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# Bankruptcy Court Casts Cloud of Uncertainty Over Treatment of Executory Contracts and Swaps

A recent decision in the Bankruptcy Court for the Southern District of New York (the "Court") in the *Lehman* case has extended the unenforceability of *ipso facto* clauses to a provision triggered by the bankruptcy filing of an affiliate of a contractual party. In bankruptcy, *ipso facto* or bankruptcy termination clauses are generally unenforceable. Thus, when a party to a contract or lease enters bankruptcy, provisions in its contracts or leases purporting to terminate the contract due to the debtor's bankruptcy filing or financial condition are unenforceable. In *Lehman Bros. Special Fin. Inc. v. BNY Corp. Trustee Servs. Ltd.*,[1] the Court held that *ipso facto* clauses are unenforceable when the counterparty against which the termination was sought to be enforced was not a debtor in bankruptcy at the time of termination, but its affiliate was. Additionally, the decision clarified the scope of the safe harbor protections' exception to the *ipso facto* rules, which allow for the liquidation, termination or acceleration of swap agreements triggered by a debtor's bankruptcy filing or financial condition, by finding that those protections do not apply to a priority flip, a standard feature in those types of instruments, since the Court viewed this as a modification to the agreement. Furthermore, the Court declined to afford comity to a previous decision reached in the same controversy in English courts, even though English law governed the transaction. The decision has broad implications for the law of executory contracts in general and on the enforceability of cross-border contracts and common swap features that are part of a larger securitized transaction in particular.

## Background

Lehman Brothers Special Financing, Inc. ("LBSF") was one of the main non-regulated derivative subsidiaries of Lehman Brothers Holdings, Inc. ("LBHI") that typically engaged in structured finance transactions. At issue in this case are two series of credit-linked synthetic portfolio notes (the "Notes") issued by Saphir Finance Public Limited Company ("Saphir"), a Lehman Brothers' special purpose entity ("SPE"), in connection with a multi-issuer secured obligation program. Each series of Notes was governed by a supplemental trust deed and related documents (the "Note Documents") which reference a credit default swap agreement (the "Swap Agreement") linked to that series. Each Swap Agreement was composed of an ISDA Master Agreement and related documents between Saphir, as issuer, and LBSF, as swap counterparty. LBHI served as a "credit support provider," essentially guaranteeing the performance of LBSF under the Swap Agreement. The Note Documents contain a priority "flipping" feature—under most circumstances, LBSF is entitled to priority of payment over the noteholders; however, following an "Event of Default," which includes the bankruptcy of LBSF or LBHI, the priority scheme flips and LBSF becomes subordinated to the noteholders.

LBHI filed for bankruptcy protection in the Southern District of New York on September 15, 2008. LBSF filed a few weeks later, on October 3, 2008.

[1] 2010 Bankr. LEXIS 141; 2010 WL 271161 (Bankr. S.D.N.Y. Jan. 25, 2010).

Following those bankruptcy filings,[2] one of the noteholders, Perpetual Trustee Company Ltd., brought suit in London against BNY Corporate Trustee Services, Inc. ("BNY"), as trustee, to enforce the liquidation and priority shift under the Note Documents, since the agreement is governed by English law. The English High Court of Justice (Chancery Division) and, on appeal, the English Court of Appeal (Civil Division) found that the priority flip was valid, effective and enforceable as a matter of English law so as to give priority to the noteholders. The English courts further held that the priority flip did not violate the English common law anti-deprivation rule (similar to the *ipso facto* provisions in the Bankruptcy Code) since it had always been an agreed feature of the Note Documents, and that the flip was triggered when LBHI filed for bankruptcy protection, prior to LBSF's filing. While the English action was proceeding, LBSF filed this adversary proceeding in the bankruptcy court seeking to determine its rights under United States law.

## Rejection of Comity

As a threshold matter, the Bankruptcy Court decided not to afford the decision of the English courts comity even though under the agreement English law governs the transaction. The Court in effect determined that the policy of the Bankruptcy Code affording broad protection to debtors was more important than the principle of comity notwithstanding the fact that this left the trustee with two conflicting, seemingly irreconcilable decisions in a cross border transaction. Under governing English law, the English courts determined that the priority flipping provisions were valid and enforceable, and accordingly, the noteholders had priority of payment; under the U.S. Bankruptcy Code, however, such flip in priority was unenforceable and accordingly, the swap counterparty retains priority.

## The *Ipso Facto* Clause

In bankruptcy law, an *ipso facto* provision is one that would modify the relationships of the parties to the contract solely because of one party's bankruptcy filing or financial condition. *Ipso facto* provisions are, as a general matter, unenforceable because they would penalize the debtor for being in financial distress or for filing a bankruptcy petition and deprive the debtor and its creditor of valuable contractual rights. It was generally believed that such prohibitions applied only to contractual provisions triggered by the bankruptcy petition or financial condition of one of the parties to the contract. A provision triggered by the petition or financial condition of a third party, on the other hand, was believed to be enforceable. The *Lehman* decision is believed to be the first to hold that the petition date of an entity not a party to the contract at issue was relevant for the purposes of *ipso facto*.

Before reaching the question concerning the application of the *ipso facto* clause, the Court had to address BNY's argument that the swap at hand was not an executory contract at all since the only performance due under the swap, if any, was payment of money. The Court found that the Swap Agreement was an executory contract because performance was due on both sides—under the ISDA Master Agreement, all obligations of the parties remain outstanding. As an executory contract, Section 365(e) of the Bankruptcy Code prohibits the termination or modification of the agreement solely due to an *ipso facto* provision.

Even if the contract was not executory, however, the result would have been the same under Section 541(c) of the Bankruptcy Code. The Court held that *ipso facto* provisions are unenforceable under Section 541(c)(1)(B) of the Bankruptcy Code which provides that a debtor's interest in property becomes property of the estate notwithstanding any *ipso facto* provisions.

Turning to the *ipso facto* issue, the Court found that the priority flip was an unenforceable *ipso facto* provision utilizing LBHI's petition date as the operative date for the invalidation of the *ipso facto* clause in the swap with LBSF, although at the time LBHI filed for bankruptcy, LBSF was not yet a debtor in bankruptcy. The Court reasoned, as a matter of statutory interpretation, that because Sections 365 and 541 of the Bankruptcy Code refer to "the commencement of *a case* under this title,"[3]

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2 Saphir issued notices of termination of the Swap Agreement, invoking the priority flipping provision, to LBSF after LBSF filed for bankruptcy protection and named LBSF's filing as the event that triggered the application of the flipping provision. In the litigation before the bankruptcy court, however, the argument turned to LBHI's filing being the triggering event.

3 Section 365(e)(1) of the Bankruptcy Code provides that "an executory contract or unexpired lease *of the debtor* may not be terminated or modified at any time . . . solely because of a provision conditioned on (A) the insolvency or financial condition of the debtor at any time before the closing of the case; (B) the commencement of a case under this title; or (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement." Section 541(c)(1) of the

rather than "the commencement of a case *by or against* a debtor," their *ipso facto* prohibitions can apply in any case under Chapter 11, not just a case filed by a party to the executory contract at issue. In its analysis, the Court also considered the legislative history, finding that an earlier version of Section 365(e)(1) of the Bankruptcy Code included such debtor-specific language.

The Court attempted to limit its decision to the "uniqueness" of the *Lehman* case, holding that: "[T]he description of the kind of relationship that is sufficient to trigger such protections affecting the rights of contracting parties is best left to a case-by-case determination," and that "due to the sheer size of the corporate family" and "emergency, unplanned nature" of the filings, "the Court is convinced that the chapter 11 cases of LBHI and its affiliates is a singular event for purposes of interpreting [the] *ipso facto* language." The Court also held that applying LBHI's filing date to invalidate the *ipso facto* clauses in the non-debtor LBSF's contracts made sense since Lehman was essentially an "integrated enterprise."

Finally, BNY argued that the priority flipping provision was essentially a subordination provision, and under Section 510(a) of the Bankruptcy Code, subordination provisions are enforceable in bankruptcy to the extent they are enforceable under applicable nonbankruptcy law. Here, the English courts already found the provision in question to be enforceable requiring its enforcement in bankruptcy as well. The Court held, however, that even though a subordination agreement is enforceable under the Bankruptcy Code to the same extent as under applicable nonbankruptcy law and the priority flip may be construed as a subordination agreement, the subordination was not a general subordination provision, but one that was triggered by the bankruptcy or financial condition of LBHI or LBSF and was, therefore, an unenforceable *ipso facto* clause.

Bankruptcy Code provides that "an interest of the debtor in property becomes property of the estate . . . notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law . . . (B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property."

## Inapplicability of Safe Harbor Provisions

The safe harbor provisions of Section 560 of the Bankruptcy Code are, in part, an exception to the *ipso facto* rule that allow for the liquidation, termination or acceleration of a swap agreement. Congress enacted these provisions to provide certainty and liquidity in the marketplace and to prevent a destabilizing ripple effect caused by the bankruptcy filing of one debtor. LBSF argued, and the Court agreed, that the priority flip is a *modification* of the parties' rights under the agreement, not a *liquidation, termination or acceleration* of a swap agreement; and as such, it is not protected by the safe harbor provisions.

The Court also found the safe harbor provisions inapplicable to the Swap Agreement because the priority flip was contained in the Note Documents, not the Swap Agreement itself or in any of the documents referenced in the Swap Agreement.

"Swap agreement" is defined in the Bankruptcy Code as, among other things, "any agreement, including the terms and conditions incorporated by reference in such agreement, which is [a swap]," 11 U.S.C. 101(53B)(A)(i), and "any security agreement or arrangement or other credit enhancement *related* to any agreements or transactions" included in the swap agreement definition. 11 U.S.C. 101(53B)(A)(vi) (emphasis added).

The Court, however, appears to have interpreted the statute as requiring a swap agreement to reference all the documents that are considered part of the integrated transaction. Relying on the facts that the Note Documents reference the ISDA Master Agreement, but none of the documents evidencing the Swap Agreement reference the supplemental trust deeds or priority flipping provisions, the Court held that the documents containing the flip provisions are not within the term "swap agreement" as defined in the Bankruptcy Code. Post *Lehman,* counterparties to similarly documented transactions face significant uncertainty as to whether their deals are covered by the Bankruptcy Code's safe harbors.

## Implications of the Bankruptcy Court's Decision

The *Lehman* decision may be a very important development in bankruptcy law. First, it could have a significant impact on the law of executory contracts. The Court

appeared to limit its holding on the *ipso facto* element to the unique facts of the *Lehman* case. Other courts, however, may apply the *Lehman* decision in arguably less unique circumstances. In fact, the *Lehman* Court's interpretation of Section 365(e) of the Bankruptcy Code does not appear to turn on any unique facts. Moreover, while the *Lehman* case may be unique, it is not uncommon. American bankruptcy jurisprudence is replete with major, large, complex and unique cases: Enron, Worldcom, Drexel, and W.T. Grant, are just a few. The size, complexity and integration level of today's large, international companies could easily fit the *Lehman* bill.

Post *Lehman,* a party to any type of executory contract, not just swaps, who exercises its rights under an *ipso facto* clause (either based on its counterparty's financial condition or an affiliate's bankruptcy filing) should be aware of a prospective invalidation of its termination. Counterparties need to manage this risk especially since there is no obvious statute of limitations for the debtor to challenge the termination.

As to the Court's refusal to grant safe harbor protections to the flip clause, its impact on structured finance is already being felt. On January 29, 2010, Fitch Ratings, Ltd. released a statement regarding the *Lehman* decision,[4] announcing that as a result of the decision, the ratings for any structured finance transaction with a derivative exposure to a counterparty that could be subject to the jurisdiction of the U.S. bankruptcy courts, either itself or through a related entity, will be placed on Rating Watch Negative.

While it was announced that the *Lehman* decision will be appealed, parties must be aware of its implications and structure their transactions accordingly. First, swaps must be drafted so as to be considered an integrated transaction for the purposes of Section 560 of the Bankruptcy Code. Following the *Lehman* decision, one might "integrate" the documents by specifically referencing them in the swap agreement. Indeed, critical provisions might as well be included in the swap agreement itself in addition to their inclusion in other transaction documents. Second, transactions could be structured to avoid the participation of a U.S. entity and the jurisdiction of U.S. courts, thus eliminating the risks associated with the application of the Bankruptcy Code to the transaction. Finally, parties should give careful consideration to drafting the triggers for the application of flip provisions such that they are not susceptible for invalidation as *ipso facto* clauses.

4 *See* Lehman Rulings May Impact Structured Finance Globally, *available at* http://www.fitchratings.com/creditdesk/press_releases/detail.cfm (requires subscription).

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If you have questions regarding the information in this legal update, please contact one of the authors or any Dechert attorney with whom you regularly work. Visit us at http://www.dechert.com/insolvency or www.dechert.com/finance&realestate.

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