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Client Alert

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The "Flip" Flap: Lehman Bankruptcy Judge Invalidates Payment Priority Clause

Introduction

On January 25, 2010, Judge James Peck of the US Bankruptcy Court for the Southern District of New York Bankruptcy Court (the Bankruptcy Court) introduced more turmoil into the world of structured financial transactions by denying enforcement of a so-called "flip" clause in connection with a swap agreement. Had the clause, found in the collateral documents supporting a structured note program, been enforced, it would have granted payment priority to holders of notes underlying the swap over Lehman Brothers Special Financing Inc. (LBSF), an affiliate of the issuer.

In his decision, Judge Peck found that the provision in question — a relatively common clause in structured deals that changes or "flips" the payment priority of a swap counterparty from first to last upon default by the counterparty — was unenforceable because it violated the *ipso facto* provisions in Sections 365(e)(1) and 541(c)(1)(B) of the US Bankruptcy Code that prohibit modification of a contract solely as a result of a bankruptcy. Judge Peck offered two alternate rationales for his conclusion that the *ipso facto* provisions were applicable in this case. First, contrary to the findings of English courts reviewing the same facts, Judge Peck found that the "flip" for reversal of priority purposes did not occur on the date of the first event of default under LBSF's contract, but instead took effect only when the contract counterparty sent a notice of default and termination, which occurred after LBSF filed for Chapter 11 protection. Second, Judge Peck found that the business affairs of LBSF and its parent, Lehman Brothers Holdings Inc. (LBHI), were so intertwined that the Chapter 11 filing of LBHI was sufficient to give LBSF the protection of the *ipso facto* provision of the Bankruptcy Code even before LBSF made its own filing. These rationales could have far reaching implications in the Lehman Chapter 11 cases and future bankruptcy cases because they expand the scope of the *ipso facto* provisions of the Bankruptcy Code in unanticipated ways. The decision has not yet been formally implemented, and it will be subject to appeal, but LBSF has already taken steps to use this decision to improve its position in other cases and negotiations.

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Background

Judge Peck's decision was issued in *Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Services Ltd.*, an adversary proceeding related to the Chapter 11 cases of LBHI and its affiliated debtors. The full background of this case requires a review of the commercial context of the case and of a separate litigation in the United Kingdom on the same facts that reached an opposite result.

BNY Corporate Trustee Services Limited (BNY) is the collateral trustee for a multi-issuer secured obligation issuance program organized by Lehman. Under the program, Saphir Finance Public Limited Company (Saphir), an affiliate of LBHI, issued notes to the public and entered into a swap agreement with LBSF guaranteed by LBHI. BNY holds various assets for the benefit of Saphir's creditors: Perpetual Trustee Company Limited (Perpetual), acting as trustee for the note holders, and LBSF, as swap counterparty. Under the relevant trust deed, which is governed by English law, LBSF enjoyed priority in payment to Perpetual in the ordinary course of business. However, the flip clause provides that an event of default by LBSF under the swap agreement, including a Chapter 11 filing by LBSF or LBHI, reverses the payment priority, placing Perpetual ahead of LBSF.

LBHI filed its petition for Chapter 11 protection on September 15, 2008, and LBSF followed with its own Chapter 11 filing on October 3, 2008. Later, on December 1, 2008, Saphir sent notices to LBSF calling an event of default based on LBSF's bankruptcy filing and exercising its remedies, including flip of payment priority. The notices purported to terminate the swap agreement and selected December 1, 2008 as the early termination date. If effective, such termination would obligate Saphir to redeem the notes.

Perpetual filed suit against BNY (the English Litigation) in the English High Court of Justice, Chancery Division (the High Court) seeking recognition of its priority of payment under the terms of the swap agreement (Noteholder Priority). LBSF intervened in the English Litigation and argued that shifting of the payment priority was ineffective under the English anti-deprivation principle, which is similar but not identical to the principle underlying the *ipso facto* provisions of the US Bankruptcy Code. The High Court held that LBSF's interests in the collateral securing the swap agreement was "limited and conditional" and therefore that shifting to Noteholder Priority did not violate the anti-deprivation principle under English law. The High Court found September 15, 2008 — the date of the LBHI's Chapter 11 filing — to be the effective date for the change in payment priority.

LBSF appealed the High Court's decision, and the English Court of Appeal unanimously affirmed the judgment, finding that LBSF had lost no property right or interest as a result of the flip to Noteholder Priority, because its rights to the collateral had always been contingent. LBSF filed a further appeal of the High Court's decision on March 26, 2010, and the Supreme Court of the United Kingdom has decided to hear the case, with hearings tentatively set for March 1-3, 2011.

After the English Litigation had been initiated, on May 20, 2009, LBSF filed a complaint against BNY as an adversary proceeding in the context of the jointly-administered LBHI Chapter 11 cases.

The US Bankruptcy Court's Decision

Impact of the English Litigation

As a preliminary matter, BNY argued that because the transaction documents are governed by English law, the Bankruptcy Court should defer to the Court of Appeal's ruling that Saphir's termination of the swap agreements and the flip to Noteholder Priority were effective. The Bankruptcy Court, however, found that it is not obligated to recognize the results of the English Litigation. Judge Peck instead held that granting comity and deferring to the results of the English Litigation was not appropriate in this case because the English courts did not take into account the prohibitions on *ipso facto* clauses under the US Bankruptcy Code.

Application of the Prohibition on *Ipso Facto* Clauses

An important issue for both the American and English courts was the question of precisely when the flip occurred. Determination of that issue defines the nature of the interests LBSF had in the collateral arrangements at the time it filed for Chapter 11 protection. Judge Peck found that the flip in payment priority did not take effect until the collateral had been sold and proceeds were ready for distribution (which has not occurred), meaning that LBSF still had payment priority on its filing date. This finding is directly contrary to the findings of the English courts, which held that the effective date of the change in payment priority was the date of LBHI's Chapter 11 filing, caused by an event of default under the swap agreement on that event.

The Bankruptcy Court also found that even if the LBHI petition date was considered the operative date for the reversal of priorities, the *ipso facto* provisions of Sections 365(e)(1) and 541(c)(1)(B) of the US Bankruptcy Code would nevertheless bar modification of payment priorities as a result of LBHI's bankruptcy filing. Judge Peck reached this result by ruling that the trigger language of Section 365(e) referring to "the commencement of *a case*," encompasses equally the commencement of a case *by or against a closely related entity as it does the commencement of a case by or against the debtor*. Judge Peck admitted that he was promulgating a somewhat vague standard in this regard, but he pointed out that the Lehman Brothers group was a fully "integrated enterprise" so he had no doubt that "the Chapter 11 cases of LBHI and its affiliates [are] a singular event for purposes of interpreting the *ipso facto* language," and that LBSF was therefore entitled to claim the *ipso facto* protections as of September 15, 2008, the date LBHI filed for Chapter 11 protection.

Application of the Safe Harbor Provisions of the Bankruptcy Code

Judge Peck rejected summarily two other arguments made by BNY. The first was that the flip clause should be enforceable because it was an essential element of an integrated swap agreement protected under the "safe harbor" provisions of Section 560 of the Bankruptcy Code.[1] Judge Peck found that argument unpersuasive as a matter of fact because the swap agreement did not even mention the flip clause, which was found only in the trust deed.

Moreover, because Section 560 of the Bankruptcy Code deals only with offset, liquidation, termination or acceleration of swap agreements, Judge Peck followed the strict logic of his September 17, 2009 ruling on LBSF's motion to compel Metavante Corporation to perform obligations under a swap agreement and to enforce the automatic stay that any clause in a derivative contract dealing with matters not expressly contemplated by Section 560 is not eligible for safe harbor protection.

Enforceability of Subordination Agreements under Section 510 of the Bankruptcy Code

BNY also argued that the flip clause should be enforceable under Section 510(a) of the Bankruptcy Code, which provides that a subordination agreement is enforceable in a bankruptcy case to the same extent that such agreement is enforceable under applicable non-bankruptcy law. Judge Peck conceded that the arrangements for payment priority could be construed as a subordination agreement but found that they differed significantly from typical subordination agreements because the "shifting nature of the subordination . . . is being activated by reason of a bankruptcy filing." Judge Peck found that this "flip" triggered by a bankruptcy filing ran afoul of the *ipso facto* provisions of the Bankruptcy Code and rendered the clause unenforceable, while a subordination agreement that provides for fixed lien or payment priorities regardless of a future bankruptcy filing would be enforceable.

Conclusion and Potential Implications

The most immediate consequence of this decision is, of course, that BNY is trapped between two contradictory court orders in two jurisdictions — one telling it to pay the note holders first and the other telling it to pay LBSF first. While the Bankruptcy Court's decision has not yet been implemented (pending coordination between the Bankruptcy Court and the English courts), BNY has stated it will appeal the Bankruptcy Court's decision once an order has been entered by the court.

Throughout his decision, Judge Peck acknowledged the difficulty of BNY's situation and he ended by expressing a hope that "the parties, this Court and the English Courts . . . [can] work in a coordinated and cooperative way to identify means to reconcile the conflicting judgments." The appeal may shed some new light on the appropriate extraterritorial reach of the US Bankruptcy Code, particularly in such an unusual situation as this in which US law is being used to upset the outcomes of litigation on identical facts in another country.

For parties other than BNY, this decision is troubling for a number of reasons, particularly since the structured note program in questioned was arranged by Lehman. The flip clause was a material element in the protection offered to the note holders and was voluntarily agreed to by LBSF in order to ensure the success of the issuance. Now, note holders will be paid only after LBSF has been paid and, in some cases, there will not be enough money to pay both. Furthermore, Judge Peck qualified his decision as being driven by circumstances that are "unique to the Lehman bankruptcy cases and unprecedented." The decision that affiliates of a debtor may be entitled to the protection of the prohibitions on *ipso facto* clauses before they actually file for bankruptcy may be applied as a precedent in future cases where entity in any "integrated enterprise" make their Chapter 11 filings over time.

Pending a decision on BNY's appeal, structured transaction and derivative lawyers should carefully consider the drafting of current and future flip clauses and swap agreements to avoid the pitfalls highlighted in this case. Parties entering into new swap agreements should consider drafting changes that would highlight the separateness of affiliated entities or trigger contract modification before any insolvency filing has taken place. Such provisions would provide stronger arguments against the applicability of the Bankruptcy Code prohibitions on *ipso facto* clauses based on the bankruptcy filing of an affiliate.

In addition, construction of agreements so that the flip clause is part of the swap agreement would promote the argument that the flip clause is enforceable under the "safe harbor" specifically applicable to swap agreements under Section 560 of the Bankruptcy Code. Especially in the context of technical agreements such swap agreements created in connection with new note issuance programs, this decision reminds parties to clearly express their intent on the key aspects of their agreement.

Endnotes

1 Section 560 of the Bankruptcy Code provides: "[T]he 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) of this title or to offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of one or more swap agreements shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title."

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