

Clients & Friends Memo

Lehman Court Finds Payment Priority Provision Is Unenforceable *Ipso Facto* Clause, And Must Be Part Of Swap For Safe Harbor Protection

January 29, 2010

On January 25, 2010, Judge James M. Peck of the United States Bankruptcy Court for the Southern District of New York ruled that provisions in a CDO indenture subordinating payments due to Lehman Brothers Special Financing Inc., as swap provider, constituted unenforceable *ipso facto* clauses under the facts and circumstances of this case. The Court also held that, because the payment priority provisions were not contained in the four corners of a swap agreement, the Bankruptcy Code's safe harbor protections, which generally permit the operation of *ipso facto* clauses, did not apply. See *Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Serv'cs Ltd. (In re Lehman Brothers Holdings Inc.)*, Adv. Pro. No. 09-01242 (JMP) (Bankr. S.D.N.Y. Jan. 25, 2010) (the "Opinion").

Background

BNY Corporate Trustee Services Limited ("BNY") serves as trustee under a Principal Trust Deed, which governs a multi-issuer secured obligation program. As part of that program, Saphir, a special purpose entity created by Lehman Brothers International (Europe), issued various series of credit-linked synthetic portfolio notes (the "Notes"), two series of which were held by Perpetual. Lehman Brothers Special Financing Inc. ("LBSF") entered into a swap agreement with Saphir. Collateral held in trust by BNY for the benefit of Saphir's creditors, including Perpetual and LBSF, backed the Notes. A Supplemental Trust Deed (together with all agreements underlying the Notes, the "Transaction Documents") governed each series of Notes. The Transaction Documents stipulated that they were subject to English law.

Under the Transaction Documents, LBSF's rights in the collateral had priority over those of Perpetual. However, upon the occurrence of an event of default attributable to LBSF under the Swap Agreement, the relative priorities reversed, with Lehman's rights in the collateral dropping to the bottom of the waterfall. In addition, the so-called "Condition 44" modified the calculation of an early redemption amount upon an LBSF default. The Transaction Documents further provided that the bankruptcy of LBSF or its credit support provider, Lehman Brothers Holdings Inc. ("LBHI" and, together with LBSF and their affiliated debtors, the "Debtors"), constituted an event of default, sufficient to trigger the subordination provisions.

LBHI filed a voluntary petition for chapter 11 relief on September 15, 2008. LBSF followed with its own petition on October 3, 2008. Saphir terminated the Swap Agreement by notice to LBSF on December 1, 2008, citing LBSF's bankruptcy filing as the relevant event of default.

Perpetual commenced litigation in England to determine the priority of its rights under the Transaction Documents. During the pendency of that action, LBSF commenced the present adversary proceeding in U.S. Bankruptcy Court seeking summary judgment on the grounds that the subordination provisions and Condition 44 constituted unenforceable *ipso facto* clauses. BNY filed a cross-motion for summary judgment on the grounds that the Court must defer to the rulings of the English Courts. BNY further argued that even if the payment modification provisions were unenforceable *ipso facto* clauses, they fall within the scope of the Bankruptcy Code's safe harbor provisions, which permit enforcement of provisions governing the liquidation of certain transactions, including swap agreements, even after a bankruptcy.

On November 6, 2009, the English appellate court upheld a lower court decision that the Noteholder Priority and Condition 44 were enforceable under English law. The Court recognized, however, that, because LBSF was a debtor under the United States Bankruptcy Code, U.S. law could impact the ultimate enforceability of the Transaction Documents. Accordingly, it invited a ruling from the United States Bankruptcy Court.

Analysis

The Court ruled on several issues. In particular, we focus here on (1) the Court's ruling that the subordination provisions and Condition 44 were unenforceable *ipso facto* clauses, and (2) the Court's ruling that the Trust Deed Agreements did not constitute part of the Swap Agreement, and thus were not subject to the Safe Harbor.

- *Payment Priority Provisions Triggered On Bankruptcy Constitute Unenforceable Ipso Facto Clauses.*

Under section 541 of the Bankruptcy Code, the Debtors' estates consist of "all legal and equitable interests of the debtor in property as of the commencement of the case." BNY contended that, under the English Court's decision, the subordination provisions took effect on the date of LBHI's bankruptcy, and, thus, the property right claimed by LBSF to the original priority "was lost" before the date of the commencement of LBSF's bankruptcy.¹ However, the Court determined that the plain language of the Transaction Documents required certain affirmative acts to be taken prior to modification of the payment priority. Based on this language, and the fact that the notice terminating the swap was not sent until after December 1, the Court held that "the relevant date for

¹ Opinion, at *16.

purposes of testing whether any shifting of priorities occurred under the Transaction Documents is the LBSF Petition Date.”²

In *dicta*, the Court suggested that “even if LBHI’s petition date were to be considered as the operative date for a claimed reversal of the priority payment under the Transaction Documents, the *ipso facto* protections” provided under the Bankruptcy Code “would bar the efficacy of such a change in distribution rights.”³

Section 365(e)(1) of the Bankruptcy Code states,

Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtors may not be terminated or modified . . . solely because of a provision in such contract or lease that is conditioned on . . . (B) the commencement of a case under this title.⁴

The Court found that the plain language of the Bankruptcy Code makes *ipso facto* clauses unenforceable if conditioned upon “the commencement of a case” under the Bankruptcy Code (as opposed to the commencement of the relevant debtor’s bankruptcy).⁵ Thus, the Court must consider the relationship between the filing of the bankruptcy and the relevant *ipso facto* clause.⁶ In this case, the Court concluded that the size and scope of these bankruptcy cases, as well as the relation between LBHI and LBSF leaves the Court “convinced that the chapter 11 cases of LBHI and its affiliates is a singular event for purposes of interpreting this *ipso facto* language.”⁷ The Court expressly recognized “the potential for further disputes over the interpretation of this language, but declines here to make any broad pronouncements” regarding when one debtor may invoke *ipso facto* protection due to the filing of another debtor. The Court applied the relevant analysis only to the facts in this case.⁸

Having determined that the subordination provisions and Condition 44 were subject to Code sections 365 and 541, the Court concluded that the provisions were unenforceable *ipso facto* clauses. The default that triggered termination of the swap, and, in turn, application of the subordination provisions and Condition 44, was the bankruptcy of LBSF. Accordingly the

² *Id.* at *17.

³ *Id.*

⁴ See also, 11 U.S.C. § 541(c)(1)(B).

⁵ *Id.* (emphasis in Opinion).

⁶ *Id.* at *18-19.

⁷ *Id.* at *20.

⁸ *Id.* at *19.

subordination provisions and Condition 44 altered the rights of LBSF on account of LBSF's bankruptcy.⁹

- *Payment Modification Provisions Must Be Part Of Swap Agreement To Receive Safe Harbor Protection.*

The Court next considered whether, even if the payment modification provisions at issue constituted *ipso facto* clauses, they fell within the scope of the protections provided by the safe harbor provisions of the Bankruptcy Code. Section 560 of the Bankruptcy Code protects a non-defaulting swap participant's contractual right to (i) liquidate, terminate or accelerate "one or more swap agreements because of a condition of the kind specified in section 365(e)(1)" of the Bankruptcy Code (the insolvency of the debtor, or commencement of a bankruptcy case) or (ii) "offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation or acceleration of one or more swap agreements."¹⁰

BNY contended that the subordination provisions and Condition 44 were part of the liquidation of the Swap Agreement, and, thus, enforceable pursuant to Bankruptcy Code Section 560. The Court did not reach this argument. Rather, the Court found, as a matter of fact, that "[a] review of the components of each Swap Agreement – the ISDA Master Agreement, schedules and written confirmation – reveals that there is no reference at all to the Supplemental Trust Deeds, the Noteholder Priority provision or" Condition 44 and these provisions "do not comprise part of the Swap Agreements themselves."¹¹ Therefore, the Court held, because the provisions of section 560 of the Bankruptcy Code "deal expressly with liquidation, termination or acceleration (not the alteration of rights as they then exist)" and because the safe harbor provision refers "specifically to 'swap agreements,' it follows that the Noteholder Priority provision and Condition 44 do not fall under the protections set forth therein."¹²

This ruling is limited only to the facts at issue – specifically the fact that the Swap Agreement did not include the subordination provisions and Condition 44 within the four corners of the Swap Agreement or by reference. Had the Swap Agreement expressly included the relevant terms, the Court would have had to consider whether the subordination provisions and Condition 44 pertain to the termination, liquidation or acceleration of a Swap Agreement, thus making them subject to the safe harbor provisions of section 560 of the Bankruptcy Code. This is an open issue that could be critical in any subsequent similar analysis.

⁹ See *id.* at *21.

¹⁰ 11 U.S.C. § 560.

¹¹ *Id.*

¹² *Id.*

The Court acknowledged the uncertainty created by this Opinion in light of the English court ruling. To that end, the Court sought to coordinate with the parties and the English Courts as to how to reconcile the opinions of the courts.

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