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Recent Lehman Decision Raises Questions About Application of Safe Harbors to Complex Financial Products

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In a decision issued on January 25, 2010 in the Lehman Brothers case, available here,[1] the U.S. Bankruptcy Court for the Southern District of New York substantially narrowed the protections that the Bankruptcy Code was thought to provide to participants in the derivatives markets. Specifically, the bankruptcy court granted summary judgment in favor of Lehman Brothers Special Financing Inc. ("LBSF") and against the Trustee with respect to a series of notes (the "Trustee"), ruling that "flip" provisions of swap documents triggered by a Lehman Brothers bankruptcy are unenforceable and that actions to enforce the swap documents violate bankruptcy's automatic stay, notwithstanding the "safe harbors" for swap agreements contained in the Bankruptcy Code. The decision has several important implications for the financial community.

The Underlying Structure: Swaps and Flips

This case involves two series of credit-linked synthetic portfolio notes (the "Notes") issued by Saphir Finance Public Limited Company ("Saphir")—a special-purpose entity created by Lehman Brothers International (Europe)—in connection with a multi-issuer secured obligation program. Each series of Notes was governed by a supplemental trust deed (a "Supplemental Trust Deed") which referenced a credit default swap agreement (a "Swap Agreement") linked to that series. Each Swap Agreement was evidenced by a written confirmation and related ISDA Master Agreement, schedules, and annexes entered into between Saphir, as the issuer of the Notes, and LBSF, as the swap counterparty.

The Notes were secured by collateral held by the Trustee in trust for the benefit of the creditors of Saphir. Saphir's creditors included Perpetual Trustee Company Limited, as the holder of the Notes (the "Noteholder"), and LBSF, as the swap counterparty. Under the Supplemental Trust Deed, the rights of LBSF to the collateral would normally take priority over those of the Noteholder. The documents provided, however, that in the event of default by LBSF under the Swap Agreement, the order of priority "flipped," so that the Noteholder would be entitled to priority over amounts otherwise payable to LBSF. In addition, as is often the case in derivatives contracts, the Swap Agreement provided that a bankruptcy filing by either LBSF or its parent, Lehman Brothers Holdings Inc.

("LBHI"),[2] would be an event of default and therefore a trigger for the "flip" provision.

The Bankruptcy: *Ipso Facto* Provisions and the Automatic Stay

LBHI filed for bankruptcy on September 15, 2008. LBSF filed for bankruptcy 18 days later, on October 3, 2008.

On November 25, 2008, counsel to the Lehman Brothers entities sent a letter to the Trustee, advising it of the "automatic stay" in place as a result of the bankruptcy filings under Section 362 of the Bankruptcy Code,[3] and asserting that contractual provisions purporting to subordinate LBSF's claims were unenforceable. On December 1, 2008, Saphir sent notices to LBSF terminating the Swap Agreement.

On May 20, 2009, LBSF commenced its adversary proceeding, seeking a declaratory judgment that (1) the "flip" provisions of the Swap Agreement that modify LBSF's payment priority upon an event of default constitute an unenforceable *ipso facto* clause under Sections 365(e)(1) and 541(c)(1)(B) of the Bankruptcy Code, and (2) any action to enforce the payment provisions modifying LBSF's payment priority violates the Code's automatic stay provisions.

The Decision

The bankruptcy court found in favor of LBSF. Three particular aspects of the opinion warrant attention.

> **1. The bankruptcy case of a "sufficiently related debtor" can trigger the ipso facto protections of Sections 365(e)(1) and 541(c)(1)(B).**

Sections 365(e)(1) and 541(c)(1)(B) of the Bankruptcy Code bar the enforcement of so-called *ipso facto* clauses—contractual provisions that alter parties' rights based on the filing of a bankruptcy petition. But until this decision, it was generally understood that these provisions of the Bankruptcy Code applied only to contractual provisions tied to bankruptcy filings *by the contractual counterparty*. A contractual provision that was triggered by the bankruptcy filing of a third party, by contrast, was widely believed to be fully enforceable as against the contractual counterparty.

This decision calls that conventional wisdom into question. Noting that "each of these sections of the Bankruptcy Code prohibits modification of a debtor's right solely because of a provision in an agreement conditioned upon the commencement of a case under this title," the bankruptcy court concluded that LBSF could assert the protections of these provisions based on the bankruptcy filing of LBHI, even though LBSF did not file for bankruptcy itself until 18 days later. Op. at 18 (emphasis in original). In reaching this conclusion, the bankruptcy court relied on the absence of the language in the statute that limited "a case" to one "by or against the debtor" and the fact that early drafts of the legislation—not adopted by Congress—did include such a modification. *Id.*

2. The "safe harbor" provisions of the Bankruptcy Code apply only to the Swap Agreement—the ISDA Master Agreement, schedules and written confirmation—and not related documents.

Even if the change in priority distribution effected by the "flip" provision would otherwise violate the *ipso facto* restriction in the Bankruptcy Code, the Code includes a "safe harbor" that allows parties to a swap agreement to terminate that agreement in the event of a counterparty's bankruptcy.[4] This "safe harbor" is part of a broad set of statutory protections intended to exempt derivatives contracts from the application of bankruptcy law and guard against instability in financial markets as a result of one market participant's bankruptcy.

But this transaction was not a simple swap agreement; rather it was a more complex structured transaction involving swaps. It therefore presented the question whether the safe harbor provision protects the exercise of a contractual term that changes the priority of distribution of collateral when that term is included in a related document, rather than in the swap agreement itself. Op. at 22. The bankruptcy court reviewed the language of Section 560 and determined—notwithstanding the statute's broad language extending to contractual provisions "arising under or in connections with the termination . . . of one or more swap agreements," and notwithstanding the Trustee's argument that the Swap Agreement expressly incorporated the terms of the Supplemental Trust Deed—that the alteration of distribution rights are not protected by the safe harbor. Because the provisions modifying distribution were contained in the Supplemental Trust Deed and not in the Swap Agreement itself, the bankruptcy court concluded that the exercise of any such provision is not protected by the statutory safe harbor. Op. at 22.

3. Decisions of foreign courts that do not appropriately consider United States bankruptcy law should not be provided comity.

It is also noteworthy that in a prior judicial decision in the United Kingdom (the "UK Decision"), the UK court held that LBSF's interest in the collateral securing the Swap Agreement was "always limited and conditional" and that the change in priority distribution became effective on the date of LBHI's bankruptcy. The Trustee argued that the agreements between the parties are governed by and construed in accordance with English law, and that the bankruptcy court should defer to the UK Decision. The bankruptcy court disagreed, noting that the United States has a strong interest in having a bankruptcy court resolve issues of federal bankruptcy law and that although the court may choose to give preclusive effect to a judgment rendered by a foreign court on the basis of comity, it is not obligated to do so. Because the bankruptcy court concluded that the UK Decision did not take sufficient account and consideration of the applicability and impact of United States bankruptcy laws, the court declined to give those decisions preclusive effect.

Implications

The potential implications of this decision are far-reaching.

First, the bankruptcy court purports to limit its holding that the *ipso facto* protections can be triggered on account of another entity's bankruptcy by stressing the unique complexity of the bankruptcies involving the Lehman-related entities and states that "nothing in this decision is intended to impact issues of substantive consolidation, the importance of each of the separate petition dates for purposes of allowing claims against each of the debtors or any other legal determination that may relate to the date of commencement of a case." Op. at 19-20. The decision nevertheless raises an important question: if a contractual counterparty terminates a contract against a non-debtor subsidiary on account of a bankruptcy by another affiliate (such as a parent guarantor), may that otherwise proper termination later be invalidated if the subsidiary-counterparty itself later seeks bankruptcy protection? If so, under what circumstances? Beyond indicating that the result in this case was heavily influenced by the complexity of the Lehman bankruptcy, the court's decision provides relatively little guidance on the extent to which a different timing of the contract termination would affect the analysis of these issues.

Second, the bankruptcy court's holding that a bankruptcy termination clause needs to be in the same piece of paper as the swap agreement (and implicit holding that being incorporated by reference into the swap agreement was insufficient) in order to be protected by the safe harbor may raise questions about the application of the safe harbor provisions to other complex financial products. If the decision withstands appellate review, it may also require parties to complex financial products that involve swap arrangements to alter the structure of the agreements, or the manner in which they are documented, to ensure that swap counterparties are able to claim the protection of the statutory safe harbor.

Finally, the decision highlights the challenges and complexities involved when multi-national bankruptcies proceed in various jurisdictions.

[1] Adversary Proceeding No. 09-01242.

[2] LBHI acts as credit support provider for LBSF's payment obligations under the Swap Agreement.

[3] References to Bankruptcy Code sections are references to 11 U.S.C. § 101 *et seq.*

4 Specifically, Section 560 of the Bankruptcy Code permits "the exercise of any contractual right of any swap participant . . . to cause the liquidation, termination , or acceleration of one or more swap agreements because [of the filing of a bankruptcy] or to offset or net out any termination values or payment amounts arising under or in connections with the termination . . . of one or more swap agreements."

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