ALERT MEMORANDUM

District Court Rules that Provisions in Lehman CDOs Setting Payment Priorities Are Protected by Safe Harbor

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On March 14, 2018, Judge Schofield of the U.S. District Court for the Southern District of New York affirmed a 2016 decision by Judge Chapman in the bankruptcy of Lehman Brothers Special Financing Inc. ("LBSF")[1] concerning the enforceability of market standard provisions setting payment priorities in structured finance transactions. In the District Court decision, *Lehman Brothers Special Financing Inc. v. Bank of America National Association*, No. 17-cv-01224, 2018 WL 1322225 (S.D.N.Y. Mar. 14, 2018) (the "Decision"),[2] Judge Schofield held that the safe harbor provisions of Section 560 of the U.S. Bankruptcy Code protect swap termination payments made pursuant to such market-standard payment priority provisions. Consistent with the Supreme Court's approach in its recent decision in *Merit Management Group, LP v. FTI Consulting, Inc.*,[3] Judge Schofield focused heavily on the text of the statute, concluding that under "the most sensible literal reading," the Section 560 safe harbor applied to the distributions at issue.[4]

The decision, which is currently pending appeal to the Second Circuit, provides clarification regarding the application of the Section 560 safe harbor to protect market standard provisions from invalidation and provides greater certainty after earlier decisions by Judge Peck in the Lehman cases finding that CDO provisions that subordinated swap termination payments to LBSF were unenforceable *ipso facto* clauses.[5]

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[1] *Lehman Bros. Special Fin. Inc. v. Bank of Am. Nat'l Ass'n*, Ch. 11 Case No. 08-13555, Adv. No. 10-03547, 553 B.R. 476 (Bankr. S.D.N.Y. 2016) (the "Bankruptcy Court Decision").
[2] Cleary Gottlieb represented several of the noteholder defendants named in this action and who moved to dismiss the complaint.
[3] *Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, 138 S.Ct. 883 (2018).
[4] Decision, 2018 WL 1322225, at *5.
[5] *Lehman Bros. Special Fin. Inc. v. BNY Corp. Tr. Serv. Ltd.*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010) ("*BNY*") (denying defendant's motion for summary judgment); *Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007-1 Ltd.*, 452 B.R. 31 (Bankr. S.D.N.Y. 2011) ("*Ballyrock*") (denying defendants' motion to dismiss).

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Background and Procedural History

In September 2010, LBSF commenced an adversary proceeding against 250 defendant noteholders, note issuers, and indenture trustees in connection with 44 synthetic collateralized debt obligations ("CDOs") created by LBSF and its affiliates. LBSF sought to recover approximately $1 billion that was distributed to defendant noteholders in termination payments following LBSF's default due to the bankruptcy filing of LBSF's ultimate holding company Lehman Brothers Holding Inc. ("LBHI").

Although the CDO transactions at issue varied in their details, their general structure was similar. In each, the issuer issued one or more series of notes to the noteholders; the issuer used the proceeds received from the noteholders to purchase investments to serve as collateral. The issuer also entered into one or more credit default swap agreements with LBSF, whereby the issuer sold credit protection on certain reference entities to LBSF. The collateral held by the CDO issuers secured both the noteholders and LBSF, as the swap counterparty. That collateral was held in trust by a trustee pursuant to an indenture or trust agreement governed by New York law (an "Indenture").[6] Each trustee also held and controlled certain of the issuers' rights to the collateral and under the CDOs.

Each Indenture contained provisions, referred to as "Priority Provisions," prescribing the order in which distributions of collateral proceeds would be made to the noteholders and swap counterparty under different circumstances. Pursuant to the Priority Provisions, distributions of collateral proceeds payable to LBSF took priority over the amounts payable to the noteholders under certain specified circumstances. However, if the swap termination payments were owed due to LBSF's default, distributions of collateral proceeds payable to the noteholders took priority over the amounts payable to LBSF.

For each swap, LBHI guaranteed LBSF's obligations and served as credit support provider for LBSF. On September 15, 2008, LBHI filed a bankruptcy petition under Chapter 11 of the U.S. Bankruptcy Code ("Code"). Because LBHI was a "credit support provider" of LBSF, this filing constituted an LBSF event of default under its swap agreements. For the vast majority of the CDO transactions at issue in this litigation, the issuers terminated the swaps in the period after LBHI's bankruptcy filing on September 15, but before LBSF's separate bankruptcy filing on October 3, 2008. Pursuant to the Priority Provisions, the noteholders were paid collateral proceeds ahead of LBSF. No payment was made to LBSF as there were insufficient collateral proceeds to satisfy the noteholders' senior priority claims.

Nearly two years after LBHI filed for bankruptcy, LBSF brought an action seeking, among other things, a declaratory judgment that the Priority Provisions are *ipso facto* clauses because they subordinated LBSF's alleged right to priority payment of the collateral as a consequence of LBHI's bankruptcy filing, and were thus unenforceable under sections 365(e)(1), 541(c)(1) and 363(*l*) of the Code (the "*ipso facto* provisions"). In pursuing these claims, LBSF relied in large part on Judge Peck's prior decisions in *BNY* and *Ballyrock*.

On June 28, 2016, Judge Chapman, who had been assigned the Lehman Ch. 11 cases after Judge Peck's retirement from the Bankruptcy Court, issued a memorandum decision dismissing LBSF's bankruptcy law claims on three independent grounds. First, the Bankruptcy Court concluded that for the majority of the transactions at issue, the Priority Provisions did not modify any existing right of LBSF as a result of its bankruptcy case, and therefore are not *ipso facto* clauses.[7] Second, the Bankruptcy Court held that even if LBSF's rights were modified, for the majority of the transactions, any such modification occurred *before* the commencement of LBSF's bankruptcy filing and therefore did not violate the *ipso facto* provisions, which apply where the debtor's rights have been "modified" *after* commencement of the debtor's

[6] For two of the CDO transactions, the collateral was secured pursuant to a trust deed governed by English law.

[7] Bankruptcy Court Decision, 553 B.R. at 495.

bankruptcy case.[8]

Third, the Bankruptcy Court held that for any of the transactions that were considered to have violated the *ipso facto* provisions, the distributions of collateral proceeds made to the noteholders pursuant to the Priority Provisions are protected by Section 560's exemption of the termination and liquidation of swap agreements from the operation of the *ipso facto* provisions.[9] In reaching this conclusion, the Bankruptcy Court focused on the "unambiguously sweeping text of section 560," which it emphasized was "plain and controlling on its face" and required a "broad and literal" interpretation.[10]

The District Court Decision

The District Court held that the Bankruptcy Court correctly concluded that the Section 560 safe harbor protects distributions of collateral under the Priority Provisions. Thus, the District Court ruled that even assuming that the Priority Provisions were *ipso facto* clauses, they remained enforceable by operation of Section 560 of the Code.[11] In relevant part, Section 560 provides that:

> The 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 [*i.e.*, in the Code's *ipso facto* provisions]… shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court … in any proceeding under this title.[12]

While "bearing in mind [Section 560's] purpose of protecting the financial markets from uncertainty due to the risk of swap agreements not being honored in bankruptcy," the District Court's analysis focused heavily on a "literal reading" of the statutory text, explaining that the Code's safe harbors "must be interpreted based on their plain meaning, subject only to the limitations present in the express language of the relevant provision."[13]

The District Court explained that the "plain meaning of liquidate" must, in the context of this case, mean "bring[ing] the swap agreement to an end by distributing the [c]ollateral pursuant to the Priority Provisions."[14] In so holding, the District Court relied on the definitions of "liquidate" set forth in legal, financial and general dictionaries, all of which the Court found—with the exception of the slang usage of "liquidate" to mean "to do away with especially by killing"—sensibly applied to the liquidation of a swap agreement.[15] "Liquidation" does not, as LBSF argued, refer solely to the calculation of amounts owed.[16] Citing to the Supreme Court's recent decision in *Merit Management*, Judge Schofield found that LBSF's reading failed to interpret "liquidate" in the specific context in which it was used, *i.e.*, in the context of Section 560 which, Judge Schofield explained, "is concerned with bringing swap agreements to an end and distributing collateral."[17] By contrast, LBSF's

[8] *Id.* at 495-500. In so holding, the Bankruptcy Court declined to adopt the so-called "singular event" theory—which is viewed by many as the most novel and controversial aspect of Judge Peck's *BNY* decision—under which, based on the circumstances of the Lehman bankruptcy cases, LBSF's October bankruptcy filing was treated as a single event with LBHI's earlier September 15 bankruptcy filing. *Id.* at 497-98.

[9] *Id.* at 500-02.

[10] *Id.* at 501-07.

[11] Decision, 2018 WL 1322225, at *4. In coming to this conclusion, the District Court did not address the two independent grounds upon which the Bankruptcy Court concluded that for the vast majority of the transactions at issue, the Priority Provisions did not violate the Code's *ipso facto* provisions. Thus, the District Court "assumed" that the Priority Provisions were unenforceable for purposes of its safe harbor analysis. *Id.*

[12] 11 U.S.C. § 560.

[13] Decision, 2018 WL 1322225, at *5.

[14] *Id.* at *6.

[15] *Id.* The Court reviewed the definitions of "liquidate" in Black's Law Dictionary and in Merriam-Webster, which Judge Schofield explained define "liquidate" to mean "bringing an undertaking to an end and paying or distributing its assets." *Id.*

[16] *Id.*

[17] *Id.*

definition of "liquidate" was based on an interpretation of the term in the context of an unliquidated claim, and would, if accepted, render the protections of Section 560 a nullity.[18]

Continuing its textual analysis, the Court found that "even though actual enforcement of the Priority Provisions fell on Trustees as agents of the Issuers, such enforcement was nonetheless a right 'of' the Issuers, who are 'swap participants' under the safe harbor."[19] Judge Schofield observed that Section 560 "requires only the exercise '*of*' a swap participant's contractual right, but that right need not be exercised '*by*' the swap participant."[20] Thus, Judge Schofield held that because the Issuers had, with LBSF's consent, assigned the right to distribute collateral pursuant to the Priority Provisions to the trustees, "when the [t]rustees terminated the swaps and enforced the Priority Provisions, they exercised the rights 'of' the Issuers."[21]

The Court also addressed LBSF's contention that the Bankruptcy Court's analysis of Section 560 was inconsistent with Judge Peck's rulings in *BNY* and *Ballyrock*. Rejecting this argument, Judge Schofield explained that *BNY* and *Ballyrock* were not controlling authority and were in any event distinguishable "because, unlike here, the provisions at issue [in *BNY*] were not part of the swap agreement."[22] Furthermore, Judge Schofield observed that reading Section 560 to protect the distribution of collateral pursuant to the Priority Provisions was consistent with Judge Peck's more recent interpretation of that safe harbor in *Michigan State Housing Development Authority v. Lehman Brothers Derivative Products, Inc.*, 502 B.R. 383 (Bankr. S.D.N.Y. 2013).[23]

Implications

— The decision provides further clarification regarding the availability of the Section 560 safe harbor to protect CDO termination payments and distributions of collateral made pursuant to market-standard payment provisions and confirms the broad reach of the Section 560 safe harbor.[24]

— The Court did not rely on the factual distinctions between Type 1 transactions (which the lower court had found entailed a modification of LBSF's rights) and Type 2 transactions (which the lower court had concluded did not effect such a modification). Instead, the Court focused exclusively on the text of Section 560.

— Following closely on the heels of the Supreme Court's opinion in *Merit Management*, the decision demonstrates that courts interpreting the safe harbors will rely heavily on the statutory text.

— The decision provides clarification regarding the drafting of CDO documents. Drafters of CDOs should be cognizant of the Court's distinction between swaps that expressly incorporated or referenced the payment priority provisions (like the ones the Court found enforceable here) and swaps that relegated such provisions solely to a separate indenture or security document (like the ones in the *BNY* case that this Court distinguished).

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[18] *Id.* at *6-7.
[19] *Id.* at *5, 7-8.
[20] *Id.* at *7 (emphasis added).
[21] *Id.* at *8.
[22] *Id.* at *7.
[23] *Id*. The Court also affirmed the Bankruptcy Court's dismissal of LBSF's tag-along state law claims, which it held failed as a matter of law because "the distributions were not improper, nor was LBSF deprived of its property in light of [its] holding that the Priority Provisions were not unenforceable *ipso facto* clauses." *Id.* at *8.
[24] Though the only safe harbor before the Court here was the Section 560 safe harbor available for swap agreements, the Court's reasoning also provides clarification regarding similarly-worded safe harbors available for other types of agreements. See Sections 555 (securities contracts), 556 (commodities contract and forward contracts), 559 (repurchase agreements), and 561 (master netting agreements).