UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Thurgood Marshall U.S. Courthouse 40 Foley Square, New York, NY 10007 Telephone: 212-857-8500

MOTION INFORMATION STATEMENT

Docket Number(s): 18-1079-bk

Caption [use short title]

In Re: Lehman Brothers Holding Inc.

Motion for: William J. Harrington to file Amicus Curiae brief in support of neither party.

Set forth below precise, complete statement of relief sought:

Mr. William J. Harrington seeks leave to file an Amicus Curiae brief in support of neither the plaintiff-appellant nor the defendants-appellees.

MOVING PARTY: William J. Harrington **OPPOSING PARTY:** The plaintiff-appellant and the defendants-appellees

☐ Plaintiff ☐ Defendant

☐ Appellant/Petitioner ☐ Appellee/Respondent

MOVING ATTORNEY: William J. Harrington (Pro Se Party) **OPPOSING ATTORNEY:** William F. Dahill / Todd G. Rosen

[name of attorney, with firm, address, phone number and e-mail]

N/A	Wollmuth Maher & Deutsch LLP / Munger, Tolles & Olson LLP
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917-680-1465; wjharrington@yahoo.com	(212) 382-3300; wdahill@wmd-law.com / (213) 683-9100; email not publicly available

Court- Judge/ Agency appealed from: Southern District of New York; Judge Lorna G. Schofield

Please check appropriate boxes:

Has movant notified opposing counsel (required by Local Rule 27.1):
☑ Yes ☐ No (explain):

Opposing counsel's position on motion:
☐ Unopposed ☐ Opposed ☑ Don't Know

Does opposing counsel intend to file a response:
☐ Yes ☐ No ☑ Don't Know

FOR EMERGENCY MOTIONS, MOTIONS FOR STAYS AND INJUCTIONS PENDING APPEAL:

Has this request for relief been made below? ☐ Yes ☐ No

Has this relief been previously sought in this court? ☐ Yes ☐ No

Requested return date and explanation of emergency:

Is oral argument on motion requested? ☑ Yes ☐ No (requests for oral argument will not necessarily be granted)

Has argument date of appeal been set? ☑ Yes ☐ No If yes, enter date: June 26 2019

Signature of Moving Attorney:

/s/ William J. Harrington **Date:** 07/10/2019 Service by: ☐ CM/ECF ☑ Other [Attach proof of service]

UNITED STATE COURT OF APPEALS FOR THE SECOND CIRCUIT

LEHMAN BROTHERS SPECIAL FINANCING INC.,

Plaintiff-Appellant,

—against—

Case No. 18-1079

BRANCH BANKING AND TRUST COMPANY, et al.

Defendants-Appellees

MOTION BY WILLIAM J. HARRINGTON FOR LEAVE TO FILE AMICUS BRIEF

William J. Harrington
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New York, New York 10003
(917-680-1465)
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Private US Citizen

CORPORATE DISCLOSURE STATEMENT

I, William J. Harrington, am a private US citizen. I self-finance research advocacy to eliminate the type of priority payment provisions at issue in this litigation (the ***flip clause***), to fix Nationally Recognized Statistical Rating Organization (***NRSRO***) credit ratings, and to improve the capitalization and regulation of asset-backed securities and other structured finance products (***ABS***) and of derivative contracts.

I have no commercial relationship with any party to the above-captioned case or any affiliate of any such party.

I have no financial or commercial interest in the above-captioned case, its outcome, or any implication thereof.

I am not employed by, or consult on a paid basis for, any entity.

I ***am*** a Key Expert on Structured Finance Topics for the Experts Board of Wikirating.org — a worldwide, independent, transparent, and collaborative organization for credit ratings. The Swiss nonprofit Wikirating Association operates the Wikirating platform.

I ***am*** affiliated as senior fellow with Croatan Institute — an independent, nonprofit, tax exempt **501(c)**(3), research institute.

I have no other professional affiliation.

TABLE OF AUTHORITIES

Statutes **Page(s)**

Financial Regulations

Other Authorities

MOTION FOR LEAVE TO FILE AMICUS BRIEF

Pursuant to Federal Rule of Appellate Procedure 29(b), I, William J. Harrington respectfully move this Court for leave to file the brief attached hereto as Exhibit A (***Proposed Brief***) as amicus curiae in the above-captioned case (***Case***.)

In support of this motion, I state the following:

1. I am a private US citizen.

2. I am not an attorney.[1]

3. I self-finance investigation into the capitalization and regulation of complex finance, publicly report findings, and disseminate them widely.[2]

4. I work to boost the sustainability of our financial system by improving price-making, reducing the likelihood of bailouts, and eliminating the flip clause.

5. Pursuant to Second Circuit Local Rule 27.1(f)(1), I aver that the collective experience of teaching myself to write and submit an amicus brief is an "extraordinary circumstance."

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[1] I worked fulltime to submit a brief after fruitlessly seeking help from professors at seven law schools and four law clinics, two attorney friends, and several others (who collectively contacted 170-plus attorneys on my behalf) in October-November 2018.

[2] Harrington, William J., "Submission to the US Commodity Futures Trading Commission Re: RIN 3038-AE85 'Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants' (In the Event of No Deal Brexit)," May 31, 2019. (https://comments.cftc.gov/PublicComments/CommentList.aspx?id=2960.)

6. Pursuant to Second Circuit Local Rule 27.1(f)(3), I am filing Exhibit A "as soon as practicable" i.e., ***on the day*** that I completed an amicus brief that is clear, concise, ***and complete***.[3]

7. My lodestar has been that the which United States District Court for the Southern District of New York (the ***District Court***) cited in affirming the decision of the United States Bankruptcy Court for the Southern District of New York (the ***Bankruptcy Court***): To present analysis and "facts of which the court may take judicial notice" (Opinion And Order, Page 7).[4]

8. I have a singular ability to help the Court deliberate the Case because I am among the few to have continually scrutinized global use of the flip clause since June 1999, when I joined the derivatives group of Moody's Investors Service (***Moody's***).

9. I support my claim with the othe following personal observations.

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[3] US Securities and Exchange Commission (***SEC***), "Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers," *FR Pending*, **June 21, 2019**, (***SEC-Swap-Margin-Rule***.) Footnotes 327, 377, 463, 519, 569, 730, 738, 796, 1052, and 1058. (https://www.sec.gov/rules/final/2019/34-86175.pdf.)

[4] (https://dlbjbjzgnk95t.cloudfront.net/1022000/1022435/https-ecf-nysd-uscourts-gov-doc1-127122046923.pdf.)

10. I have scrutinized the flip clause from the following **18** vantages: **1)** academic literature of the financial crisis; **2)** bankruptcy law of the US and other jurisdictions; **3)** byline journalism; **4)** competing exposures of the two parties to a swap contract, including the zero-sum exposure that a flip clause creates; **5)** global market practice since 1999; **6)** investigation by the US Department of Justice and attorneys general of 21 states and District of Columbia that resulted in them obtaining an $864 million settlement, including a Statement of Facts, from Moody's Corporation, Moody's Analytics, and Moody's in 2017;[5] **7)** lead NRSRO credit analyst and team leader who proposed credit ratings, voted in 1500 ABS, banking, derivative, insurance, municipal, and sovereign committees, and co-developed global methodologies for derivative contracts, including both standard swap contracts and ones in which an ABS issuer referred to a flip clause in paying a swap dealer (***flip-clause-swap-contract***); **8)** lead NRSRO analyst for 50 ABS, collateralized loan obligations (***CLOs***), and collateralized debt obligations (***CDOs***), including three that defendants-appellees issued or insured; **9)** lead NRSRO analyst for ten derivative dealers, including two Lehman Brothers affiliates, that provided swap contracts both with and without a flip clause; **10)** lead NRSRO liaison with the

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[5] US Department of Justice, "Justice Department and State Partners Secure Nearly $864 Million Settlement with Moody's Arising from Conduct in the Lead up to the Financial Crisis," *Announcement*, January 13, 2017. (https://www.**justice**.gov/opa/pr/**justice-department-and-state-partners-secure-nearly-864-million-settlement-moody-s-arising**.)

swap trading desks at 15 financial institutions, including both the plaintiff-appellant and five defendants-appellees, regarding development and implementation of a global NRSRO methodology for flip-clause-swap-contracts; **11)** legal enforceability opinions with carve-outs; **12)** longitudinal tracking of core components of the flip-clause-swap-contract, including but not limited to the flip clause; **13)** review of NRSRO methodologies for the flip-clause-swap-contract; **14)** self-financed, public-citizen advocate for responsible US finance whose advocacy against the flip-clause-swap-contract US financial regulators both cited and adopted in Dodd-Frank Wall Street Reform and Consumer Protection Act (***Dodd-Frank Act***) rulemaking;[6] **15)** Structured Finance Industry Group (***SFIG***) member from May 13, 2013 to December 31, 2013 and participant on the "Derivatives in Securitization Committee," which champions the flip-clause-swap-contract, from May 15, 2013 to December 31, 2013;[7] **16)** the student loan crisis; **17)** pro-bono "whistleblower" who regularly provides analysis to the SEC and the US Commodity Futures Trading Commission (***CFTC***) while explicitly opting **not** to be considered for a financial award; and **18)** the respective regulations and proposals of 14 financial regulators — Australian Prudential Regulation Authority, Bank of England, European Banking Authority, European Central Bank, European Commission, European Securities and

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6 (https://www.congress.gov/111/plaws/publ203/PLAW-111publ203.pdf)

7 On January 17, 2014, the SFIG Treasurer informed me that the Membership Committee had decided I would no longer be a member.

Markets Authority, Japanese Financial Services Agency, Board of Governors of the US Federal Reserve Board System (***Federal Reserve***), US Farm Credit Administration, US Federal Deposit Insurance Corporation (***FDIC***), US Federal Housing Finance Agency, Office of the Comptroller of the Currency (collectively, the preceding five US regulators, the ***prudential regulators***), the CFTC, and the SEC.

11. I am a dispassionate friend of the Court because I am agnostic regarding the correctness of both the Bankruptcy Court decision and its affirmation by the District Court.

12. I ***do*** have a well-founded view that no decision by the Court can fix the flip clause. It cannot be fixed.

13. ***The flip clause is quicksand. No financial sector or market that uses the flip clause can be stabilized because quicksand cannot be stabilized.***

14. Whatever the Court's decision, it will confirm US market and regulatory assessments that the flip clause is inherently and irredeemably defective. Upholding the flip clause will render it unacceptable to swap dealers. Striking down the flip clause will render it unacceptable to investors. Splitting the difference will exposure future parties to a decade of litigation.

15. Accordingly, the Court must contort neither law nor logic in a futile effort to prop up the flip clause. In particular, the Court must carefully review three distinctions that the Bankruptcy Court made.

Firstly, the Type 1 / Type 2 designation is a distinction without a difference.

Secondly, the inclusion of transaction documents in a swap agreement has unintended consequences because such documents are, along with the rest of a swap contract, subject to US regulations for swap margin.

Thirdly, three prudential regulators enacted rules in 2017 that explicitly make failure of a major financial institution a "singular" event.

16. My 20 years of scrutiny have produced a disquieting finding. ***Every party that agreed to or endorsed a flip clause generated the financial crisis. None was a blindsided casualty.***

17. From 2000 to 2007, US ABS issuers that entered into a swap contract almost uniformly entered into a flip-clause-swap-contract.

18. Few post-crisis issuers have entered into a flip-clause-swap-contract and none have done so since January 2016.[8]

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[8] "The good news is that embedded swaps are less prevalent in U.S. deals..." Adelson, Mark and Robbin Conner, "SFIG Vegas 2017 Conference Notes,"

19. ***US ABS are thriving without the flip-clause-swap contract!***[9]

20. In July 2010, Congress enacted its clear intent to eliminate the flip-clause-swap-contract in multiple sections of the Dodd-Frank Act. It explicitly instructs US financial regulators to establish rules that impose variation margin requirements on a swap dealer for each uncleared swap contract with an end user.

21. ***A variation margin requirement supersedes both the operation and the purpose of a flip clause, thereby rendering it doubly superfluous***.

22. In 2015, the prudential regulators and the CFTC complied with the Dodd-Frank mandate by adopting swap margin rules that intentionally kill the flip-clause-swap-contract by preventing a swap dealer from providing a new contract or amending an existing one.[10] On June 21, 2019, the SEC followed suit.

23. In 2017, three prudential regulators cited the Lehman bankruptcy in adopting additional Dodd-Frank rules to prevent the mass termination of derivative contracts in the event that an entity within a systemically important

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March 11, 2017, page 20. (http://www.**markadelson.**com/pubs/**SFIG-Vegas-2017-Conference-Notes**.pdf.)

9 "Global Securitization on Pace for $1 Trillion in 2018," *S&P Global Ratings RatingsDirect*, July 24, 2018. (https://www.**spratings**.com/documents/20184/0/**Global+Securitization+On+Pace+For+$1+Trillion+In+2018**/8f1dd609-c3e8-469f-8b81-1175a7fe1bdb.)

10 Harrington, Bill, "Existing ABS swaps also caught in swap margin net," *Debtwire ABS*, August 12, 2016. (https://www.**debtwire**.com/info/**existing-abs-swaps-also-caught-swap-margin-net**-%E2%80%94-**analysis**.)

banking organization enters bankruptcy or resolution. ***Notably, the derivative contracts of such entities must "prohibit a counterparty… from exercising cross-default rights."***[11]

24. Issuers have always had better alternatives to a flip-clause-swap-contract. As examples, issuers can accept lower ABS ratings, align the payment characteristics of assets and ABS, buy options, enter into a swap contract with two-way margin posting, increase deal resources, or let non-US investors mitigate exposures outside of a deal.[12] Unsurprisingly, each alternative costs more than a flip-clause-swap-contract, verifying that it is an artificial contrivance and not a product of free market forces.

25. I resigned from Moody's in July 2010 largely because the company thwarted an honest post-mortem of its role in the financial crisis, e.g., with

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11 Memo from Federal Reserve Chair Jerome Powell, August 24, 2017. (https://www.**federalreserve**.gov/aboutthefed/**boardmeetings**/files/**qfc-board-memo-20170901**.pdf.)

12 Tempkin, Adam, "Here's Why the Japanese Bid for CLOs Isn't Likely to Slow Soon," *Bloomberg Markets*, April 2, 2019. (https://www.**bloomberg**.com/news/articles/2019-04-02/**here-s-why-the-japanese-bid-for-clos-isn-t-likely-to-slow-soon**) Also, Rodriguez, Mayra Valladres, "Non-Banks Are The Largest Holders of Collateralized Loan Obligations," *Forbes*, June 11, 2019. "Japanese banks hold about $108 billion in US CLOs." (https://www.**forbes**.com/sites/**mayrarodriguezvalladares**/2019/06/11/**non-banks-are-the-largest-holders-of-collateralized-loan-obligations-**globally/#1160a9c6e95e.)

respect to ***the failure of all flip-clause-swap-contract components***.[13] In addition to the flip clause, the other failed components include rating agency confirmation (***RAC***), replacement/guarantee, and one-way collateralization.[14]

26. In January 2011, I began a fulltime, self-financed advocacy to eliminate the flip-clause-swap-contract as a financing tool for the US economy, particularly the housing sector.[15] My ongoing advocacy, which has largely succeeded, centers on the 40-plus technical comments that I have submitted to US and EU financial regulators, US and UK legislative inquiries, and NRSROs.[16]

27. From October 2015 - November 2016, I worked as a journalist at *Debtwire ABS*, analyzing and reporting on the regulation and use of flip-clause-

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13 Harrington, William J., "Electronic Letter to Moody's President and Chief Operating Officer Mr. Michel Madelain," June 11, 2012, final page. (HTML page 152 of Harrington, William J., "Electronic Letter to the US SEC Re: Rule Comment Number 4-661," June 3, 2013 (***WJH-SEC-Comment-06-03-2013***.) (https://www.sec.gov/comments/4-661/4661-28.pdf.))

14 Gaillard, Norbert J. and William J. Harrington, "Efficient, commonsense actions to foster accurate credit ratings," *Capital Markets Law Journal* 11, No.1 (2016): 38-59. https://doi: 10.1093/cmlj/kmv064. Regarding the respective provisions' failures, see pages 42-44, including footnotes 37, 40, 41, 42, 44, and 45, 46, and 47.

15 Both Wikirating and Croatan Institute post my work. (https://wikirating.org/ and http://www.croataninstitute.org/william-j-harrington, respectively.)

16 Most recently, SEC-Swap-Margin-Rule, pages 175-6 and 204-5.

swap-contracts. Anticipating renewed lobbying to revive the contract after the 2016 elections, I resigned to resume fulltime, self-financed advocacy in December 2016.[17]

28. Mine is the only rigorous analysis of the flip-clause-swap-contract worldwide.[18] Disappointingly, even academics and policy makers who study the financial crisis have not evaluated the contract.[19]

29. When I joined Moody's in 1999, NRSROs routinely predicated the ratings of ABS such as CDOs, CLOs, residential mortgage-backed securities (***RMBS***) on reference to a flip clause when an issuer was party to a swap contract.

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17 For lobbying and NRSRO materials to preserve flip-clause-swap-contracts, see Harrington, William J. "Electronic Letter to the CFTC 'Re: CFTC Letter No. 17-52, No-Action,'" February 2, 2018, in toto. (https://www.wikirating.org/data/other/20180203_**Harrington_J_William_31_Misrepresentations_in_CFTC**%20_**Letter_No_17-52**.pdf.)

18 As example, I was the first to publicly correct legal and NRSRO misinformation regarding legacy flip-clause-swap-contracts and the new swap margin rules. Harrington, *Debtwire ABS*, August 12, 2016.

19 For ***vacuous*** work, see Miguel Segoviano et al. "Securitization: Lessons Learned and the Road Ahead," *International Monetary Fund Working Paper WP/15/2355*, November 2013, pages 38-39. (https://www.**imf.**org/external/pubs/ft/wp/2013/**wp13255**.pdf.) Also, Harrington, William J. "Submission to the CFTC Re: RIN 3038-AD54 'Capital Requirements for Swap Dealers and Major Swap Participants,'" May 4, 2017 (***WJH-CFTC-Comment-05-04-2017***), footnote 5. "I apprised Dr. Segoviano and his co-authors of the risk characteristics of an uncleared swap with a flip clause in a teleconference on 16 January 2014." They had been unaware of the flip clause. (https://comments.**cftc.gov**/**PublicComments**/ViewComment.aspx?id=61196&SearchText=.)

In doing so, the NRSROs asserted a brazen proposition — namely, a swap contract injected **zero** counterparty exposure into either a deal or a swap dealer.

30. NRSRO endorsement made the flip-clause-swap-contract artificially cheap and pre-crisis ABS issuers used it heavily to offset the potential depreciation of securitized assets viz-a-viz ABS and to create assets.[20] Spectacularly reckless issuers accrued exponential exposure to-flip-clause-swap-contracts by buying ABS from issuers that themselves were parties to a contract.[21]

31. A flip-clause-swap-contract can reference a basis rate, a commodity, a currency, one or more entities, an interest rate, or the payment characteristics of an asset pool. The contract ***always*** exposes both a deal and a swap dealer to outsized losses regardless of which party is in-the-money. The ABS sector intentionally concocted the contract so that it could only fail its patently fantastic

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20 WJH-CFTC-Comment-05-04-2017, page 102. Under a flip-clause-swap-contract, an issuer "posted no collateral to a swap dealer and held *no* capital against its insolvency."

21 Pauley, Justin and Dave Preston, "Wachovia CDO Research presents our summary of CDO Default Statistics," *Wachovia Structured Product Research*, (December 31, 2008.) We "track 283 ABS CDOs with a total aggregate issuance amount of $295 billion that have tripped their EOD triggers between October 2007 and Dec. 31, 2008." Also, Moody's Announcement, September 11, 2008. Moody's withdrew "the ratings of 261 classes of notes issued by 34 CDOs backed primarily by portfolios of RMBS securities" and CDO-squared deals that "completed [post-EOD] liquidation." (https://www.moodys.com/research/**Moodys-withdraws-ratings-of-Notes-issued-by-34-ABS-CDOs**--PR_162573.)

purpose — namely, ensuring that neither a deal nor a swap dealer incurred ***any*** loss following the latter's bankruptcy.

32. The Bankruptcy Court detailed the 100% loss of contract values that the plaintiff-appellant (***LBSF***) incurred under 100% of a "multitude" of in-the-money, flip-clause-swap-contracts in the decision.

> ***"The amount of the proceeds of the liquidation of the Collateral was insufficient to make any payment to LBSF under the Waterfall after proceeds were paid pursuant to Noteholder Priority.***"[22]

(Memorandum Decision, Page 11. Emphasis added.)

Under a separate, very large in-the-money contract, LBSF may have lost 67%.[23] Partly owing to the outsized losses that the LBSF flip-clause-swap-contract portfolio incurred, LBSF creditors received lower recoveries than other Lehman creditors.[24]

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22 http://www.nysb.uscourts.gov/sites/default/files/opinions/202553_1360_opinion.pdf.)

23 Moody's Announcement on Ballyrock ABS CDO 2007-1, March 4, 2010. "…the Issuer has just over $137MM in cash while the credit default swap termination payments due to LBSF is approximately $405MM." (https://www.moodys.com/research/**Moodys-downgrades-the-ratings-of-two-classes-of-Notes-issued**--PR_195797.)

24 Denison, Erin, Michael Fleming, and Asani Sarkar, "Creditor Recovery in Lehman's Recovery," *Federal Reserve Bank of New York*, January 14, 2019. (https://**libertystreeteconomics.newyorkfed**.org/**2019/01/creditor-recovery-in-lehmans-bankruptcy**.html.)

Conversely, one European deal lost 34% under an *in-the-money* flip-clause-swap-contract, i.e., one that was *out-of-the-money* to a Lehman entity.[25] Collectively, European flip-clause-swap-contracts with a variety of swap dealers undermined national economies, most notably Greece.[26]

33. Pre-crisis issuers of CDOs, CLOs, RMBS, and other ABS that entered into a flip-clause-swap-contract knowingly under-capitalized their deals, i.e., intentionally adulterated them. Likewise, the corresponding swap dealers undermined themselves by under-capitalizing the offsetting exposures to the same contracts. Many *deals* failed, including most CDOs that the defendants-appellees issued or insured. Several *dealers* failed, including the plaintiff-appellant. Surviving deals and dealers, including several other defendants-appellees, might otherwise have failed but for direct and indirect government intervention.

Without the flip-clause-swap-contract, pre-crisis issuers would have either better capitalized deals or not issued them in the first place. Lehman and other

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25 Fitch Ratings Announcement on Eurosail-UK 2007-4BL: December 17, 2014. "[P]roceeds of USD116m received by the issuer represent approximately 66% of the stipulated claim amount." (https://www.businesswire.com/news/home/20141217005430/en/**Fitch-Takes-Rating-Actions-Eurosail-UK-2007-4BL-PLC**.)

26 Story, Louise, Landon Thomas Jr. and Nelson D. Schwartz, "Wall St. Helped to Mask Debt Fueling Europe's Crisis," *New York Times*, February 13, 2010. (https://www.nytimes.com/2010/02/14/business/global/14debt.html?partner=MOREOVERNEWS&ei=5040.)

swap dealers would have been better capitalized. The financial crisis might never have occurred.

34. Moody's Derivatives Group assigned and monitored ratings of the respective CDOs and ABS of 16 deals that defendants-appellees issued. The group also provided financial institution colleagues with the underlying "shadow" ratings on CDO and ABS that monoline insurers, including at least one defendant-appellee, "wrapped."

I was lead analyst in assigning the initial ratings to three CDOs that defendants-appellees issued or wrapped.[27] In total, I was lead analyst in assigning initial ratings to the respective CDOs, CLOs, and other ABS of 50 deals from June 1999 until assuming new responsibilities in Spring 2006.[28] Moreover, I was a voting member of the rating committees for many more ABS because I was the derivatives go-to person for North American analysts in all sectors.

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27 Moody's Announcements: December 20, 2002; and June 30, 2005 (two). (https://www.moodys.com/research/**MOODYS-RATES-THE-MULBERRY-STREET-CDO-LTD-OFFERING-FROM-UBS--**PR_62979) (https://www.moodys.com/research/**MOODYS-RATES-THE-CROWN-CITY-CDO-2005-1-LIMITED-OFFERING**--PR_98907) (https://www.moodys.com/research/**MOODYS-RATES-THE-CROWN-CITY-CDO-2005-2-LIMITED-OFFERING**--PR_98908)

28 Harrington, William J., "Submission to the US SEC Re: File Number S7-18-11, 'Proposed Rules for Nationally Recognized Statistical Rating Organization,'" August 8, 2011 (***WJH-SEC-Comment-08-08-2011***), pages 3 and 57-58. (https://www.sec.gov/comments/s7-18-11/s71811-33.pdf.)

The overwhelming majority of pre-crisis CDO, CLO, RMBS, and other ABS issuers that entered into a swap contract laden it with a flip clause refence to avoid adding resources to the deal. However, a CDO that I rated (and a defendant-appellee wrapped) entered into swaps but paid certain termination amounts from a ringfenced cash reserve.[29] Many CLO issuers bought an option; some but not all also entered into a flip-clause-swap-contract. Issuers in all ABS sectors simply aligned the payment characteristics of assets and liabilities and forewent a derivative contract altogether.

35. Moody's Derivatives Group assigned and monitored ratings for structured finance operating companies that dealt derivative contracts (***SFOCs***). SFOCs included: dealers of uncollateralized credit derivative contracts, although not flip-clause-swap-contracts (credit derivative product companies or ***CDPCs***); dealers of generally uncollateralized currency and interest rate derivative contracts, including flip-clause-swap-contracts (derivative product companies or ***DPCs***); and collateralized swap and repo programs. Upon joining Moody's, I became lead analyst for several DPCs, including Lehman Brothers Derivative Products (***LBDP***), Lehman Brothers Financial Products (***LBFP***), and Merrill Lynch Derivative

[29] Moody's Announcement: March 21, 2001. (https://www.moodys.com/research/**MOODYS-ASSIGNS-RATING-TO-PHOENIX-FUNDING-LIMITED-CDO**--PR_44224.)

Products (***MLDP***). I also assumed the lead in assigning the initial rating to a new DPC (Nomura Derivative Products Inc, or ***NDPI***) in 2000 and to a new collateralized swap program (Enhanced-Rating ISDA Program of JPMorgan Chase Bank) in 2005. I monitored each SFOC until resigning from Moody's in July 2010.

At various times, LBDP, LBFP, MLDP, or NDPI proposed to provide a flip-clause-swap-contract. In each instance, I responded that, in order to do so, the DPC must hold significantly more resources than would be the case for an otherwise identical, and much more standard, swap contract that did not refer to a flip clause. ***After all, almost all of a swap dealer's counterparties, i.e., those that do not reference a flip clause when paying the dealer, face outsized and potentially cascading losses in the event that the dealer fails while exposed to a flip clause.*** To limit the losses from a flip clause, DPCs were to dynamically increase or decrease the additional resources in line with the mark-to-market, i.e., the outsized exposure that the flip clause creates.[30] Largely owing to the projected costs, each DPC provided few-to-no flip-clause-swap-contracts.

36. My monitoring contributed to LBDP and LBFP ***eventually*** paying unsecured creditors in full.[31] In addition to insisting that the Lehman DPCs

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30 WJH-CFTC-Comment-05-04-2017, pages 98-107.

31 Harrington, Bill et al, "Update on the Lehman Brothers Derivative Product Companies' Bankruptcy (Plan of reorganization by the Lehman bankrupt

fully capitalize the respective exposures under new flip-clause-swap-contracts, I also obligated the DPCS to hold "capital and collateral resources in cash and highly liquid U.S. government securities…[and]…refused a request by the DPCs to credit a new monoline guarantee to capital resources upon expiry of a prior guarantee that had been in place since formation."[32]

37. More generally, all DPCs under my purview had more capital and collateral resources than otherwise because I ***did not enact*** Moody's global practice of diluting relevant benchmarks for Aaa-ratings.[33]

38. I was Team Co-Leader of SFOCs beginning in 2005, which enabled me to monitor additional SFOCs.[34] One legacy DPC that I began monitoring — Bear Stearns Financial Products (***BSFP***) — was an established provider of flip-

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estate proposes to pay 100% of allowed claims against two Lehman DPCs)," *Moody's Structured Credit Perspectives*, June 2010, pages 29-31.

32 Harrington, William J., "Electronic Letter to Moody's President and Chief Operating Officer Mr. Michel Madelain," April 1, 2013 (***WJH-Letter-Moody's-Madelain-04-01-2013***), pages 9-10 (HTML pages 24-25 in WJH-SEC-Comment-06-03-2013)

33 US Department of Justice. *Announcement*, January 13, 2017. (https://www.**justice**.gov/opa/pr/**justice-department-and-state-partners-secure-nearly-864-million-settlement-moody-s-arising**.) "Starting in 2004, Moody's did not follow its published idealized expected loss standards in rating certain Aaa CDO securities…In 2005, Moody's authorized the expanded use of this practice to all Aaa CDO securities."

34 WJH-Letter-Moody's-Madelain-04-01-2013, pages 15-18, 23-30, and 33-54 (HTML pages 30-33, 38-45, and 48-69 in WJH-SEC-Comment-06-03-2013).

clause-swap-contracts to RMBS issuers.[35] I also led colleagues in stemming CDPC trading with CDOs, RMBS, and other ABS sectors.

39. As the financial crisis unfolded, I led colleagues in directing four global financial institutions to add tangible resources to the respective portfolios of flip-clause-swap-contracts.

BSFP added capital to track ***in-the-money*** flip-clause-swap-contracts.

In March 2008, JPMorgan Chase amended a guarantee of selected obligations of multiple Bear Stearns entities to add performance obligations that Moody's Derivative Group had identified as critical to protecting BSFP counterparties.[36]

In Summer 2008, the then independent Merrill Lynch agreed to fully implement my colleagues' proposals in a credit support annex with the PARCS / PYXIS programs that secured the latter's swap claims of USD 8 billion.[37]

In 2009-2010, Bank of America agreed to finance a proposal by its new subsidiary MLDP to guarantee the performance of third-party AIG under flip-

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35 Ibid., pages 10-14 (HTML pages 25-29.)

36 Moody's Announcements: March 25, 2008 and June 4, 2008. (https://www.moodys.com/research/**Moodys-continues-Bear-Stearns-review-assigns-JPM-backed-issuer-ratings**--PR_151714.) (https://www.**moodys.com/research/Moodys-issues-rating-confirmation-for-Bear-Stearns-affiliate**--PR_156804.)

37 WJH-SEC-Comment-08-08-2011, pages 4, 21-24, 68, and 76.

clause-swap-contracts with 50 CDO and ABS issuers. The contracts were deeply in-the-money to AIG (i.e., the flip clauses exposed the tottering insurance company to significant exposure to its own credit deterioration) in part because many deals were repaying loans that AIG had made upfront when entering the respective contracts.[38]

Finally, I led SFOC colleagues in overhauling a DPC methodology and in downgrading DPCs to address deficiencies that BSFP and the Lehman DPCs revealed in 2008. The update produced a key insight: A DPC effectively holds a "walkaway" provision, which is akin to a flip clause, in the master swap with the parent institution.[39]

40. I enjoyed evaluating the exposure of a DPC under a flip-clause-swap-contract because the work informed my other major responsibility from the outset of joining Moody's — namely, evaluating the exactly opposite exposure of an ABS issuer. My interest in articulating the zero-sum nature of the flip clause flowed from two pre-Moody's jobs. I structured derivative contracts that referenced interest rates, currencies, and sovereign entities at Merrill Lynch (1992-1998) and was an international economist for the interest rate and currency service of The WEFA Group (1987-1990.)

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38 Ibid., pages 4, 27-29 (including footnote 7), 36, 40, 62-68, 70-71, and 73-74.

39 Ibid. pages 68-70. Also, WJH-CFTC-Comment-05-04-2017, footnote 87, page 99.

41. At Moody's, I co-developed three guides for an issuer that entered into a derivative contract. The guides were published in 2002, 2004, and 2006, respectively. Each specified certain parameters of a derivative contract to align it with the same aggressive numerical input that Moody's had long used to support its ABS franchise; namely that a derivative contract injected **zero** counterparty exposure into a deal.

42. The 2002 guide applied to US issuers of cashflow CDOs and described one half of the flip clause, i.e., waterfall seniority (***Moody's-2002-CDO-Framework***.)[40] "The guidelines are being published as senior noteholders and hedge counterparties in the banking industry compete increasingly for seniority." II "Hedge Counterparties Are Climbing the Waterfall."[41] Other ABS teams piggybacked on the guide to address the (with hindsight) impossible-to-reconcile clash between ABS and swap dealer.

43. The 2004 guide capped the rating for a structured note in line with certain senior termination amounts payable to a swap dealer. As example, a structured note would be rated Aa1 — i.e., only one notch below Aaa — when an

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40 "Moody's Approach for Rating Thresholds of Hedge Counterparties in CDO Transactions," *Moody's Investors Service Special Report*, October 23, 2002 (with Gus Harris, Isaac Efrat, Jerry Gluck, and Bill May).

41 Moody's Announcement: November 4, 2002. (https://www.moodys.com/research/**MOODYS-PUBLISHES-GUIDELINES-FOR-CDO-HEDGE-COUNTERPARTIES--**PR_61233.)

issuer capped certain senior termination amounts at **45% of contract notional** (**NB**, not the much smaller 45% of mark-to-market.)[42] Even so, both issuers and Moody's shunned the approach.

44. The 2006 publication applied to issuers of cashflow (as opposed to synthetic) ABS worldwide and was operational until November 11, 2013 (***Moody's-2006-Hedge-Framework***).[43] The methodology, which ostensibly supplanted existing ones, improved on them by comprehensively articulating and standardizing many flip-clause-swap-contract provisions.[44] The 2006 framework also provided a pro-forma template for incorporation boilerplate ISDA documents.[45]

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42 Dutta, Deboleena and Bill Harrington, "Capping Hedge Termination Payments in Moody's Rated Structured Notes Following Default of the Underlying Debt Instrument," *Moody's Investors Service Special Report*, September 17, 2004.

43 Manchester, Edward, Bill Harrington, and Nicholas Lindstrom, "Framework for De-Linking Hedge Counterparty Risks from Global Structured Finance Cashflow Transactions," *Moody's Investors Service Rating Methodology*, May 25, 2006.

44 Securities Industry and Financial Markets Association (***SIFMA***) and International Swaps and Derivatives Association (***ISDA***), "Proposed Brief of Amicus Curiae in Support of Defendants-Appellees and Affirmance in Lehman Brothers Special Financing, Inc. versus Bank of America National Association et al. (Case No. 17-cv-1224-LGS (Document 87)," June 16, 2017. Appendix A contains Moody's-2006-Hedge-Framework. (https://www.**sifma**.org/wp-content/uploads/2017/06/**LehmanBrothers**061617.pdf.)

45 Moody's Announcement: May 25, 2006. (https://www.moodys.com/research/**MOODYS-UNIFIES-HEDGE-FRAMEWORK-FOR-HIGHLY-RATED-STRUCTURED-FINANCE-CASH**--PR_114003.)

45. One Moody's legal colleague in London crafted the flip clause provisions. A second legal colleague in London drafted the ISDA template. No US legal analyst developed or drafted even a small part of Moody's-2006-Hedge-Framework. The absence is notable because Moody's Derivatives managers assigned a legal analyst to virtually every CDO, CLO, and SFOC.

46. ***To repeat, Moody's assigned NO US legal analyst who was well-versed in the flip-clause-swap-contract to develop Moodys-2006-Hedge-Framework***.

47. My London colleague cited first in the preceding paragraph kicked-off the project by proposing the flip clause articulation. I, not knowing that the flip clause had a stronger grounding under UK law than US law, endorsed the articulation wholeheartedly. In our shared view, we were to develop an airtight framework so that Moody's nonnegotiable rating assumption — namely, that a flip-clause-swap-contract injected ***zero*** counterparty exposure into a deal — became a reality in each contract.[46]

We spoke to teams that provided flip-clause-swap-contracts at US and EU financial institutions. Furthermore, we published two detailed comment requests that featured the flip clause articulation in 2005.[47]

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[46] WJH-SEC-Comment-08-08-2011, page 58.

[47] Moody's Announcement: December 7, 2005. (**https://www.moodys.com/research/MOODYS-REQUESTS-**

I discussed the framework with New York-based swaps teams at: Bank of America; Bank of New York; Bear Stearns; BSFP; CIBC, Credit Suisse; Deutsche Bank; Goldman Sachs; JPMorgan Chase; Lehman Brothers; Merrill Lynch (the corporation); MLDP; Swiss Re; UBS; and Wachovia. I also discussed the framework with deal counsel for US RMBS deals and with then Bank of England Deputy Governor Mr. Paul Tucker.[48]

48. The swap teams challenged many obligations such as posting collateral, replacement/guarantee, and the respective rating triggers. ***However, no swap team disputed the flip clause, let alone challenged its enforceability.***

49. Similarly, no issuer, investor, trustee, or vendor to an ABS deal or SFOC had disputed the flip clause or challenged its enforcement with me.[49] Nor, with one exception, did a US Moody's legal colleague.[50]

COMMENTS-ON-PROPOSAL-FOR-SWAPS-IN-HIGHLY-RATED--PR_106039.)

48 Moody's Announcement: August 28, 2006. (https://www.moodys.com/research/**Moodys-framework-for-de-linking-hedge-counterparty-risks-from-global**--PR_118610.)

49 William J. Harrington, Letter to Moody's President and COO Mr. Michel Madelain, October 26, 2012 (***WJH-Letter-Moody's-Madelain-10-26-2012***), pages 1-5.

50 In 2014, a former Moody's legal colleague stated that no counsel for a US deal had ever delivered a clean opinion with respect to the enforceability of the flip clause.

50. From early 2004 to December 2006, my London colleagues and I regularly updated a global team of senior Moody's management, who approved each stage of the framework-in-progress.[51]

51. Citations, and even wholesale inclusion, of Moody's-2006-Hedge-Framework in amicus briefs that SIFMA and ISDA proposed for a slew of cases corroborate that ABS practitioners — e.g., auditors, bankers, counsel, credit analysts, industry groups, insurers, issuers, swap providers, trustees, underwriters, and warehousers — contemporaneously examined the flip clause treatment therein. Additionally, a Moody's colleague who had previously worked at S&P offered that its analysts had also used Moody's-2006-Hedge-Framework.

52. The widespread reliance on the flip clause nagged at me out of simple common sense. Wouldn't the FDIC simply repudiate the flip clauses of a bank in receivership to preserve both it and taxpayer money? After all, a failed bank that had agreed to a flip clause knowingly hastened its own insolvency — i.e., was "willfully negligent." I shared the concern with Moody's Executive Vice President

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[51] Moody's Investors Service, "Structured Finance Responds to Issues of Counterparty Risk and Basel II in Calls for Comment," *Inside Credit Policy*, January 2006, pages 4-5. (https://www.moodys.com/sites/products/AboutMoodysRatingsAttachments/2005200000425263.pdf.)

and Co-Chief Operating Office Mr. Brian Clarkson. He hesitated before replying that the regulators were "aware of the issue."[52]

Mr. Clarkson's evasion was standard Moody's practice. The ABS and banking franchises maximized revenues by minimizing the respective capital implications for both deal and dealer that were party to a flip-clause-swap-contract. No Moody's financial analyst pro-actively measured issuers' derivative exposures, let alone tracked the walk-away provisions in master swaps with DPCs or the flip clause exposure to ABS deals.[53]

53. My managers in the US Derivatives Group set the example.[54] ***Firstly***, the Derivatives Group did *not* abide by Moody's-2006-Hedge-Framework in ratings *cashflow* CDOs and *cashflow* CLOs from 2006 to 2013. Instead, managers allowed issuers to cherry pick the most lenient parameters from Moody's-2002-

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52 WJH-Letter-Moody's-Madelain-10-26-2012, page 5.

53 As example, "Moody's Announcement: March 29, 2007." "The rating does not address any payments that may be due to the Class Al Swap Counterparty upon the early termination of the Class Al Swap." (https://www.moodys.com/research/**Moodys-rates-the-Class-V-Funding-III-Ltd-offering-from**--PR_126229.)

54 Moody's Derivatives managers regularly helped Goldman Sachs Mitsui Marine Derivative Products misrepresent the outsize exposures being accumulated under flip-clause-swap-contracts. WJH-Letter-Moody's-Madelain-04-01-2013, pages 10-11 (HTML pages 25-26 in WJH-SEC-Comment-06-03-2013.) "Managers provided letters upon request from GSMMDP as a 'business accommodation' stating that the senior-most debt of CDO issuers that were counterparty to GSMMDP was rated Aaa."

CDO-Framework and Moody's-2006-Hedge-Framework. Accordingly, issuers such as Lancer Funding II, Ltd jerry rigged flip-clause-swap-contracts that required less capitalization than a contract that fully adhered to either the 2002 or the 2006 framework.[55]

Secondly, Moody's managers allowed issuers of *synthetic* ABS to use Moody's-2006-Hedge-Framework in the first place. The 2006 framework excluded "synthetic transactions, such as credit default swaps and synthetic CDOs."[56]

54. Moody's still ignores issuer exposure to derivative contracts, including from flip clauses and walkway provisions, in maintaining ***ALL*** ratings (e.g., ABS, corporate, financial, municipal, and sovereign.) Ditto DBRS, Fitch Ratings and S&P Global.[57]

55. Accordingly, I respectfully request permission to file the Proposed Brief.

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55 Emails of Moody's analysts, manager Yvonne Fu, and UBS banker, May 22-23, 2007, US Senate Permanent Subcommittee on Investigations, "*Wall Street and the Financial Crisis: Anatomy of A Financial Crisis*," footnote 1084 and pages 0626-0629. (https://archive.org/stream/283228-sandp0112/283228-sandp0112_djvu.txt.)

56 Moody's-2006-Hedge-Framework, footnote 2.

57 Harrington, Bill, "Moody's bets Germany will support Deutsche Bank derivatives above all else," *Debtwire ABS*, 12 October 2016. (https://www.debtwire.com/info/**moody**%E2%80%99s-**bets-germany-will-support-deutsche-bank-derivatives-above-all-else**-%E2%80%94-analysis.)

Dated: New York, New York

June 25, 2019

By: /s/

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Dated: New York, New York
June 25, 2019

By: /s/

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PROPOSED BRIEF

18-1079-bk

IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

IN RE: LEHMAN BROTHERS HOLDINGS INC.

Debtor.

LEHMAN BROTHERS SPECIAL FINANCING INC.,

Plaintiff-Appellant,

(Caption continued on following pages)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

AMICUS CURIAE WILLIAM J. HARRINGTON'S BRIEF

William J. Harrington
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—v.—

BRANCH BANKING & TRUST COMPANY, BANK OF AMERICA N.A., U.S. BANK NATIONAL ASSOCIATION, 801 GRAND CDO SERIES 2006-1 LLC, AS COISUER, 801 GRAND CDO SPC f/a/o THE SERIES, 2006-2, AS ISUER, 801 GRAND CDO SERIES 2006-2 LLC, AS COISUER, 801 GRAND CDO SPC f/a/o THE SERIES, 2006-1, AS ISSUER, ALTA CDO SPC, f/a/o THE SERIES, 2007-1 SEGREGATED PORTFOLIO, AS ISSUER, ALTA CDO SPC, f/a/o THE SERIES, 2007-2 SEGREGATED PORTFOLIO, AS ISSUER, ALTA CDO LLC, FOR SERIES 2007-1, AS CO ISSUER, ALTA CDO LLC, FOR SERIES 2007-2, AS COISSUER, BARTON SPRINGS CDO SPC, f/a/o THE SERIES 2005-1 SEGREGATED PORTFOLIO, AS ISSUER, BARTON SPRINGS CDO SPC, f/a/o THE SERIES 2005-2 SEGREGATED PORTFOLIO, AS ISSUER, BARTON SPRINGS CDO SERIES 2005-1 LLC, AS CO ISSUER, BARTON SPRINGS CDO SERIES 2005-2 LLC, AIG TAIWAN INSURANCE CO. LTD., AMERICAN INTERNATIONAL GROUP, INC., ANZ INVESTMENT BANK, ANZ NOMINEES LIMITED, ATLANTIC CENTRAL BANKERS BANK, BALMORAL AUSTRALIA PTY LTD., BANCO DE CREDITO DEL PERU, BASIS CAPITAL PTY LIMITED, BASIS PAC-RIM OPPORTUNITY FUND, BELMONT PARK INVESTMENTS PTY LTD, BIG HORN CDO 2007-1 COLLATERAL, BLUE MOUNTAINS CITY COUNCIL, BLUE POINT CDO SERIES 2005-1 LLC, AS CO-ISSUER, BLUE POINT CDO SPC, f/a/o THE SERIES 2005-1 SEGREGATED PORTFOLIO, AS ISSUER, BNY MELLON CORPORATE TRUSTEE SERVICES LTD., BRODERICK CDO 3, LTD., CARROLL 2 CC/CARROLL HOLDINGS COMPANY AND/OR THE HOLDERS OF AN ACCOUNT IN THAT NAME, CATHOLIC DEVELOPMENT FUND FOR THE CATHOLIC DIOCESE OF BATHURST, CHERRY HILL CDO LLC FOR SERIES 2007-1, AS COISSUER, CHERRY HILL CDO LLC FOR SERIES 2007-2, AS COISSUER, CHERRY HILL CDO SPC, f/a/o THE SERIES 2007-1 SEGREGATED PORTFOLIO, AS ISSUER, CHERRY HILL CDO SPC, f/a/o THE SERIES 2007-2 SEGREGATED PORTFOLIO, AS ISSUER, CHEYNE CLO INVESTMENTS I LTD., CITICORP NOMINEES PTY LTD., CITIGROUP GLOBAL MARKETS INC., CITY OF ALBANY, CITY OF SWAN, CLASS V FUNDING III, CORP., CLASS V FUNDING III, LTD., CONTINENTAL LIFE INSURANCE COMPANY OF BRENTWOOD TENNESSEE, COPPER CREEK CDO LLC, AS CO-ISSUER, COPPER CREEK CDO SPC, f/a/o SERIES 2007-1 SEGREGATED PORTFOLIO, AS ISSUER, COUNTRY LIFE INSURANCE COMPANY, CROWN CITY CDO 2005-1 LLC, AS CO-ISSUER, CROWN CITY CDO 2005 2 LIMITED, AS ISSUER, CROWN CITY CDO 2005-2 LLC, AS COISSUER, DEUTSCHE BANK TRUST COMPANY AMERICAS, DIVERSEY

HARBOR ABS CDO, INC., DIVERSEY HARBOR ABS CDO, LTD., EASTERN METROPOLITAN REGIONAL COUNCIL, ELLIOTT INTERNATIONAL, L.P., EUROAMERICA ASESORIAS S.A., EUROCLEAR BANK SA/NV, FIRST NORTHERN BANK AND TRUST COMPANY, FREEDOM PARK CDO SERIES 2005-1 LIMITED, AS ISSUER, FULLERTON DRIVE CDO LIMITED, AS ISSUER, FULLERTON DRIVE CDO LLC, AS CO-ISSUER, FULTON STREET CDO CORP., FREEDOM PARK CDO SERIES 2005-1 LLC, AS CO-ISSUER, G & F YUKICH SUPERANNUATION PTY LTD, GARADEX INC., GATEX PROPERTIES INC., GENERAL SECURITY NATIONAL INSURANCE COMPANY, GENWORTH LIFE AND ANNUITY INSURANCE COMPANY, GEOMETRIC ASSET FUNDING LTD., GOLDMAN SACHS INTERNATIONAL, GOLDMAN, SACHS & CO. LLC, GOSFORD CITY COUNCIL, GREYSTONE CDO SERIES 2006-1 LLC, AS CO-ISSUER, GREYSTONE CDO SERIES2006-2 LLC, AS CO-ISSUER, GREYSTONE CDO SPC, f/a/o THE SERIES2006-1 SEGREGATED PORTFOLIO, AS ISSUER, GREYSTONE CDO SPC, f/a/o THE SERIES 2006-2 SEGREGATED PORTFOLIO, AS ISSUER, GUOHUA LIFE INSURANCE CO. LTD., HAVENROCK II LIMITED, HHE PARTNERSHIPLP, JEFFERSON VALLEYCDO SERIES 2006-1 LLC, AS CO-ISSUER, JEFFERSON V ALLEY CDO SPC, f/a/o THE SERIES 2006-1 SEGREGATED P ORTFOLIO, AS ISSUER, JP MORGAN CHASE BANK, N.A., JP MORGAN SECURITIES, PLC, KINGS RIVER LIMITED, AS ISSUER, KINGS RIVER LLC, AS CO-ISSUER, KLIO II FUNDING CORP., KLIO II FUNDING LTD., KLIO III FUNDING CORP., KLIO III F UNDING LTD., KMCL CARROLL AND/OR THE HOLDERS OF AN ACCOUNT IN THAT NAME, LAKEVIEW CDO LLC SERIES 2007-1, AS COISSUER, LAKEVIEW CDO LLC, f/a/o THE SERIES 2007-2 SEGREGATED PORTFOLIO, AS CO-ISSUER, LAKEVIEW CDO SPC, f/a/o THE SERIES 2007-3 SEGREGATED PORTFOLIO, AS ISSUER, LAKEVIEW CDO SPC, f/a/o THE SERIES 2007-1 SEGREGATED PORTFOLIO, LAKEVIEW CDO SPC, f/a/o THE SERIES 2007-2 S EGREGATED PORTFOLIO, AS ISSUER, LANCER FUNDING II LTD., LANCER FUNDING II, LLC, LEETON SHIRE COUNCIL, LEITHNER & COMPANY PTY LTD, LGT BANK IN LIECHTENSTEIN LTD., LIFEPLAN AUSTRALIA FRIENDLY SOCIETY LTD., LORELEY FINANCING (JERSEY) NO. 15 LIMITED, LOWER MURRAY WATER, LYNDOCH LIVING INC., MAGNETAR CONSTELLATION FUND II LTD., MAGNETAR CONSTELLATION MASTER FUND III LTD., MAGNETAR CONSTELLATION MASTER FUND LTD., MANLY COUNCIL, MARINER LDC, MARSH & MCLENNAN COMPANIES, INC., STOCK INVESTMENT PLAN, MARSH & MCLENNAN MASTER RETIREMENT TRUST, MBIA INC., MONEY GRAMS ECURITIES LLC, MORGAN STANLEY& CO. LLC,

MORGANS FINANCIAL LIMITED, MULBERRY STREET CDO, LTD., NATIONAL NOMINEES LIMITED, NATIONWIDE HYBRID MAND/NATIONWIDE SF HYBRID AND/OR THE HOLDERS OF AN ACCOUNT IN THAT NAME, NATIONWIDE SUPERANNUATION AND/OR THE HOLDERS OF AN ACCOUNT IN THAT NAME, NATIXIS FINANCIAL PRODUCTS LLC, NEWCASTLE CITY COUNCIL, OHIO PUBLIC EMPLOYEES RETIREMENT SYSTEM, OSDF, LTD., OVERSEAS PROPERTY INVESTMENT CORPORATION, PANORAMA RIDGE PTY LTD, PANTERA VIVE CDO LLC, AS CO-ISSUER, PANTERA VIVE CDO SPC, f/a/o THE SERIES 2007-1, AS ISSUER, PARKES SHIRE COUNCIL, PCA LIFE ASSURANCE CO. LTD., PEBBLE CREEK LCDO 2007-2, LLC, AS CO-ISSUER, PEBBLE CREEK LCDO 2007-2, LTD., AS ISSUER, PENN'S LANDING CDO LLC, AS CO-ISSUER, MODERN WOODMEN OF AMERICA, PENN'S LANDINGCDO SPC, f/a/o THE SERIES 2007-1 SEGREGATED PORTFOLIO, AS ISSUER, PHL VARIABLE INSURANCE COMPANY, PHOENIX LIFE INSURANCE COMPANY, PINNACLE POINT FUNDING CORP., PINNACLE POINT FUNDING LTD., PUTNAM DYNAMIC ASSET ALLOCATION FUNDS-GROWTH PORTFOLIO, PUTNAM INTERMEDIATE DOMESTIC INVESTMENT GRADE TRUST, PUTNAM STABLE VALUE FUND, PYXIS ABS CDO 2007-1 LLC, AS CO-ISSUER, PYXIS ABS CDO 2007-1 LTD., AS ISSUER, QUARTZ FINANCE PLC, SERIES 2004-1, RESTRUCTURED ASSET CERTIFICATES WITH ENHANCED RETURNS, SERIES 2005-21-C TRUST, RESTRUCTURED ASSET CERTIFICATES WITH ENHANCED RETURNS, SERIES 2006-1-C TRUST, RESTRUCTURED ASSET CERTIFICATES WITH ENHANCED RETURNS, SERIES 2007-4-C TRUST, RGA REINSURANCE CO., RUBYFINANCE PLC, f/a/o THE SERIES 2005-1, CLASS A2A9, AS ISSUER, SBSI, INC., SCOR REINSURANCE COMPANY, SECURITIZED PRODUCT OF RESTRUCTURED COLLATERAL LIMITED SPC, f/a/o THE SERIES 2007-1 FEDERATION A-1 SEGREGATED PORTFOLIO, AS ISSUER, SECURITIZED PRODUCT OF RESTRUCTURED COLLATERAL LIMITED SPC, f/a/o THE SERIES 2007-1 FEDERATION A-2 SEGREGATED PORTFOLIO, AS ISSUER, SECURITIZED PRODUCT OF RESTRUCTURED COLLATERAL LIMITED SPC, f/a/o THE SERIES 2007-1 TABXSPOKE (07-140-100) SEGREGATED PORTFOLIO, SECURITY BENEFIT LIFE INSURANCE CO., SENTINEL MANAGEMENT GROUP INC., SERIES 2007-1 TABXSPOKE (07-140-100) LLC, AS CO-ISSUER, SHENANDOAH LIFE INSURANCE COMPANY, SHINHAN BANK, SMH CAPITAL ADVISORS, INC., SOLAR V CDO LLC, AS CO-ISSUER, SOLARV CDO SPC, f/a/o THE SERIES 2007-1 SEGREGATED PORTFOLIO, ST. VINCENT DE PAUL SOCIETY QUEENSLAND, STABFUND SUB CA AG, STANDARD LIFE INSURANCE COMPANY OF INDIANA,

STANTON ABS I P.L.C., STARLING STRATEGIES LTD., STAT E STREET BANK AND TRUST COMPANY, STATE STREET GLOBAL ADVISORS, STATE STREET INTERNATIONAL IRELAND LIMITED, STICHTING SHELL PENSIOENFONDS, STOWE CDO LLC, AS CO-ISSUER, STOWE CDO SPC, f/a/o THE SERIES 2006-1 SEGREGATED PORTFOLIO, AS ISSUER, STOWE CDO SPC, f/a/o THE SERIES 2008-2-A SEGREGATED PORTFOLIO, AS ISSUER, STRATEGIC GLOBAL (PUTNAM) MANAGED TRUST, STRUCTURED CREDIT OPPORTUNITIES FUND II, LP, SUNSET PARK CDO LIMITED SPC, f/a/o THE SERIES 2004-1 SEGREGATED PORTFOLIO, AS ISSUER, SUNSET PARK CDO LIMITED SPC, f/a/o THE SERIES 2004-2 SEGREGATED PORTFOLIO, AS ISSUER, SUNSET PARK CDO LIMITED SPC, f/a/o THE SERIES 2004-4 SEGREGATED PORTFOLIO, AS ISSUER, SUNSET PARK CDO LIMITED SPC, f/a/o THE SERIES 2005-5 SEGREGATED PORTFOLIO, AS ISSUER, SUNSET PARK CDO SERIES 2005-5 LLC, AS CO-ISSUER, SUNSET PARK CDO SERIES 2005-6 LIMITED, AS ISSUER ,SUNSET PARK CDO SERIES 2005-6 LLC, AS CO-ISSUER, SUNSET PARK CDO-M LLC, AS CO-ISSUER, SUNSET PARK CDO-M LIMITED SPC f/a/o THE SERIES 2005-3 SEGREGATED PORTFOLIO, AS ISSUER, SUSQUEHANNA BANK, TAVARES SQUARE CDO LIMITED, TAVARES SQUARE CDO LLC, AS CO-ISSUER, TERWIN CAPITAL, LLC, BANK OF NEW YORK MELLON, N.A., BANK OF NEW YORK MELLON TRUST COMPANY, N.A., BANK OF NEW YORK MELLON, LONDON BRANCH, STOWE CDO SERIES 2006-1 LLC, AS CO-ISSUER, THE LIVERPOOL LIMITED PARTERNSHIP, THE WINTER GROUP, TIERRA ALTA FUNDING I LTD., TIERRA ALTA FUNDING I, CORP., TOPDANMARK EDB A/S, TRICADIA CREDIT STRATEGIES MASTER FUND, LTD., TRUSTEE U.S. BANK TRUST NATIONALASSOCIATION, UNICREDIT BANK AG, LONDON BRANCH, UNITING CHURCH IN AUSTRALIA PROPERTY TRUST (SA), VOX PLACE CDO LLC, VOX PLACE CDO LIMITED, WHITEHAWKCDO F UNDING, LLC, WHITEHAWK CDO FUNDING, LTD., ZAIS INVESTMENT GRADE LIMITED II, ZAIS INVESTMENT GRADE LIMITED V, GOLDMAN SACHS & CO., VALEO INVESTMENT GRADE CDO LTD., SUNSET PARK CDO-M LLC, AS CO-ISSUER, ZAIS INVESTMENT GRADE LIMITED X,

Defendants-Appellees,

CITIBANK, N.A., P RINCIPAL LIFE INSURANCE COMPANY,

Defendants.

CORPORATE DISCLOSURE STATEMENT

I, William J. Harrington, am a private US citizen. I self-finance research advocacy to eliminate the type of priority payment provisions at issue in this litigation (the ***flip clause***), to fix Nationally Recognized Statistical Rating Organization (***NRSRO***) credit ratings, and to improve the capitalization and regulation of asset-backed securities and other structured finance debt (***ABS***) and derivative contracts.

I have no commercial relationship with any party to the above-captioned case or any affiliate of any such party.

I have no financial or commercial interest in the above-captioned case, its outcome, or any implication thereof.

I am not employed by, or consult on a paid basis for, any entity.

I ***am*** a Key Expert on Structured Finance Topics for the Experts Board of Wikirating.org — a worldwide, independent, transparent, and collaborative organization for credit ratings. The Swiss nonprofit Wikirating Association operates the Wikirating platform.

I ***am*** affiliated as senior fellow with Croatan Institute — an independent, nonprofit, tax exempt **501(c)**(3), research institute.[1]

I have no other professional affiliation.

[1] Wikirating and Croatan Institute both post my work. (https://wikirating.org/ and http://www.croataninstitute.org/william-j-harrington, respectively.) For citations and excerpts, Harrington, William J., "Submission to the US Commodity Futures Trading Commission Re: RIN 3038-AE85 'Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants' (In the Event of No-Deal Brexit)," May 31, 2019. (https://comments.cftc.gov/PublicComments/CommentList.aspx?id=2960.)

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STATEMENT OF INTEREST

I, William J. Harrington, investigate the capitalization and regulation of complex finance, publicly report findings, and disseminate them widely. My aim is to boost the sustainability of our financial system by improving price-making, reducing the likelihood of bailouts, and eliminating the flip clause.

I do this work fulltime without compensation. No person contributed money or help to produce this brief.

The flip clause is an ABS (choose all that apply: blackhole; entirely discredited provision; Escher-staircase-to-nowhere; original sin; quicksand.) Both parties to every swap contract where payments are made by reference to a flip clause (***flip-clause-swap-contract***) knowingly drafted the contract to fail. The plaintiff-appellant, defendants-appellees, and other ***crisis-causing parties*** routinely entered into flip-clause-swap-contracts, thereby wrecking our economy and undermining our Country.

No other researcher has tracked flip-clause-swap-contract performance at all, let alone continuously from 1999. No academician or auditor has demonstrated how flip-clause-swap-contracts and walkaway provisions slashed the value of Lehman Brothers immediately upon filing for bankruptcy. No swap dealer has demonstrated that it robustly capitalizes the outsized exposure to its own credit profile in (fortunately, for our Country) shriveling portfolios of legacy flip-clause-

swap-contracts. Nor has any swap dealer publicly calibrated such a capitalization to that of otherwise identical portfolios of swap contracts that do not reference a flip clause. Likewise, no accountant has published a protocol for valuing ABS of an issuer that is party to a flip-clause-swap-contract viz-a-viz ABS of an issuer that is not party to a flip-clause-swap-contract. No law firm has produced a template for an ironclad flip-clause-swap-contract. No issuer has demonstrated that a flip-clause-swap-contract protects ABS investors half as well as a swap contract with daily, two-way exchange of variation margin. No NRSRO publishes an internally consistent methodology for the flip-clause-swap-contract or apportions the zero-sum exposure of a flip clause by debiting the respective ratings of ABS and swap dealer.[2]

Finally, no industry group has publicly addressed the flip-clause-swap-contract without lying, misrepresenting, being fatuously alarming, parroting irrelevancies, or presenting hopelessly outdated data.[3]

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[2] Gaillard, Norbert J. and William J. Harrington, "Efficient, commonsense actions to foster accurate credit ratings," *Capital Markets Law Journal* 11, No.1 (2016): 38-59. https://doi: 10.1093/cmlj/kmv064. Pages 38, 41-44, and 54-59. (https://academic.oup.com/cmlj/article-abstract/11/1/38/2366006?redirectedFrom=fulltext.) Also, Harrington, Bill, "Moody's DOJ Settlement Won't Stop Fake Rating Analysis & Derivatives Denial," *LinkedIn.com*, January 14, 2017. "The 800-page gorilla – rating methodologies are protected speech." (https://www.linkedin.com/pulse/moodys-doj-settlement-wont-stop-fake-rating-analysis-bill-harrington.)

[3] Harrington, William J. Electronic Letter to the CFTC "Re: Letter No. 17-52, No-Action," February 2, 2018 (***WJH-Corrections-to-CFTC-Letter-No-17-***

52), in toto, e.g., pages 4, 5, 15, 23-26, 68, and 94-110. (https://www.wikirating.org/data/other/20180203_**Harrington_J_William_31_Misrepresentations_in_CFTC**%20_**Letter_No_17-52**.pdf.)

Structured Finance Industry Group **(*SFIG*), "Motion for Leave to File Amicus Brief Re: Case 18-1079**," November 1, 2018. Page 1: "[T]he priority payment provisions…are central to the functioning of the securitization and swap markets." Page 2: "[T]his Court's decision will affect hundreds, if not thousands of derivatives transactions…at the heart of the structured finance industry."

SFIG, "Reply Brief in Support of Motion for Leave to File Amicus Brief Re: Case 18-1079," November 20, 2018. Page 5: "[T]his Court's decision may affect the broader securitization industry, which accounts for trillions of dollars of transactions." Page 9: "SFIG's participation is not driven by pecuniary alignment of any one" member.

SFIG, "Amicus Curiae SFIG's Brief in Support of Defendants-Appellees and Affirmance Re: Case 18-1079," November 1, 2018. Page 1: "SFIG has…members from all sectors of the securitization market." Page 1: Flip clause issues "are critical to the efficient functioning of securitization and swap markets." Page 10: "…a CDO transaction, which has at its heart a swap transaction." Page 11: "…when entering into CDO transactions, market participants…rightly expect that the swap agreement…(2nd Cir. 1998)." Page 15: A "narrow reading…would throw into doubt the viability of thousands of structured finance transactions…posing a systemic risk to the securitization markets." Pages 18-19: "[E]vents such as the UK Brexit vote…or the S&P downgrade of the US…resulted in substantial currency movements." Page 23: "***Obtaining a high rating, however, required Lehman to delink its own default from the other risks underlying the transaction*** [emphasis added]." Page 24: "Such provisions…facilitate liquidity in structured finance markets." Page 24: "…market participants may become unwilling to participate in the structured finance market altogether. Striking the Priority Provisions ***would unravel thousands of transactions*** [emphasis added]…and thereby undermine the stable operation of the structured finance markets, potentially triggering far broader repercussions to the economy…(2010)." Page 30: "[I]f the Bankruptcy Code were construed to invalidate ipso facto clauses…the impact on derivatives markets would be significant."

Our Country, the Court included, needs up-to-the-minute, fact-based, objective information and analysis of the flip-clause-swap-contract.

SUMMARY OF ARGUMENT

US Congress, markets, and regulators have consigned the flip-clause-swap-contract to the garbage heap of history.[4] ***There, the contract rots away with aerosol sprays, trans fats, asbestos tiles, and other synthetics that poisoned users, producers, and Our Country.***[5]

ARGUMENT

I. Congress Clearly Stated Intent to Fix ABS in Multiple Sections of the Dodd-Frank Act.

A. Financial Regulators *Will* Impose Rigorous Margin Requirements on *ALL* Uncleared Swap Contracts (Sections 731 and 764).

The Dodd-Frank Wall Street Reform and Consumer Protection Act (***Dodd-Frank Act***) unequivocally directs six financial regulators to adopt capital and margin rules for swap dealers and for the US Securities and Exchange Commission

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4 "Under regulatory margin requirements…subordination provisions may no longer be available to the SPV." S&P Global Ratings, "Special-Purpose Vehicle Margin Requirements for Swaps-Methodologies and Assumptions," *Criteria*, October 7, 2017, (***S&P-2017-Flip-Clause-Swap-Contract-Methodology***), paragraph 35. (https://www.**standardandpoors**.com/ja_JP/delegate/getPDF;jsessionid=21CC87997D0D3192366EE23481A9C4D1?articleId=1930885&type=COMMENTS&subType=**CRITERIA**.)

5 "The good news is that embedded swaps are less prevalent in U.S. deals than they are in European deals." Adelson, Mark and Robbin Conner, "SFIG Vegas 2017 Conference Notes," March 11, 2017, (***Adelson-Conner-SFIG-2017***), page 20. (http://www.markadelson.com/pubs/SFIG-Vegas-2017-Conference-Notes.pdf.)

(***SEC***) to do the same for security-based swap dealers.[6] Collectively, the regulators' rules must impose "capital requirements" and "initial and variation margin requirements on all swaps" and "all security-based swaps that are not cleared by a registered derivatives clearing organization." See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 731(e)(2), 124 Stat. 1704-5 and § 764 (e)(2), 124 Stat. 1786-87.[7]

Note the ***all*** in "***all*** swaps" and in "***all*** security-based swaps." Congress expressed its clear and unambiguous intent in enacting § 731 and § 764. ***All*** regulators would formulate rigorous margin rules that would encompass ***all*** swap contracts, ***no exceptions!*** To ensure CFTC and SEC compliance, Congress curbed the agencies' "exemptive authority with respect to the swaps requirements of Dodd-Frank."[8]

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6 The six regulators, respectively: Board of Governors of the Federal Reserve Board System (***Federal Reserve***); Farm Credit Administration; Federal Deposit Insurance Corporation (***FDIC***), Federal Housing Finance Agency (***FHFA***), Office of the Comptroller of the Currency (***OCC***, and, the five regulators collectively, the ***prudential regulators***); and US Commodity Futures Trading Commission (***CFTC***).

7 (https://www.congress.gov/111/plaws/publ203/PLAW-111publ203.pdf.)

8 US Department of the Treasury, "A Financial System That Creates Economic Opportunities—Capital Markets, Report to President Donald J. Trump, Executive Order 13772 on Core Principles for Regulating the United States Financial System," October 2017, page 179. "Dodd-Frank amended CEA Section 4(c)(1) and Exchange Act Section 36(c) to limit the agencies' ability to exempt many of the activities covered under Title VII. Limitations on the exemptive authority with respect to the swaps requirements of Dodd-

B. NRSROs *Will* Maintain Accurate Credit Ratings (Title IX, Subtitle C—Improvements to the Regulation of Credit Rating Agencies).

Congress plainly and clearly intended to end the ubiquitous NRSRO practice of inflating ABS credit ratings. See Dodd-Frank Act, Title IX, Subtitle C—Improvements to the Regulation of Credit Rating Agencies, 124 Stat. 1872-1890.[9]

Congress ***found*** that inaccurate ABS ratings wreaked global chaos.

> The "ratings on structured financial products have proven to be inaccurate. This inaccuracy contributed significantly to the mismanagement of risks by financial institutions and investors, which in turn adversely impacted the health of the economy in the United States and around the world."

(Dodd-Frank Act, § 931, 124 Stat. 1872.)

On January 13, 2017, Moody's corroborated the Congressional finding in settling with the US Department of Justice and the attorneys general of 21 states and Washington, D.C. In the Statement of Facts, Moody's acknowledged that it compromised ratings of pre-crisis residential-mortgage-backed securities (***RMBS***) and collateralized debt obligations (***CDOs***).[10]

Frank was perhaps a measure to ensure that the agencies…did not unduly grant exemptions." (**https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL**.pdf.)

9 Gaillard and Harrington, pages 46-48 describe Subtitle C provisions and SEC rule-making and exemption-issuing.

10 US Department of Justice, "Justice Department and State Partners Secure Nearly $864 Million Settlement with Moody's Arising from Conduct in the

The SEC has nullified Section 939G, which would have imposed expert liability on NRSROs starting July 2010.[11] Had 939G taken effect, NRSROs might be obligated to accurately evaluate the flip-clause-swap-contract in rating both ABS and swap dealers. Instead, NRSROs continue to assign and maintain wildly inaccurate ratings.[12]

C. Issuers *Will* Capitalize ABS as Advertised (Title IX, Subtitle D—Improvements to the Asset-Backed Securitization Process).

Congress plainly and clearly intended to end pre-crisis practices for assembling ABS. See the Dodd-Frank Act, Title IX, Subtitle D—Improvements to the Asset-Backed Securitization Process, 124 Stat. 1890-1898.

Lead up to the Financial Crisis," *Announcement*, January 13, 2017. (https://www.**justice.gov**/opa/pr/j**ustice-department-and-state-partners-secure-nearly-864-million-settlement-moody-s-arising**.)

11 Harrington, William J., "Can Green Bonds Flourish in a Complex-Finance Brownfield?", *Croatan Institute Working Paper*, July 2018, (***Harrington-Croatan-Institute-Working-Paper-2018***), pages 9-12. (http://www.croataninstitute.org/publications/publication/can-green-bonds-flourish-in-a-complex-finance-brownfield.)

12 "SEC Charges Moody's With Internal Control Failures and Ratings Symbols Deficiencies," *Announcement*, August 28, 2018 (***SEC-Charges-Moody's-Re-675-RMBS&CLO-Rating-Errors-2018***). (https://www.**sec.gov**/news/press-release/2018-169.) Also, Harrington, Bill, "Moody's bets Germany will support Deutsche Bank derivatives above all else," *Debtwire ABS*, 12 October 2016. (https://www.**debtwire.com**/info/**moody**%E2%80%99s-**bets-germany-will-support-deutsche-bank-derivatives-above-all-else**-%E2%80%94-analysis.)

Congress could hardly have done otherwise. Pre-crisis issuers succeeded spectacularly in structuring ABS to default in record time.[13] Many CDOs, including Big Horn Structured Funding CDO 2007-1, Broderick CDO III, Class V Funding III, and Lancer Funding II, incurred an event of default within a year of issuance. Entering into a flip-clause-swap-contract was a main way that ABS issuers knowingly undercapitalized deals. The CDO of ABS model — buy ABS from issuers that likewise enter into flip-clause-swap-contracts — leveraged the undercapitalization game exponentially.[14]

D. Walkaway Clauses Are *NOT* Enforceable Against FDIC or FHFA (Section 210).

"[N]o walkway clause shall be enforceable in a qualified financial contract of a covered financial company in default." (Dodd-Frank Act, § 210, 124 Stat. 1488.)

> "WALKAWAY CLAUSE DEFINED…any provision in a qualified financial contract that suspends, conditions, or extinguishes a payment obligation of a party, in whole or in part, or does not create a payment obligation of a party that would otherwise exist, solely because of the

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13 SEC, "Citigroup to Pay $285 Million to Settle SEC Charges for Misleading Investors about CDO Tied to Housing Market," *Announcement*, October 19, 2011. (https://www.**sec.gov**/news/press/2011/2011-214.htm.)

14 Pauley, Justin and Dave Preston, "Wachovia CDO Research presents our summary of CDO Default Statistics," *Wachovia Structured Product Research*, December 31, 2008. "283 ABS CDOs [including nine that defendants-appellees issued] with a total aggregate issuance amount of $295 billion…tripped their EOD triggers between October 2007 and Dec. 31, 2008.

> status of such party as a nondefaulting party in connection with the insolvency of a covered financial company that is a party to the contract or the appointment of or the exercise of rights or powers by the Corporation as receiver for such covered financial company…"

(Dodd-Frank Act, § 210, 124 Stat. 1488.)

The flip clause closely resembles a walkaway clause. Congress was crystal clear in enacting § 210(c)(6)(F) ***Walkaway Clauses Not Effective***. An entity that ostensibly holds an option to "walkaway" from a trouble institution cannot do so when it is in FDIC or FHFA receivership or conservatorship. ***In short, counterparties beware! An institution with a taxpayer backstop cannot transfer attendant benefits to a third party by agreeing to a walkaway clause.***

This is for good reason. The circumstance that prompts one counterparty to activate a walkaway clause — the severe credit-impairment of a financial institution — enable *all* counterparties with a walkaway to activate it. The 100% correlation of walkaway activation would strip an insured depository institution, financial company, or government-sponsored entity (***GSE***) of swap assets *after* becoming severely credit-impaired, thereby defeating the dual purposes of receivership and conservatorship — i.e., to preserve institution assets and limit losses to US taxpayers.

II. 2015 and 2019: Regulators Intentionally Kills the Flip-Clause-Swap-Contract in Implementing Dodd-Frank Mandate to Fix ABS.

A. Prudential Regulators, CFTC, and SEC Specify Daily, Two-Way Exchange of Variation Margin for Flip-Clause-Swap-Contracts.

> "Under regulatory margin requirements…subordination provisions may no longer be available to the SPV…The liquidity impact of the termination payment, if owed by the SPV to the counterparty upon termination of the swap, is mitigated by the posting of collateral by the SPV up to the termination date."[15]

In 2015, the prudential regulators and the CFTC implemented the clear Congressional intent for "initial and variation margin requirements," citing Dodd-Frank § 731 as impetus. The prudential regulators jointly adopted a final capital and margin rule in October 2015.[16] The CFTC adopted a final margin rule in December 2015.[17]

On June 21, 2019, the SEC also implemented the clear Congressional intent for "initial and variation margin requirements."[18]

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15 S&P-2017-Flip-Clause-Swap-Contract-Methodology, paragraphs 34-35.

16 Prudential Regulators, "Margin and Capital Requirements for Covered Swap Entities," 80 FR 74840, November 30, 2015 (***Prudential-Regulators-Swap-Margin-Rule***). (https://www.govinfo.gov/content/pkg/FR-2015-11-30/pdf/2015-28671.pdf.)

17 CFTC. "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants," 81 FR 636, January 6, 2016 (***CFTC-Swap-Margin-Rule***.) (https://www.cftc.gov/sites/default/files/idc/groups/public/@lrfederalregister/documents/file/2015-32320-1a.pdf.)

18 SEC, "Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers," *FR Publication Pending*, June 21, 2019 (***SEC-Swap-Margin-Rule***.) (https://www.sec.gov/rules/final/2019/34-86175.pdf.)

All three rules obligate a dealer to include the daily, two-way exchange of variation margin in a new swap with a "financial end user."[19]

> "Because financial counterparties are more likely to default during a period of financial stress, they pose greater systemic risk and risk to the safety and soundness of the covered swap entity."[20]

The Prudential-Regulators-Swap-Margin-Rule and the CFTC-Swap-Margin-Rule rule each explicitly, repeatedly, and often identically state that "financial end user" includes ABS issuers.

> "The list also includes… securitization entities…"[21]

> "[S]tructured finance vehicles… are financial end users for purposes of the final rule."[22]

Furthermore, the Prudential-Regulators-Swap-Margin-Rule and the CFTC-Swap-Margin-Rule both repeatedly state that the respective regulators

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19 Under the Prudential-Regulator-Swap-Rule and the CFTC-Swap-Margin Rule, a "new" swap is one entered into or amended starting March 1, 2017. Harrington, Bill, "Existing ABS swaps also caught in swap margin net. *Debtwire ABS*. (August 12, 2016.) (https://www.**debtwire**.com/info/**existing-abs-swaps-also-caught-swap-margin-net**-%E2%80%94-analysis.)

20 Prudential-Regulators-Swap-Margin-Rule, 80 FR, 74853.

21 CFTC-Swap-Margin-Rule, 81 FR, No. 3, 640 and Prudential-Regulators-Swap-Margin-Rule, 80 FR, 74853.

22 CFTC-Swap-Margin-Rule, 81 FR, No. 3, 643 and Prudential-Regulators-Swap-Margin-Rule, 80 FR, 74856.

definitely rejected lobbying to exempt ABS issuers from the "financial end user" category.

"The [Agencies, Commission] have not modified the definition of financial end user to exclude" structured finance vehicles.[23]

"The Commission is not excluding, as commenters urged…structured finance vehicles."[24]

"[C]ommenters urged the Commission to exclude…structured finance special purpose vehicles."[25]

> "[C]ommenters also requested that the [Agencies, Commission] exclude from the financial end user definition structured finance vehicles, including securitization" vehicles."[26]
>
> "[C]ommenters argued that covered swap entities…that enter a swap may be protected by other means—e.g., a security interest granted in the assets of a securitization SPV."[27]
>
> "These commenters urged the [Commission, Agencies] to follow the…proposed European rules under which securitization vehicles

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23 CFTC-Swap-Margin-Rule, 81 FR, No. 3, 643 and Prudential-Regulators-Swap-Margin-Rule, 80 FR, 74857.

24 CFTC-Swap-Margin-Rule, 81 FR, No. 3, 683.

25 CFTC-Swap-Margin-Rule, 81 FR, No. 3, 639.

26 CFTC-Swap-Margin-Rule, 81 FR, No. 3, 640 and Prudential-Regulators-Swap-Margin-Rule, 80 FR, 74856.

27 CFTC-Swap-Margin-Rule, 81 FR, No. 3, 640. **NB, *the facts in this Case obliterate the argument that the "security interest granted in the assets of a securitization" protects a dealer. A "security interest" in an asset that a flip clause has instantaneously reduced to $0.00 is meaningless.***

> would be defined as non-financial entities and…not be required to exchange initial or variation margin."[28]

Likewise, the SEC-Swap-Margin-Rule does not exempt ABS issuers from the "financial end user" category.[29]

B. Former Moody's Derivatives Analysts Crack ABS Hall-of-Mirrors.

1. Two-Way Exchange of Variation Margin "*Defuses*" Flip Clause.

On May 12, 2015, a former Moody's colleague who practices US law and I led an hour teleconference on ABS and the flip-clause-swap-contract with the six respective prudential regulator and CFTC teams that were writing swap margin rules.

> "Mr. Harrington and Mr. Michalek expressed approval of the proposal's inclusion of ABS issuers as financial end-users and asserted that ABS issuers in all sectors should post full margin against their swap contracts…and [with] the Agencies also discussed potential sources of systemic instability from ABS issuances and discussed whether margin requirements for ABS issuers would mitigate systemic risk."[30]

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28 CFTC-Swap-Margin-Rule, 81 FR, No. 3, 640 and Prudential-Regulators-Swap-Margin-Rule, 80 FR, 74857.

29 SEC-Swap-Margin-Rule. Pages 204-205.

30 Federal Reserve, "Conference Call Between Staff of the Prudential Regulators and the U.S. Commodity Futures Trading Commission, William Harrington and Richard Michalek," *Announcement*, May 12, 2015 (***Former-Moodys-Derivatives-Analysts-Flip-Clause-Presentation-to-Prudential-Regulators-and-CFTC-2015***), Cover. (https://www.federalreserve.gov/newsevents/rr-commpublic/harrington-michalek-call-20150512.pdf.)

> "Commenters argue against an exemption from margin requirements for issuers of ABS. Commenters believe ABS issuers current practice for dealing with counterparty credit risk is inadequate by construction and presents a systemic risk."[31]

"A commenter specifically opposed exceptions for asset-backed security issuers."[32]

The CFTC-Swap-Margin-Rule memorialized the argument that my colleague and I successfully made.

> Commenters "argued that requiring…ABS issuers to post full margin against all swap contracts would defuse commonly used 'flip clauses' and decrease the loss exposure of investors in ABS."[33]

The daily, two-way exchange of variation margin ***"defuses"*** the flip clause by enabling both a swap dealer and an ABS issuer to terminate a swap contract without referencing the deal's priorities of payments. Moreover, the reason for termination becomes largely irrelevant because the party that is owed payment will hold collateral with market value that is at least equal to the previous day's swap valuation.[34] Crucially, both parties will have agreed all prior daily valuations since

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31 CFTC, "External Meetings: Conference Call with Mr. William Harrington and Mr. Rick Michalek," May 12, 2015. (https://www.**cftc.gov**/node/157371.)

32 SEC-Swap-Margin-Rule, page 204.

33 CFTC-Swap-Margin-Rule, 81 FR, No. 3, 640. Also, Former-Moodys-Derivatives-Analysts-Flip-Clause-Presentation-to-Prudential-Regulators-and-CFTC-2015, page 7 (HTML page 8.)

34 As an additional boon for financial stability, the daily, two-way exchange of variation margin also prevents a swap dealer from unilaterally depriving a

having entered the swap, i.e., they will have established a track record of mutually accepting both the termination valuation and the means of monetizing it.

2. ABS is *Non-Eligible Collateral*, Partly Because of the Flip-Clause-Swap-Contract.

"ABS issuers should not be permitted to post ABS as Margin."[35]

> "A commenter recommended that the Commission apply a 100% haircut to a structured product, asset-backed security, re-packaged note, combination security, and any other complex instrument."[36]

In response, the SEC instituted a new "ready market" formulation "to exclude collateral that cannot be promptly liquidated."[37]

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deal of collateral simply by paying an NRSRO to issue a no-downgrade letter. Smith, Corinne, "Counterparty conundrums: Issuers and investors adapting to swap dilemmas." *Structured Credit Investor*, April 13, 2013. (https://www.structuredcreditinvestor.com/ and, by permission, in Harrington, William J., "Electronic Letter to US Securities and Exchange Commission," February 2, 2014, pages 17-19, https://www.sec.gov/comments/s7-08-10/s70810-256.pdf.) In 177 instances, a dealer "successfully petitioned Moody's to be allowed to amend an existing derivative contract with an ABS transaction so as to avoid posting collateral." Also, Moody's Announcement, May 1, 2018 (https://www.moodys.com/research/**Moodys-No-Rating-impact-on-PELICAN-MORTGAGES-NO-3-following**--PR_383075.) "RBS will not take further action following the trigger breach, which constitutes 'other action' as remedial action under the swap documentation."

35 Former-Moodys-Derivatives-Analysts-Flip-Clause-Presentation-to-Prudential-Regulators-and-CFTC-2015, Cover.

36 SEC-Swap-Margin-Rule, page 175.

37 Ibid., pages 175-176.

The Prudential-Regulators-Swap-Margin-Rule and the CFTC-Swap-Margin-Rule are even more stringent. Both assign ***zero*** credit to private-label ABS and other non-eligible collateral in ***any*** instances.[38]

> The "final rule generally does not include ABS, including mortgage-backed securities, within the permissible category of publicly traded debt securities."[39]

The only eligible ABS collateral is that issued or fully guaranteed by the US government or certain GSEs.[40] Such ABS issuers do not enter into flip-clause-swap-contracts.

III. US Issuers Shunned the Flip-Clause-Swap-Contract After 2008; Quit Cold Turkey in 2016; Issued Record Amounts in 2018!

"The good news is that embedded swaps are less prevalent in U.S. deals than they are in European deals."[41]

Actually, the news is great! Only 54 US securitization and structured finance deals *with investment grade debt* are party to a flip-clause-swap-contract.[42] To the extent additional US deals are parties to a contract, they are most likely *pre-*

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38 Prudential-Regulators-Swap-Margin-Rule, 80 FR, 74872.

39 CFTC-Swap-Margin-Rule, 81 FR, No. 3, 666 and Prudential-Regulators-Swap-Margin-Rule, 80 FR, 74871.

40 Ibid. Also, CFTC-Swap-Margin-Rule, 81 FR, No. 3, 701-702 §23.156 Forms of margin, and Prudential-Regulators-Swap-Margin-Rule, 80 FR, 74870-2.

41 Adelson-Conner-SFIG-2017, page 20.

42 WJH-Corrections-to-CFTC-Letter-No-17-52, pages 2-4. At least six of the 60 deals have terminated or run-off the respective flip-clause-swap-contracts.

crisis, zombie CDO and RMBS deals with little-to-no value, i.e., deals with ABS that incurred downgrades to "C" or lower years ago.[43]

In short, the US markets have consigned the flip-clause-swap-contract to the garbage heap of history. There, the contract rots away with aerosol sprays, trans fats, asbestos tiles, and other synthetics that poisoned users, producers, and Our Country.

The 54 deals with investment grade debt and a flip-clause-swap-contract, including 34 that the student loan company Navient sponsors, are "private-label." ***(GSEs that issue ABS such as Fannie Mae and Freddie Mac don't use the flip-clause-swap-contract.)*** Each of the 54 deals embedded a contract at closing. Only twenty-two deals closed between 2010–January 2016. The remaining 32 deals closed between 2003–2008.

Fourteen of the 34 Navient-sponsored deals with a flip-clause-swap-contract closed between 2010–January 2016. Each has only an interest-rate contract. Of the remaining 20 Navient-sponsored deals that closed between 2003–2008, some also embed currency contracts. ***Apart from Navient predecessor Sallie Mae, few sponsors used contracts that referenced currencies because they are exceptionally volatile.*** Since 2017, even Navient has gone to great lengths to retire currency

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[43] For example, the 650 RMBS deals with USD 49 BN par cited in SEC-Charges-Moody's-Re-675-RMBS&CLO-Rating-Errors-2018.

contracts and liabilities. For three deals, the company simultaneously terminated the currency contract, called the euro-denominated tranche, and issued a US dollar tranche without a swap contract.[44]

Many US issuers of collateralized loan obligations (***CLOs***) ***do*** place a flip clause in the priority of payments ***without*** providing the capital, legal, and operational resources for the respective deals to exchange variation margin daily, i.e., to comply with the US swap margin rules. To-date, the CLOs have not entered swap contracts.[45] Instead, CLO investors such as Japanese banks mitigate exposures themselves.[46]

More broadly, ***no*** US ABS issuer has made the "significant structural changes…to post and collect variation margin."[47] Accordingly, no US ABS issuer has entered into any swap — neither one with daily, two-way exchange of variation

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44 Moody's Announcements: October 20, 2017; February 2, 2018; and February 23, 2018. (https://www.moodys.com/research/**Moodys-upgrades-six-tranches-in-four-Navient-FFELP-securitizations**--PR_374267.) (https://www.moodys.com/research/**Moodys-upgrades-three-classes-of-notes-in-SLM-Student-Loan**--PR_378819.) (https://www.moodys.com/research/**Moodys-upgrades-two-classes-of-notes-in-SLM-Student-Loan--PR** 379894.)

45 Harrington-Croatan-Institute-Working-Paper-2018, pages 25-27.

46 Tempkin, Adam, "Here's Why the Japanese Bid for CLOs Isn't Likely to Slow Soon," *Bloomberg Markets*, April 2, 2019. (https://www.**bloomberg.**com/news/articles/2019-04-02/**here-s-why-the-japanese-bid-for-clos-isn-t-likely-to-slow-soon**.)

47 CFTC-Swap-Margin-Rule, 81 FR, No. 3, 640.

margin nor one that references a flip clause — since January 2016. ***The result? ABS is thriving!***[48]

The flip-clause-swap-contract was central to the EU financial crisis.[49] Even so, RMBS and other issuers use the flip-clause-swap-contact owing to EU policy that the US has prudently rejected.[50] As evidence, the US economy habitually outperforms the EU.[51] Also, our social compact rejects bailing out financial companies again, whereas the EU tolerates government support for national champions.

IV. 2017-2019: Congress and Regulators Hasten Dodd-Frank Demise of Flip-Clause-Swap-Contract.

A. 2017: Regulators Prescribe "Singular" Event Against Lehman Repeat.

48 Haunss, Kristen, "US CLO issuance sets new record with more than US$124 billion of volume," *Reuters*, December 12, 2018. (https://www.**reuters**.com/article/clo-record/refile-**us-clo-issuance-sets-new-record-with-more-than-us124bn-of-volume**-idUSL1N1YH1S5.)

49 Durden, Tyler and Marla Singer, "Is Titlos PLC (SPV) the Downgrade Catalyst Trigger Which Will Destroy Greece?" *Zero Hedge*, February 15, 2010. (https://www.**zerohedge.com**/article/**titlos-llc-special-purpose-vehicle-downgrade-catalyst-trigger-which-will-destroy-greece**.)

50 Harrington-Croatan-Institute-Working-Paper-2018, pages 18-21 and 35.

51 Timsit, Annabelle, "The euro-zone economy is back on familiar ground—slow, grinding growth," *Quartz*, February 7, 2019. (https://qz.com/1544961/**the-euro-zone-economy-is-back-on-familiar-ground-slow-grinding-growth**/.)

A "primary goal of the final rule—to avoid the disorderly termination of QFCs in response to the failure of an affiliate."[52]

> "The final rule facilitates the resolution of a large financial entity under the US Bankruptcy Code and other resolution frameworks by ensuring that the counterparties of solvent affiliates of the failed entity cannot unravel their contracts with the solvent affiliate solely based on the failed entity's resolution."[53]

In 2017, the Federal Reserve, the FDIC, and the OCC adopted respective rules that operate to prevent mass terminations of swaps and other "qualified financial contracts" (***QFCs***) with affiliates of a systemically important institution in receivership. Rule commentary repeatedly cites the Lehman bankruptcy as cautionary tale. *In-the-money counterparties activated terminations with LBHI or cross-default terminations with solvent Lehman affiliates*. *Out-of-the-money swap counterparties* ***with flip clauses*** *activated them*. *Out-of-the-money counterparties* ***without flip clauses*** *suspended payments rather than terminating swaps, "reducing the liquidity available to the bankruptcy estate."*[54]

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52 Federal Reserve, "Restrictions on Qualified Financial Contracts of Systemically Important US Banking Organizations and the US Operations of Systemically Important Foreign Banking Organizations; Revisions to the Definition of Qualifying Master Netting Agreement," 82 FR 42882, September 12, 2017, page 42907. (https://www.**federalregister**.gov/documents/2017/09/12/2017-19053/**restrictions-on-qualified-financial-contracts-of-systemically-important-us-banking-organizations-and**.)

53 Ibid., page 42883.

54 Ibid.

> Commenter: "[L]osses in the Lehman bankruptcy alone due to the ability of counterparties to close out QFCs and seize collateral destroyed millions if not billions of dollars…the exemption of QFCs from the automatic stay of the US Bankruptcy Code has effectively subsidized the cost of credit extended among QFC participants."[55]
>
> "This final rule is meant to help avoid a repeat of the systemic disruptions caused by the Lehman failure by preventing the exercise of default rights in financial contracts from leading to such disorderly and destabilizing severe distress or failures."[56]

The fix? No cross-default provisions in swap contracts!

> "[A] covered entity is prohibited from entering into covered QFCs that would allow the exercise of cross-default rights—that is, default rights related, directly or indirectly, to the entry into resolution of an affiliate of the direct party—against it."[57]

The QFC rules paves the way for at least a temporary "singular" event to benefit Country, institution in receivership, and non-terminating counterparties.

> "Title II of the Dodd-Frank Act's stay-and-transfer provisions would address both direct default rights and cross-default rights. But… no similar statutory provisions would apply to a resolution under the US Bankruptcy Code. The final rule attempts to address these obstacles to orderly resolution by extending the stay-and-transfer provisions to any type of resolution of a covered entity."[58]
>
> "The final rule is intended to yield substantial net benefits for the financial stability of the United States."[59]

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55 Ibid., page 42914.
56 Ibid., page 42883.
57 Ibid., page 42890.
58 Ibid., page 42903.
59 Ibid., page 42914.

> "The final rule should also benefit the counterparties of a subsidiary of a failed GSIB by preventing the severe distress or disorderly failure of the subsidiary and allowing it to continue to meet its obligations."[60]

Had the QFC rules been in place in 2008, no CDO could not have terminated a flip clause until the plaintiff-appellant (LBSF) entered bankruptcy. The "singular" event would have been a legal, market, and practical reality.

> "[T]o ensure that the proposed prohibitions would apply only to cross-default rights…the final rule provides that a covered QFC may permit the exercise of default rights based on the direct party's entry into a resolution proceeding.[61]

B. 2018: Congress Keeps ABS Fixes in Reversing Dodd-Frank Provisions.

The 115th Congress (2017-2018) intentionally preserved ***all*** Dodd-Frank provisions that fix ABS, including those that kill the flip-clause-swap-contract. In 2018, Congress enacted one bill that tweaked the Dodd-Frank Act and let a second bill, a wholesale reversal of the Dodd-Frank Act, die.[62]

President Trump signed into law the Economic Growth, Regulatory Relief, and Consumer Protection Act (Pub. L. No. 115-174, S.2155) on May 24,

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60 Ibid., page 42904.

61 Ibid.

62 Shearman and Sterling, "First Major Dodd-Frank Reform Bill Signed Into Law," *Perspective*, May 25, 2018. (https://www.shearman.com/perspectives/2018/05/first-major-dodd-frank-reform-bill.)

2018.[63] The act primarily eases Dodd-Frank restrictions on community and regional banks.

Had Congress intended to protect the flip-clause-swap-contract under US bankruptcy law, Congress would have passed the Financial Choice Act of 2017. [64] The failed bill would have eased the CFTC-Swap-Margin-Rule by exempting many swap contracts from margin posting.[65] The bill also would have amended US Bankruptcy Law so that Chapter 11 proceedings covered large financial institutions.[66]

C. 2019: CFTC Chairperson Gives Up on Exempting Flip-Clause-Swap-Contract from Margin Posting.

CFTC Chair Giancarlo co-published a White Paper that proposed a host of Dodd-Frank rule reversals on April 26, 2018.[67] ***The CFTC did enact*** many reversals in the remainder of Giancarlo's term, ***but did not*** reinterpret "financial entity in the Commodity Exchange Act" to exempt "a variety of end users,

63 (https://www.congress.gov/bill/115th-congress/senate-bill/2155.)

64 H.R. 10 - Financial Choice Act of 2017, 115th Congress. (https://www.congress.gov/bill/115th-congress/house-bill/10.)

65 Ibid., "Title VIII-Capital Markets Improvements, Subtitle C--Harmonization of Derivatives Rules."

66 Ibid., "Title I--Ending 'Too Big to Fail' and Bank Bailouts, Subtitle B--Financial Institution Bankruptcy."

67 Giancarlo, J. Christopher and Bruce Tuckman, "Swaps Regulation Version 2.0," *CFTC White Paper*, April 24, 2018. (https://www.cftc.gov/sites/default/files/2018-05/oce_chairman_swapregversion2whitepaper_042618.pdf.)

including…special purpose vehicles."[68] The reinterpretation ***would have*** granted a key SFIG ask by exempting flip-clause-swap-contracts from the CFTC-Swap-Margin-Rule.[69] Ultimately, Giancarlo and allies dropped the reinterpretation from to-do lists.

V. Don't Contort 219 Years of US Bankruptcy Law to Legitimize Crisis-Causing, Flip-Clause-Swap-Contract Craze of 2000-to-2007.

A. Waterfall Seniority is Exceedingly Valuable to Swap Dealers Because It Ensures Even Zombies Pony Up.

With a flip clause, a swap dealer and an ABS issuer both charge a steep price (waterfall subordination) for a high value good (waterfall seniority).

The benefit to a swap dealer from waterfall seniority is immense because it protects swap assets in many circumstances, including when a deal is in default. Conversely, the cost to ABS investors is also immense because senior payments to the dealer deplete cash that might otherwise repay interest or principal.

As examples, ***two crisis-era, defaulted deals that ringfenced cash for senior termination payments*** stopped repaying ABS.

(1) By February 2009, ***Ballyrock CDO ABS 2007-1 Limited*** had not paid "any classes of notes…since…November 2008" because the

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68 Ibid., page 80.

69 CFTC staff discussed an exemption with SFIG many times in 2017. "WJH-Corrections-to-CFTC-Letter-No-17-52, pages 78-79 and 113.

deal was husbanding cash against a possible termination obligation to ***LBSF***.[70]

(2) After incurring an event of default on March 31, 2009, ***Cheyne CLO Investments I*** paid a large swap termination to ***Credit Suisse***. "Today's rating downgrades reflect the increased expected loss associated with each tranche due to the termination of T[otal]R[eturn]S[wap] transactions" with Credit Suisse.[71]

Similarly, ***waterfall seniority protects in-the-money, swap assets that a dealer retains rather than terminates with a zombie deal***. Indeed, dealers such as AIG, Bank of America, Barclays Bank, Bear Stearns Financial Products (***BSFP***), Deutsche Bank, Goldman Sachs, JPMorgan, and Merrill Lynch preserved assets under most flip-clause-swap-contracts with zombie CDO and RMBS deals.[72] Each

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70 "Moody's Announcement: March 4, 2010." (https://www.moodys.com/research/**Moodys-downgrades-the-ratings-of-two-classes-of-Notes-issued**--PR_195797.)

71 "Moody's Announcement: August 11, 2009." (https://www.moodys.com/research/**Moodys-downgrades-SF-CDO-notes-issued-by-Cheyne-CLO-Investments**--PR_184715.)

72 As examples, Barclays Bank and Deutsche Bank collectively had 37 high value flip-clause-swap-contracts with 31 zombie RMBS deals. "Moody's Announcement: October 17, 2011." (https://www.moodys.com/research/**Moodys-takes-action-on-37-swaps-in-thirty-one-RMBS**--PR_228507.) (**NB,** Moody's "counterparty instrument rating" **minimizes** the potential for waterfall subordination of a swap dealer. The rating is — like the flip clause itself — circular and self-referencing. Gaillard and Harrington, footnote 23.)

dealer concluded that it would maximize the value of a given flip-clause-swap-contract by allowing a deal to continue paying according to schedule rather than by terminating and possibly inducing a fire-sale shortfall.[73]

In fact, waterfall seniority, even in a zombie deal, can determine whether a credit-impaired, flip-clause-swap-contract dealer remains solvent. LBSF shows how the flip to subordination can spur dealer insolvency and cut estate assets.[74] Conversely, two other credit-impaired dealers, AIG and Merrill Lynch, remained solvent in part by taking extraordinary actions to preserve seniority (i.e., avoiding subordination) of deep-in-the-money contracts with distressed CDO and RMBS deals. Some actions — e.g., executing a credit support annex or paying a higher rated entity to guarantee performance viz-a-viz deals — appeared reasonable but were in fact completely gratuitous given the contracts' deep-in-the-money value to the dealers. The credit support annexes were gratuitous because the respective

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73 Ibid. Regarding a representative high-value flip-clause-swap-contract, Moody's assigned it a counterparty instrument rating of Aa3 on November 29, 2010, five months after having downgraded a formerly Aaa-rated tranche in the zombie RMBS deal to Ca on April 14, 2010. (https://www.**moodys.com/credit-ratings/ACE-Securities-Corp-Home-Equity-Loan-Trust-Series-2006-NC3-credit-rating**-715036579.)

74 Fleming, Michael J. and Asani Sarkar, "The Failure Resolution of Lehman Brothers," *FRBNY Economic Policy Review 185*, December 2014, in toto, e.g., pages 179, 185, 186, and 188. (https://www.**newyorkfed**.org/medialibrary/media/**research**/epr/2014/1412flem.pdf)

dealers could not possibly owe money to the respective deals. Likewise, the performance guarantees by higher-rated entities were gratuitous because the dealers had no payment or performance obligations viz-a-viz the deals to guarantee.[75]

NRSROs issued the rating agency conditions (***RACs***) that effectuated each gratuitous dealer action.[76] In a particularly egregious instance, Fitch and Moody's each greenlighted an entirely circular scheme in which MLDP guaranteed the performance obligations of its own affiliate-guarantor.[77] ***With other equally***

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75 Harrington, William J., "Submission to the US SEC Re: File Number S7-18-11, 'Proposed Rules for Nationally Recognized Statistical Rating Organization,'" August 8, 2011, pages 4, 27-29 (including footnote 7), 36, 40, 62-68, 70-71, and 73-74. (https://www.sec.gov/comments/s7-18-11/s71811-33.pdf.)

76 Gaillard and Harrington, Regarding RAC generally, pages 42-44, especially footnotes 40-43.

77 "Moody's Announcement: December 14, 2011." (https://www.moodys.com/research/**Moodys-Determines-No-Negative-Rating-Impact-Due-to-New-Guaranty**--PR_233539.)
Also, "Fitch Announcement: March 12, 2015." (**https://www.businesswire.com/news/home/20150312006588/en/Fitch-Rating-Impact-4-SF-Deals-Bank**.)
Also, "Moody's Announcement: April 3, 2012." (https://www.moodys.com/research/**Moodys-Determines-No-Negative-Rating-Impact-Due-to-Amendment-to**--PR_241278.)
Also, SEC, "Paul A. Gumagay, Office of Commissioner Louis A. Aguilar, Teleconference with William J. Harrington," *Memorandum*, June 30, 2014, page 1. (https://www.**sec.gov**/comments/s7-08-10/s70810-304.pdf.)

egregious RACs, swap dealers took the action of "taking no action" to remediate the credit impact on deals.[78]

B. Flip Clauses Are *Ipso-Facto* Provisions.

The decision by the United States Bankruptcy Court for the Southern District of New York (the ***Bankruptcy Court***) plainly shows that 100% of the flip clauses in 100% of the CDOs *ipso facto* modified LBSF's rights by 100%.

> "***The amount of the proceeds of the liquidation of the Collateral was insufficient to make any payment to LBSF under the Waterfall after proceeds were paid pursuant to Noteholder Priority***."[79]

(Memorandum Decision, Page 11. Emphasis added.)

In a cavalier aside, the Bankruptcy Court mulled an alternative reality in which flip clause activation might have benefited both CDOs and LBSF!

> Had "the proceeds of the sale of the Collateral been much greater than they were, LBSF may have even received a payment in connection with its purported 'in-the-money' position in the Swaps."

(Memorandum Decision, Page 26, Footnote 83.)

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78 "Moody's Announcement: July 20, 2012." (https://www.moodys.com/research/**Moodys-No-Negative-Rating-impact-on-11-SF-CDOs-following**--PR_251415.)

79 (http://www.nysb.uscourts.gov/sites/default/files/opinions/202553_1360_opinion.pdf.)

Indeed! Also, "money might grow on trees" if only "pigs had wings!"

The unfounded fantasy of greater proceeds is pie-in-the-sky musing that misses the forest, the trees, and the entire eco-system. The instance in which a flip clause is activated — namely, the bankruptcy of a flip-clause-swap-contract dealer — is the same instance in which many financial markets, including seemingly unrelated ones, falter. Moreover, the larger the failed swap dealer and its flip-clause-swap-contract portfolio, the larger the negative impact on other, seemingly unrelated, markets.

The scale of the Lehman bankruptcy, including the flip-clause-swap-contract portfolio, all but ensured that the most asset prices would plummet. There was no scenario, save a US government bail-out of Lehman Brothers, in which "the proceeds of the sale of the Collateral" would have "been much greater than they were."

C. Type 1 / Type 2 is a Distinction *Without* a Difference.

Given the zero-sum stakes of waterfall seniority, the determining conditions must be construed as operational from the outset rather than as materializing only upon activation at a later date. More particularly, LBSF drafted every flip-clause-swap-contract to enjoy the significant benefit of waterfall seniority from the outset and to permanently relinquish the seniority for a deeply subordinate

position upon certain instances of its own credit impairment. Likewise, each ABS issuer knowingly agreed to the conditions that permanently relegated LBSF waterfall priority to a very subordinate place from a very senior one.

The same has always been the case for all flip-clause-swap-contract dealers globally. At the outset of each contract, a swap dealer drafts and agrees the potential for a flip to waterfall subordination from seniority.

The Bankruptcy Court formulated an entirely artificial and wholly contrived protocol in categorizing each CDO as a Type 1 Transaction or a Type 2 Transaction.

Neither type contains "materially distinct types of language" (Memorandum Decision, Page 20.) Both types modified "LBSF's rights because of its default" (Memorandum Decision, Page 23.) Specifically, all 44 CDOs gave LBSF:

> "right to payment priority of a Swap termination payment (if it was 'in-the-money') that was fixed at the outset of the Transaction as the default option — meaning, LBSF had an automatic right to payment priority ahead of the Noteholders unless the conditions for an alternative priority was established."

(Memorandum Decision, Pages 20-21.)

Accordingly, the flip clauses in Type 2 Transactions are *ipso facto* provisions just as the flip clauses in Type 1 Transactions are *ipso facto* provisions.

The flip clause of each CDO, i.e., of both "Types," operated identically to those of the other 43 CDOs. To the extent that the "enforcement of the Priority Provisions in Type 1 Transactions effected an *ipso facto* modification of LBSF's rights," the enforcement of the Priority Provisions of the Type 2 Transactions did so. (Memorandum Decision, Page 23).

There is neither a practical instance nor a theoretical one in which the flip clause of any Type 1 Transaction would operate differently from the flip clause of any Type 2 Transaction. There is no instance in which the flip clause of a Type 1 Transaction would activate without the flip clauses of all Type 2 Transactions also activating, and vice-versa. Regulators and investors assessed the respective flip clauses of the 44 CDOs identically. Underwriters and issuers, including the plaintiff-appellant and most defendants-appellees, marketed the respective flip clauses of the 44 CDOs identically. Each NRSRO modeled the flip clauses of the 44 CDOs identically. NRSRO methodologies neither specified nor now recognize a "toggle between two potential Waterfalls" that becomes "applicable upon Early Termination" (Memorandum Decision, Page 22). Likewise, NRSROs that assigned "counterparty instrument ratings" to flip-clause-swap-contracts themselves continue to maintain identical ratings to the respective contracts in any Type 1 Transaction and any Type 2 Transaction, other contract provisions being similar.

D. Distinction *With* a Difference (and Unintended Consequence): Swap Agreement That Incorporates ABS Documents Activates Margin Posting.

> "Judge Peck's determination in BNY that section 560 did not apply relied in no small measure on a ruling that the priority provisions at issue in that case 'did not comprise part of the swap agreement,' and thus the provisions governing the liquidation were not a part of the swap agreement. The facts here are different...the Priority Provisions are either explicitly set forth in the schedules to the ISDA Master Agreements or are incorporated into such schedules from the Indentures." (Memorandum Decision, Page 40.)

A flip-clause-swap-contract cannot work regardless of whether it incorporates ABS documents as "part of the swap agreement." A Navient-sponsored deal, ***SLM Student Loan Trust 2003-7***, demonstrates the lose-lose outcomes.

SLM 2003-7 exchanges dollars for euros under a flip-clause-swap-contract. The counterparty Natixis is subject to the Prudential-Regulators-Swap-Margin-Rule.[80] SLM 2003-7 amended governing documents in January 2019.[81] ***If the flip-clause-swap-contract incorporated the documents, the flip clause may be***

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80 Moody's Announcement on SLM Trusts with CDC Ixis / Natixis as Flip-Clause-Swap-Contract Dealer: March 28, 2018. (https://www.moodys.com/research/Moodys-reviews-for-downgrade-three-classes-of-notes-from-two--PR_381201.)

81 Moody's Announcement: January 15, 2019. Navient amended SLM 2003-7 to "add the ability to purchase an additional 10% of the initial pool balance" and "establish a revolving credit facility that enables the trust to borrow money from Navient Corporation on a subordinated basis." (https://www.moodys.com/research/**Moodys-downgrades-one-class-of-notes-in-SLM-Student-Loan**--PR_393791.)

valid, but Natixis was also obligated to ensure that it and the deal began the daily, two-way exchange of variation margin on the amendment effective date. Otherwise, Natixis has been violating the Prudential-Regulators-Swap-Margin-Rule, which unequivocally defines a "new" swap as one that is entered into ***or amended in any way*** on or after March 1, 2017.

Conversely, if the flip-clause-swap-contract did not incorporate the SLM 2003-7 governing documents at time of amendment, the flip clause may be void per "Judge Peck's determination in BNY." Further, the flip clause may remain void because the circumstance cannot be redressed without activating the obligation for the daily two-way exchange of variation margin. Accordingly, Navient must write-off the deal's residual value and NRSROs must downgrade the ABS.

In fact, NRSROs must downgrade all ABS of issuers that have not incorporated a flip clause into a flip-clause-swap-contract. The deals cannot redress the circumstance without also activating the obligation for the daily two-way exchange of variation margin.

E. Scrap 1992 Precedent: Swap Asset is *NOT* Mere "Unrealized Investment Gain."

> "A swap agreement provision denying an in-the-money defaulting party recovery is 'neither a penalty, a forfeiture, nor an unjust enrichment' because it merely requires a party to 'forego an unrealized investment gain.' *Drexel Burnham Lambert Prod. Corp. v. Midland Bank PLC*, No. 92 Civ. 3098, 1992 WL 12633422, at *2 (S.D.N.Y.

Nov. 10, 1992).” (United States District Court for the Southern District of New York, Opinion and Order, Page 16.)[82]

The 1992 holding is bad precedent.[83] Simply put, a swap contract that is in-the-money ***is a real-world, real-time asset***. A swap dealer manages a swap asset as money-good in all reporting, accounting, and risk management. The global market for swap contracts operates with the understanding that a contract is always a real-world asset for one party and a corresponding real-world liability for the other party. Swap dealers could not exist if in-the-money contracts were merely “unrealized investment gains” because none would have assets.

Eliminating “an early termination payment due to be made to the defaulting party” penalizes it by 100% and bestows the non-defaulting party with a 100% windfall — namely, 100% write-off of a liability.[84]

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82 (https://dlbjbjzgnk95t.cloudfront.net/1022000/1022435/https-ecf-nysd-uscourts-gov-doc1-127122046923.pdf.)

83 Marchetti, Peter, “Amending the Flaws in the Safe Harbors of the Bankruptcy Code: Guarding Against Systemic Risk in the Financial Markets and Adding Stability to the System,” *Emory Bankruptcy Developments Journal* 31, No. 2 (2015). Footnote 217: The “*Drexel* decision did not cite any supporting precedent, did not contain an extensive analysis of the conclusion it reached, and is of ‘dubious precedential value.’” (http://law.emory.edu/ebdj/content/volume-31/issue-2/articles/amending-flaws-safe-harbors-guarding-systemic-markets-stability.html#section-6f8b794f3246b0c1e1780bb4d4d5dc53.)

84 Collins, Sean F., “Rights, Duties and Obligations of Counter-Parties Following Default Under Derivative Contracts,” *Alberta Law Review* 42:1 (2004): 153-166, https://doi.org/10.29173/alr487. Page 165: “If the benefit derived from the non-defaulting party is grossly disproportionate to the

Even NRSROs, which generally inflate ABS cashflows, debit scheduled swap obligations in all simulations.[85]

damages suffered…then it is possible that the provision…can be construed as a penalty." (https://www.albertalawreview.com/index.php/ALR/article/view/487.)

[85] Harrington, William J., Electronic Letter to the SEC, September 11, 2013. A "model…merely references a generic placeholder that exchanges payments with an ABS issuer" until swap maturity. Page 6. (https://wikirating.org/data/other/20130911_Harrington_J_William_ABS_Losses_Attributable_to_Securitization_Swaps.pdf.)

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UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

CAPTION:

Lehman Brothers Special Financing Inc., Plaintiff - Appellant

v.

Branch Banking & Trust Company, et al., Defendants - Appellees

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