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The enforceability of structured finance subordination provisions: where to next?

Feature

The Enforceability of Structured Finance Subordination Provisions

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In July 2009, the High Court in England confirmed the validity under English law of contractual provisions common in structured finance transactions which subordinate payments to a swap counterparty in circumstances where the swap counterparty has defaulted on its obligations under the terms of the relevant swap agreement.1 The decision of the High Court was upheld by the English Court of Appeal in November 2009.2 However, in January 2010, Judge Peck of the US Bankruptcy Court delivered a decision which concludes that the very same provisions are unenforceable as violating the ipso facto provisions of the US Bankruptcy Code.3 This article examines each of these decisions and analyses the potential impact arising from the conflict they present.

KEY POINTS

- Towards the end of last year, the English courts confirmed the validity of contractual provisions common in structured finance transactions which subordinate payments to a swap counterparty in circumstances where the swap counterparty has defaulted on its obligations. However, earlier this year, the US Bankruptcy Court delivered a decision which concludes that the very same provisions are unenforceable.

- As a result of these conflicting decisions, market participants have been left with uncertainty as to what will happen next. Some observers have speculated that the decision of the US Bankruptcy Court throws into doubt the enforceability of subordination provisions and may have negative credit implications for structured finance transactions.

- However, the ramifications of the decision of the US Bankruptcy Court may not be so widespread, as the decision is limited to the facts of the case.

- In many transactions, it is thought that the existing structural mitigants (including the requirement for swap counterparties to be replaced or to post collateral upon ratings downgrade) are likely to be sufficient to avoid any negative credit implications.

BACKGROUND

PARTIES

The case involves the following parties to a multi-issuer synthetic CDO programme, called the Dante Programme: (a) certain noteholders (namely, Perpetual Trustee Company Limited ('Perpetual') and Belmont Park Investments Pty Ltd & Ors ('Belmont', and together with Perpetual, the 'Noteholders')); (b) Lehman Brothers Special Financing Inc ('LBSF') as swap counterparty; (c) Lehman Brothers Holdings Inc ('LBHI') as credit support provider in respect of LBSF; and (d) BoNY Corporate Trustee Services Limited ('BoNY') as trustee.

FACTS

The relevant facts are:

- The transaction documents relating to the Dante Programme (the '*Transaction Documents*') provided that the swap counterparty shall be paid in priority to the noteholders upon enforcement of the security granted by the issuer unless '... an Event of Default (as defined in the Swap Agreement) occurs under the Swap Agreement and the Swap Counterparty is the Defaulting Party ...', in which case noteholders should get paid first (the '*Subordination Provision*', and the change in priority expressed to be effected by the Subordination Provision upon the occurrence of such an Event of Default, the 'Priority Flip').

- The Transaction Documents were expressed to be governed by English law.

- On 15 September 2008, LBHI applied to the US Bankruptcy Court for protection under Chapter 11 of the US Bankruptcy Code. This event constituted an Event of Default under the Swap Agreement.

- On 3 October 2008, LBSF applied to the US Bankruptcy Court for protection under Chapter 11 of the US Bankruptcy Code.

- After 3 October 2008, payments due by LBSF to the issuer were not made and payments due by the issuer to the noteholders were not made.

- On 1 December 2008 the issuer terminated the Swap Agreement by notice to LBSF, citing LBSF's bankruptcy filing as the relevant event of default.

On 13 May 2009 and 9 June 2009, the Noteholders issued claims in the High Court against BoNY to procure the realisation of the collateral and its application in favour of the noteholders in priority to any claim of LBSF. On 20 May 2009, LBSF issued a complaint in the US Bankruptcy Court against BoNY contending that the Subordination Provision is rendered unenforceable by certain provisions of the US Bankruptcy Code as being in breach of the protection afforded by Chapter 11. BoNY filed a cross-motion on the grounds that the Bankruptcy Court must defer to the rulings of the English Courts. BoNY further argued that even if the Subordination Provision was an unenforceable *ipso facto* clause, it falls within the scope of the Bankruptcy Code's safe harbour provisions, which permit enforcement of provisions governing the liquidation of certain transactions, including swap agreements, even after a bankruptcy. LBSF applied for a stay of the High Court proceedings pending resolution of the issues before the US Bankruptcy Court.

HIGH COURT DECISION

LBSF argued that the Subordination Provision violates the general rule of *pari passu* distribution among creditors under English insolvency law and is therefore void under English law. In doing so, LBSF relied on what has been described as the 'anti-deprivation rule'.[4] The Noteholders contended that the anti-deprivation rule only invalidates a contract which as a result of bankruptcy proceedings seeks to remove an asset from a bankrupt's estate which was his at the commencement of the bankruptcy proceedings and does not invalidate a contract in which the bankrupt's interest is limited to cease on its bankruptcy.

The Chancellor reviewed the case law concerning the anti-deprivation rule and concluded that, although it is clear that: (a) a contract purporting to exclude the mandatory provisions of the Insolvency Act 1986 is contrary to public policy and therefore void; and (b) there exists an exception to such principle for the grant of an interest in property determinable on the insolvency of the grantee (but not the grantor), between these two extremes there exists an uncertain area.

However, the Chancellor was able to conclude that the Subordination Provision was not contrary to English public policy and was enforceable. He did so for a number of reasons including that the intention of the parties was that the priority afforded to LBSF was conditional on LBSF continuing to perform the swap agreement and that LBSF's beneficial interest in the collateral was, as to its priority, always limited and conditional and it never could have passed to a liquidator or trustee in bankruptcy free from those limitations and conditions. The Chancellor also put weight on the fact that the collateral to be liquidated by BoNY is property of the issuer acquired with the subscription proceeds received from the noteholders, and '[i]n no sense was it derived directly or indirectly from [LBSF] as the swap counterparty'.

The Chancellor went on to say that even if he had decided this issue differently and found that the Subordination Provision offended the anti-deprivation rule, the provision would still have been valid and enforceable if triggered by an Event of Default other than LBSF's insolvency. In this case, the Event of Default which triggered the Priority Flip was the Chapter 11 filing by LBHI, which preceded the Chapter 11 filing of LBSF, so the anti-deprivation rule did not apply.

COURT OF APPEAL DECISION

On appeal, LBSF contended that the Priority Flip constituted deprivations which fell within the scope of the anti-deprivation rule. However, the Master of the Rolls concluded that the effect of the Priority Flip was not to divest LBSF of any property -- it merely changed the order of priority in which rights were to be exercised. The right granted to LBSF was a security right over assets purchased with the Noteholders' money and, from the very inception, the priority was contingent upon there being no Event of Default. In drawing this conclusion, the Master of the Rolls placed weight on the fact that the property was acquired with money provided by the Noteholders in whose favour the Priority Flip operated, and appears to have drawn a distinction between, on the one hand, the property or right itself and, on the other hand, the priority in which such right can be exercised.

The Master of the Rolls went on to conclude that even if the Priority Flip had constituted a deprivation within the rule, the rule would not have been engaged because the triggering event was the LBHI filing for Chapter 11 which occurred prior to the LBSF filing -- any deprivation that takes effect before a winding-up order (or its equivalent) is not caught by the rule unless effected pursuant to a sham transaction. The Master of the Rolls also dismissed LBSF's argument that the LBHI filing operated to effect a deprivation of an asset owned by one of its subsidiaries, LBSF, and so fell foul of the rule, stating that it was not open to the court to treat a closely integrated group of companies as a single economic unit as a matter of law save if the limited grounds for piercing the corporate veil exist.

Lord Justice Patten agreed with the conclusions drawn by the Master of the Rolls based on substantially similar reasoning.

BANKRUPTCY COURT DECISION

As a preliminary matter, the Bankruptcy Court determined that the otherwise binding decisions of the English courts did not prevent the court from examining the relevant provisions of the Transaction Documents under the protections afforded to debtors under the Bankruptcy Code.

Under s 541 of the Bankruptcy Code, the debtor's estate consists of 'all legal and equitable interests of the debtor in property as of the commencement of the case'. BoNY contended that the Priority Flip 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. 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 1 December, the court held that 'the relevant date for purposes of testing whether any shifting of priorities occurred under the Transaction Documents is the LBSF Petition Date.' 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'.

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). Thus, the court must consider the relationship between the filing of the bankruptcy and the relevant *ipso facto* clause. 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'. The court expressly recognised 'the potential for further disputes over the interpretation of this language' but declined 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.

Having determined that the Subordination Provision was subject to Code ss 365 and 541, the court concluded that the provision was an unenforceable *ipso facto* clause. The default that triggered termination of the swap, and, in turn, application of the Priority Flip was the bankruptcy of LBSF. Accordingly the Subordination Provision altered the rights of LBSF on account of LBSF's bankruptcy.

The court next considered whether, even if the Subordination Provision constituted an *ipso facto* clause, it fell within the scope of the protections provided by the safe harbour 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'.

BoNY contended that the Subordination Provision was part of the liquidation of the Swap Agreement, and, thus, enforceable pursuant to Bankruptcy Code s 560. The court did not reach this conclusion. Rather, the court found, as a matter of fact, that '[a] review of the components of each Swap Agreement -- the ISDA [International Swaps and Derivatives Association] 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.' Therefore, the court held, because the provisions of s 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 harbour 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.'

IMPACT OF DECISIONS

Following the decision of the US Bankruptcy Court, there has been uncertainty as to what will happen next. Even the court acknowledged the uncertainty created by this decision in light of the ruling of the English courts. To that end, the court sought to co-ordinate with the parties and the English courts as to how to reconcile the opinions of the courts.

Some observers have speculated that the decision of the US Bankruptcy Court throws into doubt the enforceability of subordination provisions that are market standard in structured finance transactions, creates uncertainty in respect of the rights of swap counterparties and noteholders in such transactions and may even lead to structured finance transactions migrating from the US. A number of rating agencies have confirmed that the decision may have negative credit implications for investors in many structured finance deals and that the impact will vary greatly depending on a variety of factors, including whether the swap counterparty is subject to the US Bankruptcy Code, the size, type, liquidity and maturity of the swaps and the ratings of the swap counterparty relative to the rating of the liabilities in the transaction. In many transactions, it is thought that the existing structural mitigants (including the requirement for swap counterparties to be replaced or to post collateral upon ratings downgrade) are likely to be sufficient to avoid any negative credit implications.

It is important to note, however, that the ramifications of the decision of the US Bankruptcy Court may not be so widespread, as the decision is limited to the facts of this case and the court did not consider whether similar subordination provisions in the terms of a safe harboured contract would, in fact, be protected.

1 See *Perpetual Trustee Co Ltd v BoNY Corporate Trustee Services Ltd and anor* [2009] EWHC 1912 (Ch).

2 See *Perpetual Trustee Co Ltd, Belmont Park Investments Pty Limited v BoNY Corporate Trustee Services Ltd, Lehman Brothers Special Financing Inc* [2009] EWHC Civ 1160.

3 See *Lehman Brothers Special Financing Inc. v BoNY Corporate Trustee Services Ltd* (*In re Lehman Brothers Holdings Inc*), Adv Pro No 09-01242 (JMP) (Bankr SDNY 25 Jan 2010).

4 'A man is not allowed ... to provide for a different distribution of his effects in the event of bankruptcy from that which the law provides. It appears to me that this is a clear attempt to evade the operation of the bankruptcy laws'. See *Ex parte Mackay* (1873) LR 8 Ch App 643.