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The Dante Decision: A Legal Analysis

Introduction

A recent decision in the U.S. **Lehman Brothers** bankruptcy case held that investors in a collateralized debt obligation called Dante did not have the right to jump ahead of Lehman to get repaid, contradicting an English court decision and raising questions about how similar deals will be treated.

It addressed the enforceability of so-called *ipso facto* clauses—contractual provisions that call for the termination or the alteration of a party's rights upon a party's insolvency. The decision also discussed the Bankruptcy Code's safe harbor provisions, which permit enforcement of *ipso facto* clauses in connection with the termination, liquidation or acceleration of certain derivatives contracts. The court held that the contractual provisions at issue, which subordinated a swap counterparty's right to a termination payment upon a default by that party, were unenforceable *ipso facto* clauses and not within the ambit of the Bankruptcy Code's safe harbor provisions.

On January 25, 2010, Judge **James Peck** of the U.S. **Bankruptcy Court for the Southern District of New York** ruled that, as a matter of law, provisions in a CDO indenture subordinating payments due to **Lehman Brothers Special Financing Inc. (LBSF)**, 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.

Background

BNY Corporate Trustee Services Ltd. 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, two series of which were held by **Perpetual**. 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 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 Perpetual's rights in the collateral leapfrogging those of LBSF. In addition, the so-called Condition 44 modifies the calculation of an early redemption amount upon an LBSF default. The transaction documents further provide that the bankruptcy of LBSF or its credit support provider, **Lehman Brothers Holdings Inc. (LBHI)**, constituted an event of default, sufficient to trigger the subordination provisions.

LBHI filed a voluntary petition for Chapter 11 relief on Sept. 15, 2008. LBSF followed with its own petition on Oct. 3, 2008. Saphir terminated the Swap Agreement by notice to LBSF on Dec. 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. Meanwhile, LBSF commenced the present adversary proceeding in U.S. Bankruptcy Court seeking summary judgment on the grounds that the noteholder priority and Condition 44 constituted unenforceable *ipso facto* clauses. BNY filed a cross-motion for summary judgment on the grounds that the U.S. Bankruptcy 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 Nov. 6, 2009, the English appellate court upheld a lower court decision that the noteholder priority and Condition 44 were enforceable under English law. The English court recognized, however, that, because LBSF was a debtor under the U.S. Bankruptcy Code, U.S. law could impact the ultimate enforceability of the transaction documents. Accordingly, it invited a ruling from the U.S. Bankruptcy Court.

Analysis

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. 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 Dec. 1, 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." 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 stated that the plain language of the Bankruptcy Code makes clear that *ipso facto* clauses are 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 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. Having determined that the subordination provisions and Condition 44 were subject to Bankruptcy Code sections 365 and 541, the court concluded that the provisions were unenforceable *ipso facto* clauses. 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.

BNY contended that the noteholder priority and Condition 44 were part of the liquidation of the swap agreement, and, thus, enforceable pursuant to Bankruptcy Code section 560. The court disagreed, finding, as a matter of fact, that "[a] review of the components of each swap agreement—the 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 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."

Impact

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.

Following this opinion, there has been uncertainty as to what will happen next. Even 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.

Some observers have speculated that this opinion will apply to numerous similar cases pending in the Lehman bankruptcies. Such assumptions may explain reports that Lehman claims were trading at a significant premium immediately following the decision. It is important to note, however, that the ramifications of this opinion 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 harbored contract would, in fact, be protected.

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