Clients&FriendsMemo

Second Circuit's *Lehman* Flip Clause Decision Continues the Expansion of the Bankruptcy Code Safe Harbors

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On August 11, 2020, the United States Court of Appeals for the Second Circuit affirmed lower court decisions rejecting Lehman Brothers Special Financing Inc.'s ("LBSF") attempt to recover nearly $1 billion in payments to noteholders and enforcing certain Priority Provisions (defined below) that subordinated payments otherwise payable to LBSF under related swap transactions.

In its *per curiam* decision, the Court found that the Priority Provisions contained in collateralized debt obligation ("CDO") indentures that were triggered by the 2008 bankruptcy filing of Lehman Brothers Holding Inc. ("LBHI") were contractual rights whose enforcement was protected by the Bankruptcy Code safe harbor provisions applicable to swaps entered into in connection with those CDOs.

In rejecting LBSF's arguments, the Second Circuit held that even if the Priority Provisions were *ipso facto* clauses, the termination of the transactions and distribution of proceeds of collateral were protected by the safe harbor for swap agreements contained in section 560 of the Bankruptcy Code.

By its ruling, the Second Circuit maintains its expansive view of safe harbor protections generally[1] and (a) applies safe harbor protections to a swap transaction entered into in connection with a structured debt transaction; (b) broadly construes "liquidation" to include both the calculation of obligations and the distribution of collateral proceeds; (c) interprets the ability to effectively incorporate other agreements into a transaction by reference; and (d) endorses actions by entities exercising enforcement rights on behalf of safe harbor-protected parties.

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[1] The Second Circuit's December 2019 decision in the Tribune Company chapter 11 proceeding is another example of the Court interpreting the Bankruptcy Code's safe harbor provisions in an expansive manner. Cadwalader's memorandum discussing that decision is available at https://www.cadwalader.com/resources/clients-friends-memos/no-youre-a-customer--recent-second-circuit-decision-circumscribes-merit-and-preempts-state-law-impairment-of-safe-harbor-protections-in-the-wake-of-a-failed-lbo.

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I. Background

In the years preceding the Lehman bankruptcy cases, LBSF and its affiliates structured numerous synthetic CDOs, each of which consisted of: (1) a CDO transaction, in which a Lehman special purpose vehicle (the "Issuer") marketed and sold notes to noteholders and used the proceeds to acquire highly rated securities to serve as collateral and generate income to make interest payments to the noteholders, and (2) a credit default swap between the Issuer and LBSF, pursuant to which LBSF would make regular payments to the Issuer and could be entitled to a payment from the Issuer in the event of a default of a reference entity or reference transaction.

A third-party trustee held the collateral in trust and, upon the occurrence of an event of default, was empowered to issue a termination notice, which would accelerate payment on the notes and trigger termination of the swap. LBSF as swap counterparty enjoyed payment priority over the noteholders under certain circumstances, but pursuant to certain payment priority provisions (the "Priority Provisions"), in the case of LBSF's default, LBSF's payment was subordinated to the noteholders' payment.

On September 15, 2008, LBHI filed a voluntary petition for chapter 11 relief, triggering an LBSF default on the credit default swaps. The default caused the termination of the swaps and led to the liquidation of the CDO collateral and subsequent distributions of proceeds therefrom. LBSF itself filed for chapter 11 two weeks after LBHI's filing. Because LBSF had defaulted, when the transactions were terminated and the collateral securing the transactions was liquidated, the Priority Provisions stated that noteholders should be paid ahead of LBSF, despite LBSF's "in the money" position on the swap at the time the default occurred.

In 2010, LBSF commenced an adversary proceeding challenging the priority of payments to the noteholders under 44 such CDO transactions and related credit default swaps, asserting both bankruptcy law and state law causes of action claiming that swap amounts owed to LBSF should have priority. LBSF argued that the Priority Provisions in the indentures governing the CDOs, which caused LBSF's swap claims to be subordinated to the defendant noteholders' claims upon an LBSF default, should be deemed *ipso facto* provisions, the enforcement of which is generally barred by the Bankruptcy Code.

Five years later, the noteholder defendants filed a motion to dismiss LBSF's claims, which Judge Chapman of the Bankruptcy Court for the Southern District of New York granted. The District Court for the Southern District of New York subsequently affirmed Judge Chapman's decision.

A. Lower Court Decisions

In granting defendant noteholders' motion to dismiss, Bankruptcy Judge Chapman found that the

Priority Provisions in only five of the 44 transactions were *ipso facto* clauses, and that the Priority Provisions in the remaining 39 transactions did not modify LBSF's rights. In the alternative, Judge Chapman found that even if LBSF's rights were modified in those 39 transactions, the modifications in all but two transactions occurred prior to LBSF's bankruptcy filing, and therefore did not implicate *ipso facto* concerns.

Judge Chapman also concluded that if the Priority Provisions in any of the transactions were *ipso facto* clauses, the Priority Provisions are enforceable under Bankruptcy Code section 560's safe harbor, which permits the exercise of a swap participant's contractual right to cause the termination, liquidation or acceleration of a swap agreement despite the Bankruptcy Code's general prohibition on the enforcement of *ipso facto* clauses and despite the imposition of the Bankruptcy Code's automatic stay.[2]

Judge Schofield of the District Court for the Southern District of New York relied entirely on Bankruptcy Judge Chapman's ruling that section 560's safe harbor protected the priority noteholder distributions at issue to affirm the dismissal of the bankruptcy law claims and also affirmed Judge Chapman's dismissal of LBSF's state law claims. Thereafter, LBSF appealed to the Second Circuit.

II. Second Circuit Decision

The Second Circuit began its analysis by discussing the Bankruptcy Code provisions that collectively prohibit enforcement of *ipso facto* clauses and section 560's protection of a swap participant's contractual right to terminate, liquidate, or accelerate a qualifying swap transaction upon a counterparty's bankruptcy.

The Court then explained that for the safe harbor to protect the shift in priority effectuated by the Priority Provisions, the following conditions must apply: (1) the Priority Provisions must be "swap agreements"; (2) the distribution of the collateral must constitute "liquidation"; and (3) the trustees must have exercised a "contractual right of a[ ] swap participant" in liquidating the collateral and distributing the proceeds.

A. The Priority Provisions are Part of the Swap Agreements

LBSF did not dispute that the ISDA Master Agreement and related schedules and confirmations governing the transactions fall within the Bankruptcy Code definition of "swap agreement". Instead,

[2] Bankruptcy Judge Chapman also dismissed LBSF's related state law claims for breach of contract, unjust enrichment, and fraudulent transfer as well as LBSF's request for a declaratory judgment that the Priority Provisions were unenforceable penalties. These dismissals were based on the Bankruptcy Court's determination that the Priority Provisions were not unenforceable *ipso facto* clauses and LBSF was not improperly deprived of any property or contractual right.

LBSF argued that the Priority Provisions, set forth in the CDO indenture, were not part of the swap agreement and therefore not protected by section 560 of the Bankruptcy Code.

The Court summarily dismissed this argument, explaining that the ISDA Master Agreements (through the schedules thereto) explicitly incorporated by reference the Priority Provisions by stating "all amounts, payable or expressed to be payable by [the Issuer] . . . shall be recoverable only from . . . the Collateral . . . , subject in any case to the Priority of Payments set out in the Indenture."

According to the Court, because the Priority Provisions are incorporated by reference into the swap agreement and dictate the distributions to be made thereunder, the Priority Provisions fall within the Bankruptcy Code's definition of swap agreement, which includes "the terms and conditions incorporated by reference."

B. The Distribution of Collateral Constitutes "Liquidation"

The Second Circuit noted that the section 560 safe harbor applies when a swap participant exercises its contractual right "to cause the liquidation, termination, or acceleration of one or more swap agreements." Therefore, for the safe harbor to protect the Priority Provisions, the application of such provisions must constitute a liquidation, termination or acceleration.

The Court ruled that the application of the Priority Provisions and the distributions made pursuant thereto constitute a liquidation for purposes of the section 560 safe harbor. Because "liquidation" is not defined in the Bankruptcy Code, the Court turned to the Black's Law Dictionary definition in its analysis and noted that "to 'liquidate might plausibly mean '[t]o settle (an obligation) by payment or other adjustment' or '[t]o ascertain the precise amount of (debt, damages, etc.).'"

LBSF argued that the latter definition is appropriate for purposes of interpreting the section 560 safe harbor, meaning that the scope of a liquidation for purposes of applying the safe harbor should be limited to ascertaining the precise amount of debt or damages. LBSF pointed to, among other things, the fact that Chapter 7 of the Bankruptcy Code refers to liquidation and distribution as distinct concepts, to support its position.

The Court disagreed with LBSF, and held that in the context of the safe harbors, the term liquidation must include the disbursement of proceeds from the liquidated collateral.

The Court's analysis on this issue includes an overview of the ban on enforcement of *ipso facto* clauses and a discussion of how this ban exposes a contract counterparty to significant bankruptcy risk. The point of the section 560 safe harbor, the Court explains, is to exempt the non-bankrupt swap counterparty from the ban on enforcement of *ipso facto* clauses and reduce its vulnerability to

counterparty bankruptcy risk. Therefore, reading section 560's reference to liquidation to include distribution of collateral furthers the statutory purpose of protecting swap participants from such risk.

The Court explained that adopting LBSF's reading of the provision would render the safe harbor hollow, because simply calculating amounts due would not provide security to swap participants if they are unable to collect such amounts.

The Second Circuit also rejected LBSF's argument that the lower courts' application of the safe harbor improperly protected the "entire transaction[ ] merely because one component of such transaction is safe harbored." According to LBSF, a broader safe harbor application ran afoul of the Supreme Court's recent *Merit Management* decision.[3] The Court explained that both the Bankruptcy Court and District Court appropriately focused on the specific action at issue, the transfers enforcing the Priority Provisions, and determined that the application of the Priority Provisions constituted the exercise of a contractual right of liquidation that was safe harbored as part of the liquidation process.

C. The Trustees Exercised a Contractual Right of a Swap Participant

The Court then turned to LBSF's argument that the trustees' termination of the swaps and distribution of collateral proceeds fell outside of the section 560 safe harbor because the trustees are not swap participants.

The Court dispensed with this argument by explaining that section 560 only requires the exercise of a contractual right "of" any swap participant, not that such right be exercised "by" a swap participant. The transaction documents granted to the Issuers the right to terminate the swap transaction and liquidate the collateral and expressly permitted the trustees under the indentures to exercise those rights. Consequently, the fact that the trustees were exercising those contractual rights and distributing the proceeds in accordance with the Priority Provisions did not render the safe harbor inapplicable.[4]

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[3] *Merit Mgmt. Grp. v. FTI Consulting, Inc.*, 138 S. Ct. 883 (2018).

[4] The District Court and Second Circuit dispatched LBSF's state law claims summarily. The state law claims generally required LBSF to allege that it was entitled to the payments. Both courts followed the Bankruptcy Court and determined that the Priority Provisions were not unenforceable *ipso facto* clauses and asserted that the state law claims rise and fall with the disposition of the bankruptcy law claims. As to the penalty claim, all three courts held that the claim only applies to a liquidated damages provision, not present in this case.

III. Conclusion

The Second Circuit's decision continues the recent amplification and expansion by various courts of the rights encompassed within the Bankruptcy Code safe harbors. Parties to safe harbored agreements now have more clarity on what the right to "liquidate" means in practice – and that right is more than mere math or calculating the quantum of a claim.

In this case, the Court interpreting the term liquidation to include the determination of priority and distribution of proceeds had a substantial impact, as LBSF was in the money upon termination but ended up receiving none of the approximately $1 billion that was distributed thereafter. The Court also clarified that the right "of" a swap participant encompasses the ability of collateral trustees acting under express authorizations to terminate transactions and liquidate collateral. Finally, the documentation of safe harbor-protected transactions is eased by the Court's broad endorsement of incorporation by reference of other agreements.

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