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Bankruptcy Court Invalidates Springing Subordination Provisions in Credit Default Swap Transaction

A federal bankruptcy court in New York has struck down “springing” subordination provisions in a credit default swap transaction. The case raises the possibility that a contract provision stating that the parties’ rights will change in the event of bankruptcy (a so-called “*ipso facto*” clause) may be unenforceable if an affiliate or credit support provider of the contract party seeks bankruptcy protection, even though it is not the same entity as the contract party. The court’s decision may interest lawyers who give substantive consolidation and enforceability opinions in structured financings.

The case arose from the bankruptcy of Lehman Brothers Holdings Inc. (“LBHI”) and its subsidiaries, including Lehman Brothers Special Financing Inc. (“LBSF”) – “the largest business bankruptcy in history.”¹ The litigants held competing interests in collateral securing obligations of an issuer of credit-linked synthetic portfolio notes issued by a Lehman special purpose entity (the “Notes”). LBSF was a credit default swap counterparty and LBHI provided credit support for the transaction. Under a provision in the loan documents (which were governed by English law), payment priority shifted from LBSF to the holder of the Notes (the “Noteholder”) upon the bankruptcy of LBSF *or* LBHI. (LBHI entered bankruptcy in September 2008, followed shortly thereafter by LBSF). LBSF commenced litigation in bankruptcy court against the trustee for the Noteholder, seeking a declaration that the priority shifting provision was unenforceable under the Bankruptcy Code and that LBSF retained senior rights in the collateral. The Noteholder had earlier brought suit in England and had prevailed before both the trial and appellate courts there.

In January 2010, the New York bankruptcy court reached a contrary result. The court declared that provisions of the loan documents purporting to shift payment priority in the event of LBSF’s *or* LBHI’s bankruptcy are unenforceable *ipso facto* clauses, and that an

¹ Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Services Limited (In re Lehman Brothers Holdings Inc.), 422 B.R. 407, 420 (Bankr. S.D.N.Y. 2010).

attempt to enforce such provisions would violate the automatic stay imposed by Section 362(a) of the Bankruptcy Code. (Section 365(e)(1) of the Bankruptcy Code generally invalidates *ipso facto* clauses – contract provisions that purport to terminate or modify a debtor’s rights based solely on financial condition or bankruptcy). Importantly, the court stated that its conclusion would not change regardless of whether LBSF’s bankruptcy or that of its affiliate, LBHI, was the relevant priority shifting event. Viewing the Lehman entities as an “integrated enterprise,” the court reasoned that “the financial condition of one affiliate affects the others.” Exercising judicial discretion, the court refused to recognize the English court’s judgment because doing so would be contrary to fundamental policies of the United States. Furthermore, the bankruptcy court held inapplicable certain Bankruptcy Code provisions that recognize the validity of “subordination agreements” enforceable outside bankruptcy or create a “safe harbor” permitting *ipso facto* termination of derivatives contracts, since those provisions do not expressly address shifting priorities. Acknowledging that the trustee holding the collateral had been placed in a difficult (if not untenable) position by conflicting directives of the English and U.S. courts, the bankruptcy court called upon the parties to work cooperatively and ordered a status conference for the purpose of exploring means to harmonize the decisions. Three months after issuing its decision, the court has not entered an implementing order, and it is likely that any such order will be appealed.

It is unclear what the long-term impact of the court’s decision will be. The court invited speculation as to the circumstances under which the bankruptcy case of one entity might be sufficiently related to the bankruptcy of an affiliate to invoke the Bankruptcy Code’s *ipso facto* provision on behalf of the second debtor, but left the question open to case-by-case determination. Despite the singular nature and complexity of the Lehman case and the unprecedented circumstances surrounding the filings, the novelty of the issues decided, the uncertainty resulting from the court’s unwillingness to state a limiting principle and the high profile of this bankruptcy case suggest that the decision may have far-reaching effect. As the bankruptcy court observed:

No case 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 – in this instance the counterparty’s parent corporation as credit support provider. Because this is the first such interpretation of the *ipso facto* language, the Court anticipates that the current ruling may be a controversial one, especially due to the resulting conflict with the decisions of the English courts.

The court correctly anticipated that its decision would prove controversial: ratings agencies promptly warned of possible downgrades, and commentators predicted that in the future structured notes may receive ratings no higher than those of a counterparty or credit support provider. Some commentators advised forming securitization vehicles under English law to safeguard them from attack by U.S. bankruptcy courts or incorporating *ipso facto* clauses in swap agreements rather than loan documents to take advantage of the statutory “safe harbor”. Attempts to structure or draft around the Bankruptcy Code are likely to be unsuccessful, however, since the *Lehman* court determined that the statutory safe harbor does not extend to shifting priorities. Moreover, any entity with substantial assets in the United States, regardless of its place of formation, may invoke the jurisdiction of U.S. bankruptcy courts.

Regarding substantive consolidation, *Lehman* may be viewed as part of a line of cases in which bankruptcy courts have focused on the needs of a corporate group to impose a decision affecting creditors of one debtor based on the status of another, without substantively consolidating the entities.² Although the *Lehman* court was careful to say that “[n]othing in this decision is intended to impact issues of substantive consolidation,” lawyers who give substantive consolidation opinions in complex structured financings should be aware of the decision and consider expressly disclaiming any opinion as to whether a bankruptcy court would enter orders determining the validity and enforceability of the rights of one entity (including a “special purpose entity” or “SPE”) in and to its assets (including contract rights), or allowing the sale, use or lease of an SPE’s assets by an affiliate, based upon the status of the affiliate or the needs of the corporate group of which the SPE and the affiliate are a part, and without making appropriate findings and effecting a formal substantive consolidation.

Regarding enforceability opinions (in this case, enforceability of loan documents or swap agreements containing subordination provisions), *Lehman* undercuts the common assumption that *ipso facto* clauses are in all cases enforceable against non-debtors, such as guarantors of a debtor’s obligations. The court noted that the language of Section 365(e)(1) of the Bankruptcy Code, which invalidates *ipso facto* clauses, is not limited to the commencement of a bankruptcy case “by or against the debtor”, and concluded that “the absence of such precise limiting language is significant.” Opinion givers may wish to consider whether, in interpreting this statutory language, the persuasive authority of *Lehman* may extend beyond the bankruptcy courts to other courts considering bankruptcy principles. Even before *Lehman*, some non-bankruptcy courts refused to enforce similar clauses, citing Congressional policy or anti-forfeiture principles.³

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² Compare *In re Gen. Growth Props., Inc.*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009).

³ *151West Assocs. v. Printsiples Fabric Corp.*, 459 N.Y.S.2d 605 (N.Y. App. Div. 1983), *judgment aff’d*, 460 N.E.2d 1344 (N.Y. 1984); *Staples, Inc. v. Moses*, 806 N.Y.S.2d 448 (N.Y. Sup. Ct. 2005); compare *In re Metrobility Optical Sys., Inc.*, 268 B.R. 326 (Bankr. D.N.H. 2001) (enjoining landlord from drawing down letter of credit supporting lease obligations where tenant-obligor’s bankruptcy was event triggering drawdown).