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Clients&FriendsMemo

Structured Finance Subordination Provisions Upheld by High Court

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Introduction

The High Court[1] in England has 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.

The Judgment

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, and (c) BNY Corporate Trustee Services Limited ("BoNY") as trustee.

Background

The relevant facts are:

- The transaction documents relating to the Dante Programme provide 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").

[1] See *Perpetual Trustee Co. Ltd v BNY Corporate Trustee Services Ltd and Lehman Brothers Special Financing Inc.*; *Belmont Park Investments Pty Ltd & Ors v BNY Corporate Trustee Services Ltd and Lehman Brothers Special Financing Inc.* [2009] EWHC 1912 (Ch)

- On 3rd October 2008, LBSF applied to the US Bankruptcy Court for protection under Chapter 11 of the US Bankruptcy Code. This constituted an Event of Default under the Swap Agreement.
- After 3rd 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 13th May 2009 and 9th 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 20th May 2009, LBSF issued a complaint in the US Bankruptcy Court against BoNY contending that the Subordination Provision is forbidden by certain provisions of the US Bankruptcy Code as being in breach of the protection afforded by Chapter 11 and applied to the High Court to have the actions commenced by the Noteholders stayed pending resolution of the US Bankruptcy Court complaint.

The issues to be determined by the High Court were whether to grant the stay of proceedings requested by LBSF and, if not, what orders to make in respect of such proceedings.

Claims

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 principle":

> "there cannot be a valid contract that a man's property shall remain his until bankruptcy, and on the happening of that event go over to someone else, and be taken from his creditors"[2]

> "a man in 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"[3]

However, the Noteholders contended that the anti-deprivation principle 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.

[2] See *Money Markets International Stockbrokers Ltd v London Stock Exchange Ltd* [2002] 1 WLR 1150

[3] See *Ex parte Mackay* (1873) LR 8 Ch App 643

Issues to be determined

The High Court had to consider:

(a) the breadth of the anti-deprivation principle;

(b) whether it applies if there is no insolvency process in relation to LBSF in England; and

(c) whether it applies if the clause operates on an event other than the bankruptcy of LBSF (for example, as a result of a payment default).

The Chancellor reviewed the case law concerning the anti-deprivation principle and concluded, 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), that 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 the following reasons:

- 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 court should not be "*astute to interpret commercial transactions so as to invalidate them*" particularly where "*consequential doubt might be cast on other long-standing commercial arrangements*";
- the intention of the parties was that the priority afforded to LBSF was conditional on LBSF continuing to perform the swap agreement;
- the priority of LBSF never extended to a time after the event of default under the swap agreement in respect of which LBSF was the defaulting party; and
- 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.

Having made such a determination, the Chancellor concluded that the two further issues before the Court (the issues referred to at (b) and (c) above) did not arise although he did give his views on these issues suggesting that the case is likely to go further. In summary:

- the Chancellor did not agree that the anti-deprivation principle could only be applied where LBSF is subject to English insolvency proceedings; and

- the Chancellor was of the view that if he had decided the first issue differently and found that the Subordination Provision offended the anti-deprivation principle, it would still have been valid and enforceable if triggered by another Event of Default (such as the insolvency of the credit support provider).

Stay of proceedings

On the basis that the hearing relating to the indemnities to which BoNY is entitled as a condition to it enforcing the security has been deferred, the Chancellor was of the view that the hearing relating to the application by LBSF for a stay of proceedings should also be deferred. In doing so, the Chancellor has effectively permitted LBSF to pursue any rights of appeal in the English courts and, more importantly, recognised that the application of US bankruptcy law could result in a different conclusion on the enforceability of the Subordination Provision.

Importance of Decision

This case highlights some of the uncertainties concerning transactions that were not structured with the insolvency of swap providers in mind. The case has stirred interest among market participants as subordination provisions have become a common feature in rated structured finance transactions[4]. If these provisions were found to be unenforceable, the ratings of many structured finance transactions would likely be impacted. Until now, the enforceability of such provisions in structured finance transactions has not been tested by the English courts. It is likely that the decision of the High Court will be appealed by LBSF.

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[4] Indeed, as part of their rating criteria for structured finance transactions, rating agencies require such subordination provisions. See for example "Moody's Approach to Rating SF CDOs" by Moody's, 2 March 2009