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Lehman Brothers: *Ipso facto* clauses and the anti-deprivation rule – US and English Courts speak a different language

On January 25, 2010, the United States Bankruptcy Court for the Southern District of New York entered an order granting summary judgment in favor of Lehman Brothers in a dispute involving so-called “flip clauses” contained in collateralized debt obligation (CDO) transactions. Flip clauses – designed to reorder payment priorities in CDO transactions – seek to ensure that a defaulting swap counterparty is not paid any termination payments until the noteholders are repaid in full. The purpose of these types of provisions is to prevent a defaulting swap counterparty from benefiting as a result of its own default at the expense of the noteholders.

Prior to the US Bankruptcy Court’s decision, the English Court of Appeal had also considered the enforceability of flip provisions in the context of the same transaction. In a judgment rendered on November 6, 2009, the English court had arrived at the opposite conclusion.

This Client Publication considers the conflicting judgments and the implications for cross-border financial and other contracts.

Background

The subject of both the US and English proceedings was a dispute arising out of a synthetic CDO transaction where an English law trust deed (the equivalent of a US trust indenture) contained a “flip clause” that changed the priority of payments upon the default of the swap counterparty. Pursuant to the CDO transaction, Lehman Brothers Special Financing Inc. (“LBSF”) entered into swap agreements with a special purpose vehicle (“SPV”) and the SPV issued certain notes to certain classes of noteholders. Lehman Brothers Holdings Inc. (“LBHI”) guaranteed LBSF’s obligation in respect of the swaps. When LBHI commenced its chapter 11 proceeding on September 15, 2008, it

triggered a default under the swap agreements. LBSF filed for bankruptcy nearly three weeks later on October 3, 2008.

Due to the default under the swap agreements, the holder of the notes issued by the SPV, Perpetual Trustee Company Limited (“Perpetual”), directed the collateral trustee, BNY Corporate Trustee Services Limited (“BNY”), to give effect to the flip clause, liquidate the collateral securing the notes and the swap agreement and distribute the proceeds in accordance with the altered priority of payments. When BNY refused to comply, Perpetual commenced an action against BNY in the English Court, seeking a judgment directing BNY to enforce the security over the collateral and further

declaring that BNY is obligated to make distributions in accordance with the flip clause. LBSF intervened and argued that the flip clause is invalid under US bankruptcy law.

During the pendency of the English proceedings, LBSF commenced an adversary proceeding in the Lehman chapter 11 cases against BNY seeking a declaratory judgment that the flip clause is invalid under US bankruptcy law. LBSF, as the swap counterparty, asserted that the flip clause is an unenforceable *ipso facto* provision under the US Bankruptcy Code¹ and to enforce such a provision would be a violation of the automatic stay.² LBSF and BNY then filed cross-motions for summary judgment in the adversary proceeding.

The US Bankruptcy Court's View

The US Bankruptcy Court considered three issues in deciding the cross-motions for summary judgment:

(i) whether the flip clause is an unenforceable *ipso facto* provision; (ii) whether the trust deed that contained the flip clause is safe harbored;³ and (iii) whether the flip clause is a subordination agreement that must be given effect in bankruptcy.⁴

With respect to the first issue, LBSF argued that the flip clause is an unenforceable *ipso facto* provision because the trust deed is an “executory contract” (as used in the US Bankruptcy Code) and the clause is conditioned on the filing of a bankruptcy case. BNY responded with

three main arguments: (i) the transaction documents provide that they are to be governed by English law so the US Bankruptcy Court must defer to the determination of the English Court; (ii) the trust deed is not an executory contract so the *ipso facto* prohibition in the US Bankruptcy Code is not applicable; and (iii) even if the trust deed is an executory contract, the flip clause was triggered by LBHI's bankruptcy filing such that the property right claimed by LBSF was already lost before LBSF itself had filed for bankruptcy.

Further, BNY argued that even if the flip clause is an *ipso facto* provision, the trust deed that contained the clause is safe harbored under the US Bankruptcy Code. BNY asserted that because the swap agreement and the trust deed operate as an integrated whole, they should both be viewed as “swap agreements” entitled to safe harbor treatment. In addition, BNY maintained that the flip clause related to the “liquidation” of the swaps, an act that expressly is safe harbored. LBSF countered that the trust deed is not safe harbored because it is not a “swap agreement” within the meaning of the US Bankruptcy Code, and that the flip clause, which relates to distribution priorities (as opposed to “liquidation, acceleration or termination”), does not fall within the scope of the safe harbor.

BNY further argued that the flip clause qualified as a “subordination agreement” within the meaning of the US Bankruptcy Code, and, therefore, should be given effect in bankruptcy. LBSF disagreed.

The US Bankruptcy Court ruled in favor of LBSF on all counts. As a preliminary matter, the court held that because it was interpreting the US Bankruptcy Code, it was not required to defer to the determination of the English Court. On the *ipso facto* issue, the US Bankruptcy Court concluded that the flip clause was unenforceable because (i) the provision appeared in the transaction documents which qualified as “executory contracts” and (ii) the *ipso facto* protection was available to LBSF at the time of LBHI's chapter 11 filing, notwithstanding that LBSF itself did not file for bankruptcy protection for nearly three weeks

¹ Under the US Bankruptcy Code, provisions that purport 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 are unenforceable upon the commencement of the bankruptcy proceeding. Such provisions are commonly referred to as *ipso facto* clauses (the Latin phrase meaning “by the fact itself”) because the fact of bankruptcy or insolvency itself purports to trigger the termination or modification.

² The automatic stay prohibits parties from taking any action, based upon a prepetition obligation of the debtor, that has an adverse effect on the debtor's property.

³ The US Bankruptcy Code provides that the exercise of contractual rights to liquidate, terminate or accelerate derivatives contracts is not stayed in bankruptcy.

⁴ Under the US Bankruptcy Code, a subordination agreement is enforceable in bankruptcy to the same extent that such agreement is enforceable under applicable nonbankruptcy law.

thereafter.⁵ In reaching the conclusion that the *ipso facto* protections were available to LBSF upon its parent's chapter 11 filing, the US Bankruptcy Court primarily relied on equitable factors and did not cite any supporting case law.

With respect to the safe harbor issue, the US Bankruptcy Court held that the trust deed containing the flip clause did not qualify for safe harbor treatment because it was not sufficiently integrated into the related swap agreements. The US Bankruptcy Court also held that because the safe harbor deals expressly with "liquidation, termination or acceleration," as opposed to the alteration of payment priority, the flip clause did not qualify for safe harbor treatment.

Finally, on the subordination agreement issue, the US Bankruptcy Court held that notwithstanding the US Bankruptcy Code's express recognition of subordination agreements, the flip clause could not be given effect because of the separate prohibition in the US Bankruptcy Code against *ipso facto* clauses.

The US Bankruptcy Court's decision is subject to appeal.⁶

The English Court Of Appeal's View

Unlike the US Bankruptcy Code, there are no specific provisions of English insolvency law that prohibit modifications to contracts or the termination of contracts based on the insolvency of the counterparty.

There is however a common law rule that is best characterized as the "anti-deprivation rule" that prevents contracts from providing that someone's property is taken away from them upon bankruptcy and so is not available for their creditors.

The English Court of Appeal considered how that rule should be applied to complex financial instruments, particularly where the parties are assumed to be commercially sophisticated and expertly advised. The English Court made the point that it is important that, so far as possible, judicial decisions in the insolvency field need to be clear and consistent and that the Courts should not extend the categories of transactions that can be set aside in an insolvency beyond those circumstances provided for in the English Insolvency Act.

The English Court concluded that, as a matter of English law, the only asset LBSF ever had was a limited recourse right to payment from the SPV in an order of priority of payments that could change over time. That asset was not altered by the change in the priority of payments.

The English Court concluded that the rule cannot apply where the asset of which the insolvent is being deprived was acquired with another person's money.

The English Court also considered that, on an analysis of the terms of the transaction documentation, any apparent deprivation had taken place before LBSF had commenced bankruptcy proceedings. This is in contrast to the US Bankruptcy Court which, on reviewing the same provisions, concluded that any change in the priority of payments only took effect post the LBSF bankruptcy filing when the proceeds of enforcement of the collateral were to be applied.

Implications For Cross-Border Financial And Other Contracts

This precedent setting decision has implications beyond CDO transactions involving Lehman Brothers and impacts the securitization markets more generally as swaps and flip clauses are often employed in securitization structures to achieve credit enhancement or as a means of synthetic investment. Indeed, the rating agencies have announced that they are undertaking a review of existing structures to evaluate the impact of this decision on assigned ratings. One possible result of this rating agency review is that notes

⁵ As additional support, the US Bankruptcy Court reasoned that because the flip clause does not become relevant until the underlying collateral is liquidated – which had not yet occurred at the time of LBSF's bankruptcy filing – LBSF's right to payment had not been altered at the time it commenced its own chapter 11 case. The transaction documents, however, appear to provide that the flip provision becomes applicable upon the occurrence of an event of default, such as LBHI's bankruptcy filing.

⁶ As of the date of this Client Publication, BNY had not filed a notice of appeal.

issued in a securitization structure employing swaps may not be rated higher than the rating of the swap counterparty making these notes ineligible for investment by entities such as insurance companies and pension plans. Another trend resulting from this decision may be the migration of these securitization transactions outside of the US and a reluctance to use counterparties, trustees and other service providers

with a nexus to the US. Until the issue of enforceability of flip clauses in bankruptcy is given further clarity either through the appeal process or additional case law, the current uncertainty may well chill the securitization markets. Shearman & Sterling is working closely with its clients on structuring and implementing alternative arrangements designed to address the concerns raised by this decision.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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