ALERT MEMORANDUM

Second Circuit Rules that Provisions in Lehman CDOs Setting Payment Priorities Are Protected by Safe Harbor

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On August 11, 2020, a panel of the U.S. Court of Appeals for the Second Circuit held that the safe harbor provisions of Section 560 of the U.S. Bankruptcy Code protect swap termination payments made pursuant to market standard provisions setting payment priorities in structured finance transactions. The Court's *per curiam* decision, *Lehman Brothers Special Financing Inc. v. Bank of America National Association*, No. 18-1079 (2d Cir. Aug. 11, 2020) (the "Decision"),[1] affirmed a 2018 decision by Judge Schofield of the U.S. District Court for the Southern District of New York[2] affirming a 2016 decision by Judge Chapman in the bankruptcy of Lehman Brothers Special Financing Inc. ("LBSF").[3]

In reaching its conclusion, the Second Circuit focused on the text of the Section 560 safe harbor and the relevant context of the language, holding that the statutory term "liquidation" unambiguously applied to the distributions of collateral at issue.[4]

The Decision both clarifies the application of Section 560 to protect market standard provisions from invalidation and provides greater certainty after earlier decisions by Judge Peck in the Lehman bankruptcy held CDO provisions that subordinated swap termination payments to LBSF were unenforceable *ipso facto* clauses outside the scope of the safe harbor.[5]

[1] Cleary Gottlieb represented several noteholder defendants in this action.
[2] *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) ("*LBSF 2*"),
[3] *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) ("*LBSF 1*").
[4] Decision at 18-20.
[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).

Background

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 in termination payments that were distributed to defendant noteholders following LBSF's default due to the bankruptcy filing of LBSF's ultimate holding company Lehman Brothers Holdings 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 and 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] The Indenture also empowered the trustee to exercise 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 a "Credit Support Provider" for LBSF under the relevant ISDA Master Agreements (the "ISDAs"). On September 15, 2008, LBHI filed a bankruptcy petition under Chapter 11 of the U.S. Bankruptcy Code (the "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.

LBSF's action sought, among other things, a declaratory judgment that the Priority Provisions were *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*, each of which had ruled in LBSF's favor on similar claims in connection with similarly structured CDO's.

The Second Circuit Decision Affirmed the Lower Courts' Plain Reading of Section 560

Before the Second Circuit was LBSF's challenge to the District Court's holding that under "the most sensible literal reading" of the statutory text, Section 560 "protects the distributions of the Collateral under the Priority Provisions."[7] The Second Circuit affirmed. Finding that LBSF "failed to identify any

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

[7] *LBSF 2*, 2018 WL 1322225, at *3, 5. In addition to holding that Section 560 protected the Priority Provisions, the Bankruptcy Court dismissed LBSF's claims on two other independent grounds, holding that for the vast majority of the transactions at issue, the Priority Provisions were not unenforceable *ipso facto* clauses, *LBSF 1*, 553 B.R. at 495, and further that, even if LBSF had a right that was modified, the Code's *ipso facto* provisions did not apply to

error in the District Court's opinion," the Second Circuit "adopt[ed] the cogent reasoning of the District Court," and held that the Section 560 safe harbor protects distributions of collateral under the Priority Provisions.[8] Thus, the Second Circuit ruled that "even if the Priority Provisions were *ipso facto* clauses, their enforcement was nevertheless permissible under the section 560 safe harbor."[9]

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.[10]

Relying on the statutory text of Section 560, the Second Circuit explained that the applicability of the safe harbor turns on whether: "(1) the Priority Provisions are 'swap agreements'; (2) the distribution of the Collateral constitutes 'liquidation'; and (3) the Trustees, in liquidating the Collateral and distributing its proceeds, exercised a 'contractual right of a[] swap participant.'"[11]

As to the first condition, the Second Circuit noted that the Code's "sweeping definition" of "swap agreement" expressly includes "the terms and conditions incorporated by reference in such agreement."[12] It was therefore of no consequence that the Priority Provisions were set out in the Indentures. Since the ISDAs stated that recoveries on collateral were "subject in any case to the Priority of Payments set out in the Indenture," they served to incorporate such provisions by reference.[13] Thus, the Second Circuit reasoned, the Priority Provisions were part of a "swap agreement" protected by Section 560.[14]

As to the second condition, the Second Circuit examined the meaning of the term "liquidation" by considering its ordinary meaning and "'the specific context in which that language is used.'"[15] The Court noted that Section 560 operates as an exemption from the Code's anti-*ipso facto* regime, a regime that, as the Supreme Court recently opined in *Mission Product Holdings, Inc. v. Tempnology, LLC*, 139 S. Ct. 1652 (2019), "bars a non-bankrupt counterparty from modifying or terminating an executory contract," thereby exposing a party to significant risk upon its counterparty's bankruptcy.[16] "By affording swap agreements special treatment," the Second Circuit explained, "section 560 shields swap participants from some of the risks associated with a counterparty's bankruptcy and enables them to unwind transactions."[17] Bearing this context in mind, the Court "conclude[d] that the term 'liquidation,' as used in section 560, must include the disbursement of proceeds from the liquidated Collateral."[18]

Although the Court found that the meaning of liquidation was "unambiguous," it also considered legislative history.[19] In so doing, it found that the congressional reports of the legislation pursuant to which Section 560 was enacted accorded with the Court's interpretation that Section 560 protects "a swap participant's ability to unwind the swap transaction."[20] Specifically, the Court stated, "[r]eading section 560's reference to 'liquidation' of a

most of the transactions, *id.* at 495-500. Having affirmed on the basis of its Section 560 ruling, the District Court found it unnecessary to address these other grounds and instead "[a]ssum[ed] that the Priority Provisions are *ipso facto* clauses" for purposes of its safe harbor analysis. *LBSF 2*, 2018 WL 1322225, at *4.

[8] Decision at 12.
[9] *Id.* at 16.
[10] 11 U.S.C. § 560.
[11] Decision at 15-16.
[12] *Id.* at 16.
[13] *Id.* at 17.
[14] *Id.*
[15] *Id.* at 18 (quoting *Merit Management Group, LP v. FTI Consulting, Inc.*, 138 S. Ct. 883, 892-93 (2018)).
[16] *Id.* at 19.
[17] *Id.* at 20.
[18] *Id.* at 18.
[19] *Id.* at 20.
[20] *Id.*

swap agreement to include distribution of the Collateral furthers the statutory purpose of protecting swap participants from the risks of a counterparty's bankruptcy filing by permitting parties to quickly unwind the swap."[21]

The Court rejected a number of counterarguments, including LBSF's contention that the U.S. Supreme Court's recent decision in *Merit Management Group, LP v. FTI Consulting, Inc.*, 138 S. Ct. 883 (2018) ("*Merit*") undercuts the Bankruptcy and District Courts' analysis of Section 560.[22] The Second Circuit disagreed, emphasizing that *Merit* analyzed a different safe harbor provision and was entirely consistent with the lower courts' analysis of the statutory text and conclusion that the trustee's distribution of the collateral was safe harbored as part of the liquidation process.[23]

The Second Circuit also directly addressed LBSF's assertion that the Bankruptcy and District Courts' analysis of Section 560 was inconsistent with Judge Peck's rulings in *BNY* and *Ballyrock*.[24] The Second Circuit expressly acknowledged a conflict with *BNY* and *Ballyrock* and rejected Judge Peck's reading of the safe harbor in those decisions, explaining that "the term 'liquidation,' as used in section 560, is in our view broad enough to include the subordination of LBSF's payment priority and distribution according to the amended waterfall of payment priorities."[25]

Finally, the Second Circuit agreed with the District Court that Section 560 "requires the exercise of a contractual right '*of*' any swap participant, not *by* one."[26] Thus, the Second Circuit explained that Section 560, by its plain language, applied to the trustees' enforcement of the Priority Provisions since such enforcement constituted an exercise of the right of the issuers – who are indisputably swap participants.[27]

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.

— The decision confirms the broad reach of the Section 560 safe harbor (and the analogous safe harbors for other financial contracts).[28] In particular, the Court stated in multiple instances that Section 560 protects the ability of swap participants to take all steps necessary to "unwind" a swap agreement, including distributing the proceeds of collateral.

— Unlike the prior decisions, the Court expressly rejected the view expressed in Judge Peck's decisions in *BNY* and *Ballyrock* that "liquidation," as used in Section 560, does not encompass rights to subordinate the debtor's payment priority or distribute collateral proceeds according to a modified waterfall priority. As a result, the decision suggests that Section 560 (and the analogous safe harbors) may protect tear-up

[21] *Id.* at 20-21.
[22] *Id.* at 22-23.
[23] *Id.* at 23-24.
[24] *Id.* at 24 n.11.
[25] *Id.* In reading Section 560 to protect distributions of collateral under the Priority Provisions, the Bankruptcy and District Courts distinguished *BNY* and *Ballyrock* because the Priority Provisions in this case were incorporated into the ISDAs and thus part of the swap agreements. *LBSF 1*, 553 B.R. at 503; *LBSF 2*, 2018 WL 1322225 at *7. The lower courts further 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 BR. 383 (Bankr. S.D.N.Y. 2013). *LBSF 1*, 553 B.R. at 504; *LBSF 2*, 2018 WL 1322225 at *7.
[26] *Id.*at 25 (emphasis in original).
[27] *Id.*
[28] 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).

provisions or the "First Method" under the 1992 ISDA Master Agreement.

— The decision, in line with the Second Circuit's recent holding in *Tribune*,[29] confirms that the Supreme Court's recent *Merit* decision does not dictate a general narrowing of the safe harbors. Rather, the Court clarified, *Merit*'s reach is limited to the issue it addressed (i.e., the scope of the anti-avoidance safe harbor set forth in Section 546(e) of the Code), and otherwise supports the reading of Bankruptcy Code safe harbors according to their plain terms.

— The decision provides guidance regarding the drafting of CDO documents and financial contracts more generally. Specifically, the safe harbors will apply to provisions that are incorporated by reference into a swap agreement or other protected contract, but potentially not to provisions that simply relate to protected contracts.

— In a footnote, the Court noted that "[t]he scope of the term 'liquidation' does not turn on whether immediate distribution is required." As a result, the decision casts doubt on the continued validity of Judge Peck's holding in "Metavante" that a safe harbored counterparty may waive its safe harbored rights by unduly delaying its exercise of remedies.[30]

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[29] *In re Tribune Co. Fraudulent Conveyance Litig.*, No. 13-3875-CV, 2019 WL 6971499 (2d Cir. Dec. 19, 2019).

[30] *See e In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (JMP), Tr. 9/15/2009.