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Judge Chapman Flips the Script

US Bankruptcy Court for the Southern District of NY Grants Noteholders' Motion to Dismiss Based on Lehman's Failure to State Claim With Respect to Flip-Clause Litigation

On June 28, 2016, in what essentially was a clean sweep for the noteholder and trust certificate holder defendants (the "Noteholders"), the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court") granted an omnibus motion to dismiss Lehman Brothers Special Financing, Inc.'s ("LBSF") adversary proceeding, which sought the avoidance and recovery of various Noteholder distributions. In addition to rejecting Judge Peck's "singular event theory," Judge Chapman also found that the flip-clause provisions at issue were not unenforceable as argued by LBSF, and that regardless, all related collateral distributions were covered by the Bankruptcy Code's safe harbors for financial contracts.[1]

Background

Lehman was party to numerous synthetic collateralized debt obligation ("CDO") transactions, whereby Lehman entered into swap agreements with special purpose vehicles ("SPV") that, in turn, issued notes to various classes of noteholders.[2] The swaps in the Lehman synthetic CDO structures were entered into by LBSF, with Lehman Brothers Holdings Inc. ("LBHI") acting as guarantor. The transaction documents include provisions governing payment priority from the liquidation of collateral after termination of the swaps (the "Priority Provisions"). Upon termination, LBSF held payment priority ahead of payments to the Noteholders under some circumstances ("LBSF

1 *Lehman Bros. Special Fin. Inc. v. Bank of Am. Nat'l Ass'n (In re Lehman Bros. Holdings Inc.)*, No. 10-03547, 2016 WL 3621180 (Bankr. S.D.N.Y. June 28, 2016, as amended July 8, 2016).

2 In a typical synthetic CDO structure, the SPV issues notes to investors, then uses the proceeds to purchase assets to serve as collateral (generally for all obligations under the structure, both to the swap counterparty and to the noteholders) that is held with a trustee. The SPV enters into a swap agreement whereby the SPV sells credit protection in relation to certain reference obligations/entities in exchange for periodic premium payments made for the benefit of the SPV. The effect is to synthetically supply the assets from which investment returns to noteholders are derived.

The documentation underlying such structures typically contains a "flip-clause" that changes the priority of payments upon the default of the swap counterparty, with the goal of ensuring that the defaulting swap counterparty is not paid any termination payments until the noteholders are repaid in full. Ordinarily, collateral proceeds are first used to pay any amounts owed to the swap counterparty and second to pay amounts owing under the notes. Upon an event of default of the swap counterparty, however (such as a bankruptcy filing), the priorities "flip" such that proceeds are first used to pay amounts owing under the notes, and second to pay amounts owing under the swap.

Priority"), while in other circumstances the Noteholders held payment priority ahead of LBSF ("Noteholder Priority"). The type of priority depends on both the circumstances of the early termination of the swap (*e.g.*, an event of default), and which party defaulted, thus causing the early termination.

On September 15, 2008, LBHI filed for bankruptcy relief, triggering various defaults under the swap agreements whereby LBSF became the defaulting party.[3] LBSF filed for bankruptcy relief nearly three weeks later on October 3, 2008. For each swap transaction, the issuer (or its agent) designated an "early termination date" based on LBSF's default, and delivered termination notices which both terminated the swaps and accelerated the amount due on the notes.[4] In each instance, the trustees applied Noteholder Priority because the early terminations were the result of an event of default, and LBSF was the defaulting party.

Early in the bankruptcy cases, there was litigation over one of the CDO structures[5] in which LBSF argued, among other things, that the flip-clause was invalid under US bankruptcy law as an unenforceable *ipso facto* provision.[6] In January 2010, Judge Peck issued a decision finding that the flip-clause was unenforceable.[7] In so holding, Judge Peck concluded that, upon LBHI's chapter 11 filing, the Bankruptcy Code's *ipso facto* protections became available to LBSF, notwithstanding that LBSF had not yet filed for bankruptcy protection at that time, relying primarily on equitable factors as opposed to supporting case law.[8] The United States District Court for the Southern District of New York (the "District Court") granted the trustee's motion for leave to appeal, concluding that "there is substantial

[3] Because LBHI was a guarantor of LBSF's payment obligations under the swaps and served as a credit support provider to LBSF, LBHI's bankruptcy triggered an event of default.

[4] Of the 44 transactions at issue, 36 swaps were terminated prior to the LBSF petition date, and seven were terminated after the LBSF petition date. For the majority of the swaps terminated prior to the LBSF petition date, the collateral was liquidated and payments were distributed prior to the LBSF petition date (the "Pre-Pre Transactions"). For others, the swaps were terminated prior to the LBSF petition date but distributions were not made until after the LBSF petition date (the "Pre-Post Transactions"). Finally, with respect to the remaining swaps, the termination of the swaps, liquidation of the collateral and distribution of proceeds all occurred after the LBSF petition date.

[5] *Lehman Bros. Special Fin. Inc. v. BNY Corp. Trustee Servs. Ltd. and Lehman Brothers Special Fin. Inc.*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010) (commonly referred to as the "*Perpetual*" adversary proceeding).

[6] Under the Bankruptcy Code, a provision that purports to modify or terminate an executory contract (a contract where performance is due on both sides) based on the bankruptcy or insolvency of either party is unenforceable upon the commencement of a bankruptcy proceeding.

[7] Prior to Judge Peck's decision, the English Court of Appeal also had considered the enforceability of flip provisions in the context of the same transaction and arrived at the opposite conclusion. While acknowledging the conflicting ruling, Judge Peck concluded that he was not bound by that result on the basis of comity, and that application of the relevant provisions of the Bankruptcy Code dictated a contrary result.

[8] In May 2011, Judge Peck entered a decision in another flip-clause adversary proceeding in which he cited to his prior *Perpetual* decision and followed its logic in finding the flip-clause at issue unenforceable. *Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007-1 Ltd. (In re Lehman Bros. Holdings Inc.)*, 452 B.R. 31 (Bankr. S.D.N.Y. 2011).

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 *ipso facto* provisions."[9]

In September of 2010, LBSF commenced the present adversary proceeding challenging the enforceability of the flip-clause in a number of CDO structures and seeking, among other things, a declaratory judgment that the Priority Provisions are unenforceable *ipso facto* clauses and that distributions made pursuant thereto violated the automatic stay. In December of 2015, the Noteholders filed a motion to dismiss.

Decision

While the decision is fairly detailed, the core question is the enforceability of the alleged *ipso facto* clause in the applicable documents. The answer to that question, in turn, can be broken down into three categories of issues that were ruled upon by Judge Chapman.

No Flip for "Type-Two Transactions"

First, the Bankruptcy Court considered whether the Priority Provisions constitute *ipso facto* clauses, which required the Bankruptcy Court to determine (i) the nature of the rights LBSF held prior to the early termination date; (ii) whether enforcement of the Priority Provisions modified any right of LBSF; and, if so, (iii) when such modification occurred.

The Bankruptcy Court noted two different categories of swap transactions based on differences in the language of the Priority Provisions. In "Type 1 Transactions," LBSF held an *automatic* right to payment priority of a swap termination payment ahead of the Noteholders unless the conditions for an alternative priority were satisfied (*e.g.*, LBSF would be paid before the Noteholders unless LBSF, as defaulting party, triggered an early termination of the swap, in which case the payment priorities would "flip" and the Noteholders would be paid first). In "Type 2 Transactions," the Priority Provisions do *not* establish a default priority position for a termination payment; instead, the determination as to whether LBSF or the Noteholders would be paid first remained unfixed until the swap actually was terminated (based on the circumstances surrounding the termination).

The Bankruptcy Court held that enforcement of the Priority Provisions in Type 1 Transactions effected an *ipso facto* modification of LBSF's rights, reasoning that because LBSF held a right to receive its termination payments ahead of payments to Noteholders (which right was modified as a result of LBSF's default on those swaps), LBSF was divested of its priority right as a result of its default. In contrast, the enforcement of the Priority Provisions in Type 2 Transactions did not effect any modification of LBSF's rights. The Bankruptcy Court reasoned that LBSF never held a right to priority payment; such a right only would have arisen if, upon early termination of a swap, the conditions necessary to trigger LBSF Priority existed. As a result, the Bankruptcy Court found that only the Priority Provisions with respect to Type 1 Transactions *ipso facto* modified LBSF's rights because of its default. However, as described below, the Bankruptcy Court also found that the safe harbor applicable to "swap agreements" of section 560 of the Bankruptcy Code nonetheless protects distributions made pursuant to Type 1 Transactions.

[9] Following the District Court decision, Lehman entered into a non-public settlement agreement resolving all disputes relating to the transaction documents.

Dismissal of Singular Event Theory

Next, the Bankruptcy Court held that with respect to the Pre-Pre Transactions and the Pre-Post Transactions,[10] any modification of the Priority Provisions that occurred before the LBSF petition date did not *ipso facto* modify LBSF's rights in violation of the Bankruptcy Code.[11] In so holding, Judge Chapman declined to adopt the "singular event theory" from *Perpetual*, wherein Judge Peck observed that LBSF could claim the Bankruptcy Code's protections against *ipso facto* clauses as of the earlier LBHI petition date. The Bankruptcy Court also held that any modification of LBSF's rights was effective upon the early termination resulting from LBSF's default, and not upon the subsequent sale and distribution of the collateral proceeds (as argued by LBSF). For Pre-Pre Transactions and Pre-Post Transactions, LBSF's right to receive payment ahead of the Noteholders under the Priority Provisions was thus fixed prior to the LBSF petition date, and therefore was not modified after LBSF's bankruptcy filing in violation of the Bankruptcy Code.

Safe Harbors

Finally, the Bankruptcy Court held that the distributions made pursuant to the Priority Provisions are protected by the safe harbor for "swap agreements" of section 560 of the Bankruptcy Code.[12] LBSF argued that because distribution of the proceeds of the collateral was not mandatory under the relevant documents, the distributions to Noteholders are unrelated to the liquidation and termination of the swaps, and as a result, fall outside the scope of the safe harbor.[13] The Bankruptcy Court disagreed, noting that the liquidation of the collateral and the distribution of proceeds pursuant to the Priority Provisions directly followed the termination of the swaps. Accordingly, termination of the swaps led to the liquidation of the collateral, the determination of the amount due to each secured party and the corresponding distribution of those amounts pursuant to the applicable waterfall. As a result, the Bankruptcy Court held that enforcement of the Priority Provisions was part of the exercise of a right to cause the liquidation or termination of the swaps.

[10] As a reminder, the Pre-Pre Transactions are those where the collateral was liquidated and payments were distributed prior to the LBSF petition date. The Pre-Post Transactions are those where the swaps were terminated prior to the LBSF petition date but distributions were not made until after the LBSF petition date.

[11] Section 365(e)(1) provides that only modifications that occurred *after* the commencement of the case may be invalidated. 11 U.S.C. § 365(e)(1) (emphasis added).

[12] Section 560 of the Bankruptcy Code provides: The exercise of any contractual right of any swap participant or financial participant to cause the liquidation, termination or acceleration of one or more swap agreements because of a condition of the kind specified in section 365(e)(1)…shall not be stayed, avoided or otherwise limited by operation of any provision of this title or by order of a court…in any proceeding under this title. 11 U.S.C. § 560.

[13] In so arguing, LBSF relied heavily on language in Judge Peck's decision in *Perpetual* holding that section 560 did not protect the relevant priority provisions. The Bankruptcy Court noted that Judge Peck's determination in *Perpetual* relied on a ruling that the priority provisions at issue did not comprise part of the swap agreement, and so the provisions governing liquidation were not part of the swap agreement. *Perpetual*, 422 B.R. at 421. Here, however, the Bankruptcy Court found that the Priority Provisions are either explicitly set forth in the schedules to the ISDA Master Agreements or are incorporated into such schedules from the relevant indentures.

LBSF also argued that here, the right to enforce the Priority Provisions and make distributions belonged to the trustees and/or noteholders, who were neither swap participants nor financial participants as defined by the Bankruptcy Code. The Bankruptcy Court again disagreed, and held that the enforcement of the Priority Provisions was a right of the issuers, who indisputably meet the definition of swap participants,[14] as each issuer was a party to the respective swaps. The Bankruptcy Court also noted that the trustees' acting on behalf of the issuers does not preclude the application of the safe harbors, citing the Second Court's *Tribune* decision for the proposition that the safe harbors are intended to and must protect transactions, not individual parties, if they are to protect the stability and efficiency of the financial markets.[15] Because the collateral was held by the trustees to secure the obligations the issuers owed to the secured parties, the Bankruptcy Court found that the issuers held a corresponding right to liquidate the collateral upon early termination to satisfy their obligations.

Conclusion

This decision, which we believe was the correct result, was still somewhat surprising as Judge Chapman previously had referred to Judge Peck's "singular event" theory as law of the case. However, Judge Peck himself recognized that his decisions in *Perpetual* and *Ballyrock* might be overturned, stating: "[t]he Court is not aware of any other case that has … ever declared that the operative 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…[b]ecause this is the first such interpretation of the ipso facto language, the Court anticipates that the current ruling may be a controversial one…"[16] With respect to the safe harbor arguments, the Bankruptcy Court correctly noted that a broad reading of the safe harbors is consistent with congressional intent in creating (and subsequently expanding) the safe harbors to promote the stability and efficiency of the financial markets.

[14] Section 101(B)(53C) defines "swap participant" as any entity that, at any time before the filing of the petition, has an outstanding swap agreement with the debtor. 11 U.S.C. § 101(B)(53C).

[15] *Deutsche Bank Trust Co. Ams. v. Large Private Beneficial Owners (In re Tribune Co. Fraudulent Conveyance Litig.)*, 818 F.3d 98 (2d Cir. 2016) (confirming sweeping breadth of the section 546(e) safe harbor and rejecting interpretation of section 546(e) that would lead to irreconcilable conflict with the purpose of the statute).

[16] It is notable that Judge Peck also declined to extend his "singular event" theory to other legal issues relating to the separate petition dates of LBHI and LBSF.

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