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Clients&FriendsMemo

District Court Grants BNY Leave to Appeal Bankruptcy Court's Interlocutory Order In Lehman, Prohibiting Enforcement Of Ipso Facto Clause In Swap

October 13, 2010

On September 21, 2010, the United States District Court for the Southern District of New York granted BNY Corporate Trustee Services Limited leave to appeal a decision of the Bankruptcy Court in the Lehman Brothers bankruptcy case.[1] The Bankruptcy Court held that a key provision of certain transaction documents constituted an unenforceable *ipso facto* clause. The District Court granted leave to appeal the Bankruptcy Court decision even though it was interlocutory. The District Court held that the case warranted interlocutory review because the Bankruptcy Court decision represented a controversial question of first impression and because appellate review would advance resolution of the litigation.

The "Flip" Provision

As previously discussed by the authors in a January 29, 2010 Clients & Friends Memo (Lehman Court Finds Payment Priority Provision Is Unenforceable Ipso Facto Clause, And Must Be Part of Swap For Safe Harbor Protection), BNY served as trustee under a Principal Trust Deed, governing a multi-issuer secured obligation program. As part of that program, Saphir Finance Public Limited Co.. a special purpose entity created by Lehman Brothers International (Europe), issued multiple series of credit-linked synthetic portfolio notes, two series of which were held by Perpetual Trustee Company Limited. Lehman Brothers Special Financing Inc. ("**LBSF**") entered into swap agreements with Saphir. BNY held the collateral in trust for the creditors of Saphir, including LBSF as swap counterparty and Perpetual as noteholder.

Pursuant to the transaction documents, payments to LBSF, as swap counterparty, had priority over payments to Perpetual, as noteholder. However, upon an event of default caused by LBSF, the transaction documents provided for a "flip" in priority so that Perpetual would receive payment before LBSF. Events of default under the swaps included a bankruptcy of any party to the

[1] *Lehman Bros. Special Fin. Inc. v. BNY Corp. Trust Servs. Ltd. (In re Lehman Bros. Special Fin. Inc.)*, Adv. Pro. No. 09-01242 (JMP) (S.D.N.Y. Sept. 21, 2010) (the "**Order**").

transaction, including LBSF or Lehman Brothers Holdings Inc. ("**LBHI**"), which provided credit support for LBSF.

LBHI filed for bankruptcy on September 15, 2008. LBSF, a subsidiary of LBHI, filed on October 3, 2008. On December 1, 2008, after both LBSF and LBHI filed for bankruptcy, Saphir terminated the swaps.

The Resulting Litigation

In May 2009, Perpetual commenced litigation in England to determine its rights under the transaction documents. LBSF subsequently commenced a parallel adversary proceeding in the Bankruptcy Court. LBSF sought declaratory judgment that the contractual provisions modifying LBSF's payment priority upon an event of default constituted an unenforceable *ipso facto* clause, in violation of sections 365(e)(1) and 541(c)(1)(B) of the Bankruptcy Code and that, as a result, LBSF was entitled to payment priority with respect to the collateral.[2]

On November 6, 2009, the English Court of Appeal, affirming the lower court, ruled that the flip provision was enforceable under English law. LBSF has further appealed to the Supreme Court of the United Kingdom, which has scheduled a hearing for March 2011.

On January 25, 2010, the Bankruptcy Court issued a memorandum decision concerning the impact of the Bankruptcy Code.[3] Bankruptcy Judge James Peck ruled that "provisions in the Transaction Documents purporting to modify LBSF's right to a priority distribution solely as a result of a chapter 11 filing constitute unenforceable *ipso facto* clauses . . . ."[4] Judge Peck based his decision on sections 365(e)(1) and 541(c)(1)(B) of the Bankruptcy Code, which "prohibit the modification of a debtor's right solely because of a provision in an agreement conditioned 'on the commencement of a *case* under this title.'"[5]

Citing to the legislative history and "plain language" of the relevant Bankruptcy Code provisions, the Court concluded that the *ipso facto* provisions of the Bankruptcy Code "appl[y] to the commencement of a case (presumably any case that is related in some appropriate manner to the contracting parties)."[6] The Court continued: "No case has ever declared that the operative

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2 Order at 4.

3 *See Lehman Bros. Special Fin. Inc. v. BNY Corp. Trust Servs. Ltd. (In re Lehman Bros. Holdings, Inc.)*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010).

4 Order at 6.

5 *Id.* (*quoting* 11 U.S.C. §§ 365(e)(1); 541(c)(1)(B) (emphasis in opinion)).

6 *Lehman Bros. Special Fin. Inc.*, 422 B.R. at 419.

bankruptcy filing is not limited to the commencement of a bankruptcy case by the debtor-counterparty itself but may be a case filed by a related entity. . . ."[7] Applying this "novel statutory interpretation" to the facts, Judge Peck concluded that the separate bankruptcy filings of LBHI and LBSF "constituted 'a singular event' for *ipso facto* purposes – but not for purposes of 'any other legal determination that may relate to the date of commencement of a case.'"[8] Judge Peck held that LBHI's petition "entitled LBSF, consistent with the statutory language, fairly read, to claim the protections of the *ipso facto* provisions of the Bankruptcy Code because its ultimate corporate parent and credit support provider . . . had filed a case under the Bankruptcy Code."[9]

Following the entry of the opinion, the Court determined not to enter an order until the English court ruled. BNY subsequently moved for entry of an order. The Bankruptcy Court entered an interlocutory order several days later. BNY then moved for leave to appeal the order.

Analysis

Under 28 U.S.C. § 1292(b), a court shall grant leave to appeal an interlocutory order only if: "(1) the order being appealed 'involves a controlling question of law', (2) there is 'substantial ground for difference of opinion' as to that question, and (3) 'an immediate appeal from the order may materially advance the ultimate termination of the litigation.'"[10] The Second Circuit also has held that "use of this certification procedure should be strictly limited because only exceptional circumstances [will] justify a departure from the basic policy of postponing appellate review until after the entry of a final judgment."[11]

In this case, LBSF conceded that the Bankruptcy Court's decision involved controlling questions of law, thus addressing the first prong.[12] With respect to the second prong, the District Court stated that Judge Peck himself predicted his decision would be "controversial" and pertained to a difficult issue of first impression."[13] Furthermore, "numerous legal and other commentaries [questioned] the correctness of Judge Peck's ruling."[14]

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7 *Id.* at 422.

8 Order at 7 (*quoting Lehman Bros. Special Fin. Inc.*, 422 B.R. at 420).

9 *Lehman Bros. Special Fin. Inc.*, 422 B.R. at 420.

10 Order at 10 (*quoting* 28 U.S.C. § 1292(b)).

11 Order at 10 (*quoting In re Flor*, 79 F.3d 281, 284 (2d Cir. 1996) (internal quotations omitted)).

12 Order at 11.

13 *Id.* at 11-12.

14 *Id.* at 12-13.

LBSF "responded meekly" by citing to a single article, which admitted that Judge Peck's ruling was of a "groundbreaking nature." Thus, the District Court concluded "that there is substantial ground for difference of opinion" over whether Judge Peck applied the correct legal standard in reaching his decision that LBHI's bankruptcy filing entitled LBSF to claim the protections of the Bankruptcy Code's *ipso facto* provisions.[15]

Finally, the Court considered whether review of the matter would "materially advance the ultimate termination of the litigation" thus satisfying the third prong under 28 U.S.C. § 1292(b). LBSF asserted that appeal would prolong the litigation because the "'Bankruptcy Court would be precluded from effectively communicating with the English Court until BNY's appeals are exhausted' and that no such appeal should go forward because it might be rendered 'moot' by the final result in the English Litigation."[16] The District Court dismissed these assertions:

> In the end, it is not difficult to see LBSF's arguments for what they really are: an attempt to use the English proceedings to insulate Judge Peck's decision from appellate review for as long as possible. For many months, LBSF opposed entry of any order memorializing the Bankruptcy Court's decision; now it vigorously seeks to forestall any review. LBSF's efforts to shield Judge Peck's unprecedented and – for LBSF – extremely favorable decision from review are, of course, not surprising; indeed, LBSF does not deny that, since the decision was handed down, [LBSF] has used it as leverage in settlement negotiations concerning billions of dollars worth of similar transactions. LBSF's desire to insulate Judge Peck's ruling from appellate scrutiny only further demonstrates the need for appellate review.[17]

For these reasons, the District Court held: "Judge Peck's decision resolved controlling questions of law that may dispose of the ultimate issue in this Adversary Proceeding – that is whether the Swap Counterparty Priority or Noteholder Priority applies." Accordingly, the Court held that immediate review would advance the termination of the litigation.[18]

The Court concluded by stating that, in addition to satisfying the relevant standard under 28 U.S.C § 1292(b), the case "presents precisely the sort of 'extraordinary circumstances' that warrant an interlocutory appeal. . . . Judge Peck's decision is of obvious and critical importance to the LBHI bankruptcy as it could allow LBSF to recover billions of dollars from various other structured finance

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[15] *Id.* at 13.

[16] *Id.*

[17] *Id.* at 15.

[18] *Id.* at 14.

deals that would otherwise be distributed to noteholders."[19] Moreover, "Judge Peck's interpretation of the Bankruptcy Code's *ipso facto* provisions has potentially far-reaching ramifications for the international securities markets, and has triggered significant uncertainty in the financial community."[20] The District Court "is not suggesting that the financial community's reaction to Judge Peck's decision necessarily casts doubt on its *legal* correctness. But the decision's potentially game-changing effect on the structured finance business *does* militate in favor of reviewing the decision now – not months or even years, from now."[21]

Next Steps

On October 8, 2010, the District Court held a status conference setting an expedited briefing schedule with briefs due between October 25 and November 30. District Court Judge McMahon may welcome *amicus* briefs though she set no date for their filing. Finally, Judge McMahon did not set a hearing date and may rule on the papers alone.

LBSF's appeal in the English courts will continue simultaneously on the other side of the Atlantic with a hearing set for March 2011. This should lead to more clarity on the Bankruptcy Court's expansive reading of the Bankruptcy Code's *ipso facto* provisions by the end of 2011.

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[19] *Id.* at 15.

[20] *Id.* at 16.

[21] *Id.* (emphasis in Order).