to track down the Swap Collateral. Borrowers should not wait idly for information, which troubled Original Lenders or Original Co-Lenders may be hesitant to provide, or delay providing, since providing clear information to Borrowers might enable them to file an appropriate and timely claim, thereby jeopardizing a Section 363 sale of the Borrower's collateral to meet dire liquidity needs of a failing financial institution. As mentioned above, after a bankruptcy court sale, the collateral will likely belong to the Bank Lender rather than the Borrower.

Instead, Borrowers should take a multi-pronged approach that includes, at a minimum:

(i) Sending default notices before a bankruptcy filing;

(ii) Filing proofs of claim against any contractual counterparties listed in the financing documents; and

(iii) As discussed above, closely monitoring the proceedings of those counterparties *and their affiliates* for material developments that could prejudice their interests.

Had FirstBank filed proofs of claim against both Lehman Swap Provider and Lehman Parent for the $61 million in excess Swap Collateral, it likely would have received approximately $41.5 million based on public disclosures regarding the dividends issued to general unsecured creditors of Lehman Swap Provider and Lehman Parent.[5]

CONCLUSION

In summary, let's just hope that *The Lehman Trilogy* does not become a recurring series in connection with future banking failures.

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[5] See In re Lehman Brothers Holdings Inc., 08-bk-13555, Final Decree, Dkt. No. 61141 (indicating 40.40% recovery on general unsecured claims against Lehman Swap Provider); see also Notice Regarding Twenty-Sixth Distribution, Dkt. No. 61564 (indicating 27.55% recovery on third party guarantee claims against Lehman Parent); see also Modified Third Amended Joint Chapter 11 Plan, Dkt. No. 22973, pp. 77-78 (claimants entitled to distributions from separate debtors on account of separate proofs of claim until the claim is paid in full).