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Bankruptcy Court Broadly Applies Safe Harbors and Rejects Singular Event Theory Precedent

In a decision that parts ways with two prior decisions in the Lehman bankruptcy, *Lehman Brothers Special Financing Inc. v. Bank of America National Association*, No. 10-3547, Bankruptcy Court Judge Shelley Chapman (who is now presiding over the Lehman case) dismissed Lehman Brothers' claims seeking to claw back transfers made to noteholders in connection with the early termination of hundreds of swap transactions.

Lehman claimed that the applicable transaction documents contained an unenforceable ipso facto clause in their payment priority provisions and that the safe harbors of the Bankruptcy Code did not protect such payments from clawback. The court concluded that some, though not all, of the provisions did constitute ipso facto clauses, but the safe harbors were meant to be interpreted broadly and literally and did protect the payments from clawback. Lehman's reliance on two prior Lehman decisions decided by Judge James M. Peck (who, prior to his return to private practice, presided over the Lehman case), *Lehman Bros. Special Fin. Inc. v. BNY Corp. Trustee Servs. Ltd.*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010) and *Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007-1 Ltd.*, 452 B.R. 31 (Bankr. S.D.N.Y. 2011), was unavailing.

Background

Before its bankruptcy, Lehman Brothers Special Financing Inc. (LBSF) was involved in various collateralized debt obligation transactions. The documents governing these transactions contained specific provisions regarding priority of payments (often referred to as "waterfalls") to the parties to the transaction, in particular to noteholders and LBSF, as a swap counterparty under one or more swaps that were part of the transaction structure. Many of the documents stated that LBSF's payment priority would be determined at the time of a default under the swap. For some of these transactions, however, the documents stated that LBSF had a payment priority at the outset, but if LBSF became the defaulting party under the swap, then LBSF would lose that priority.

The September 15, 2008, bankruptcy filing of LBSF's parent, Lehman Brothers Holdings, Inc. (LBHI), caused LBSF to become a defaulting party under the swap agreements. Issuers then terminated their swaps with LBSF based on the default. Termination of the swaps gave noteholders a priority claim on the collateral.

LBSF filed for bankruptcy three weeks later.

In those transactions where the collateral was liquidated and distributed to noteholders before LBSF's bankruptcy filing, the parties and the court termed it a "pre-pre" transaction. When the termination occurred before LBSF's bankruptcy but the liquidation and distribution occurred afterwards, the court termed it a "pre-post" transaction. Finally, "post-post" transactions were when the early termination and distribution of collateral both occurred subsequent to LBSF's bankruptcy.

Lehman initiated an adversary proceeding to invalidate the payment priority provisions as unenforceable ipso facto clauses and to claw back the proceeds of the liquidated collateral paid to the noteholders.

Court's Analysis

The court examined the two types of priority provisions to see if they contained ipso facto clauses. In the "Type 1 Transactions," (which were all post-post transactions), if LBSF was in the money under a swap, it had priority in the waterfall from the outset, ahead of the noteholders. However, that priority was lost if LBSF became the defaulting party under the swap. The court explained this type of waterfall modified LBSF's right to payment and was therefore an unenforceable ipso facto clause.

In the "Type 2 Transactions," the priorities of payment were not determined until the swap was terminated. If at the time of termination LBSF was the defaulting party under the swap, then LBSF did not have a right to payment priority. Conversely, if the early termination of the swap was not based on an event attributable to LBSF, LBSF had a right to payment priority. The court explained that in this type of transaction, the condition precedent to LBSF's having any priority was never triggered. Therefore, LBSF never had a payment priority, much less one that was modified by LBHI's bankruptcy filing, and therefore such provisions could not be considered an unenforceable ipso facto clause.

Alternatively, the court stated that even if the Type 2 transactions did involve an ipso facto clause, for both "pre-pre" and "pre-post" transactions, the modification of LBSF's rights was trigged by LBHI's *earlier* bankruptcy filing, and therefore *before* LBSF's bankruptcy and *before* the Bankruptcy Code's limitation on the enforceability of ipso facto was applicable to LBSF. In so holding, the court declined to adopt Judge Peck's "singular event" analysis contained in the *BNY* decision.

The court noted that in *BNY*, Judge Peck, focusing on the "integrated enterprise" of the Lehman entities and the exigent circumstances surrounding the Lehman bankruptcy filings, stated in dicta that the LBHI petition date could "be considered as the operative date for a claimed reversal of the payment priority" and that LBSF was entitled to claim the protections of the ipso facto provisions as of the LBHI petition date. The court stated it should "undertake to determine anew whether there is an enduring legal basis" to adopt the theory and determined there was not. The court stated, "As critical as it was early in these cases that the contours of due process of law be 'situational' and 'function[ ] as a flexible standard at times of genuine emergency,' there was then, as there is now, an equally important need for uniformly applicable and readily applicable substantive legal principles."

The court then addressed the applicability of the Bankruptcy Code's safe harbors to the distributions that were made to the noteholders. The court rejected LBSF's argument that the safe harbor's use of the term "liquidate" did not include distribution of the proceeds of the liquidated collateral. Instead, the court explained that "the plain meaning of [section 560] protects both the act of liquidating and the manner for carrying it out." Explaining further, the court stated that the Second Circuit and courts in the circuit have repeatedly noted in cases decided subsequent to *BNY* and *Ballyrock* that the safe harbors require a "broad and literal interpretation." The court stated that "a broad reading of the safe harbors is consistent, and goes hand-in-hand, with congressional intent in creating (and subsequently expanding) the safe harbors to promote the stability and efficiency of financial markets."

The court also noted that the payment provisions at issue were clearly a part of the swap agreements, a fact that made them distinguishable from the *BNY* and *Ballyrock* decisions. In those cases, Judge Peck had concluded that the payment provisions of the transaction documents were not incorporated into the swap agreements, giving rise to the argument that they were beyond the scope of the safe harbor's protection of swap agreements.

Takeaway

Judge Chapman's rejection of Judge Peck's "singular event" theory, and her expansive reading of the safe harbors, should give transaction parties added comfort that market expectations will not be upset by bankruptcy courts.

In addition, however, careful drafting can help ensure that a payment priority provision is never determined to be an unenforceable ipso facto clause. Such provisions should be drafted so that payment priority is not altered by a party's default. Instead, the transaction documents should provide that payment priority is only determined when the swap is terminated.

In determining whether or not the safe harbor provisions applied, the fact that the schedule to the swaps either contained the priority of payment provision, or expressly incorporated such provisions by reference, weighed in favor of finding that the safe harbors applied. In order for swap participants to reduce exposure in case a counterparty files for bankruptcy, and ensure they are given the benefit of the safe harbor provisions, they should take care to ensure payment provisions are similarly contained in the schedule to their swap or are expressly incorporated by reference.

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Kit Weitnauer
404.881.7780
kit.weitnauer@alston.com

Shanell Cramer
212.210.9580
shanell.cramer@alston.com

Will Sugden
404.881.4778
will.sugden@alston.com

Aimee Cummo
212.210.9428
aimee.cummo@alston.com

David Wender
404.881.7354
david.wender@alston.com

Karen Gelernt
212.210.9535
karen.gelernt@alston.com

Jonathan Edwards
404.881.4985
jonathan.edwards@alston.com

Lorraine Sarles
213.576.1096
lorraine.sarles@alston.com

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