ALERT MEMORANDUM

Lehman Bankruptcy Court Holds Provisions in Lehman CDOs Setting Payment Priority Are Enforceable and Protected by Safe Harbor

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Last week, Judge Chapman of the U.S. Bankruptcy Court for the Southern District of New York decided an issue of importance in the bankruptcy of Lehman Brothers Special Financing Inc. ("LBSF") and its affiliates. In this decision, *Lehman Brothers Special Financing Inc. v. Bank of America National Association*, Ch. 11 Case No. 08-13555, Adv. No. 10-03547 (Bankr. S.D.N.Y June 28, 2016) (the "Decision"),[1] Judge Chapman held that market-standard provisions in structured finance transactions that set the priority of payment for swap termination payments to swap counterparties in the event of a swap counterparty default are enforceable when the default is due to the filing of a bankruptcy – in this case, the bankruptcy of the counterparty LBSF's ultimate holding company Lehman Brothers Holding Inc. ("LBHI").[2]

This decision substantially protects such market-standard provisions from invalidation and provides greater certainty after earlier rulings by Judge Peck, in *Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Services Ltd. (In re Lehman Bros. Holdings Inc.),* 422 B.R. 407 (Bankr. S.D.N.Y. 2010) ("*BNY*"), invalidated CDO provisions that subordinated swap termination payments.

1 Cleary Gottlieb represented several of the noteholder defendants named in this action and who moved to dismiss the complaint.

2 Decision at 23.

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The Priority Provisions and LBSF's Default

This litigation involved claims brought by LBSF against about 250 defendant noteholders, note issuers, and indenture trustees in connection with 44 synthetic collateralized debt obligations (CDOs) that were terminated due to LBSF's default. LBSF sought to recover approximately $1 billion that was distributed to defendant noteholders in termination payments following LBSF's default. In pursuing these claims, LBSF relied in large part on Judge Peck's prior decision in *BNY*, which concerned the English law-governed *Dante* CDO program, as well as a second decision by Judge Peck that denied a motion to dismiss in the context of a New York law-governed CDO.[3]

Although the CDO transactions at issue in this case varied in certain respects, each transaction involved three interrelated components. *First*, the issuer issued one or more series of notes to investors, the noteholders, whose investment funded the issuer's purchase of collateral. *Second*, the issuer and swap counterparty, LBSF, entered into one or more credit default swap agreements, whereby the issuer sold synthetic credit protection on certain reference entities to LBSF and LBSF provided fixed premium payments to enhance the interest payments to be made to the noteholders. *Third*, the issuer used cash proceeds received from the noteholders to purchase investments to provide investment income and serve as collateral.

The collateral held by the CDO issuers secured both the noteholders and LBSF, the swap counterparty. That collateral was held in trust by a trustee pursuant to an Indenture or Trust Agreement governed by New York law, with the exception of two CDO transactions whose collateral was secured pursuant to a Trust Deed governed by English law. The Indentures, Trust Deeds, and Trust Agreements at issue in this litigation contained common provisions, referred to as "Priority Provisions," which prescribed 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 circumstances, but in the event that swap termination payments were owed due to LBSF's default, collateral proceeds payable to LBSF were due after amounts payable to the noteholders.[4]

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. Because LBHI was a "credit support provider" of LBSF, this filing constituted an LBSF event of default under its swap agreements with the various CDO issuers. 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, and no payment was made to LBSF as there were insufficient collateral proceeds to satisfy the noteholders' senior priority claims.

In 2010, LBSF commenced this litigation seeking, among other things, a declaratory judgment that the Priority Provisions are unenforceable *ipso facto*

[3] *See Lehman Brothers Special Financing Inc. v. Ballyrock ABS CDO 2007-1 Ltd. (In re Lehman Bros. Holdings Inc.)*, 452 B.R. 31 (Bankr. S.D.N.Y. 2011) (relying on *BNY* in denying motion to dismiss).

[4] The Priority Provisions were material components of the CDO transaction documents, as they mitigated the transactions' counterparty default risk by confirming the noteholders' rights to the collateral in the event of LBSF's or its affiliate guarantor's default. *See* Standard & Poor's, *Global Cash Flow and Synthetic CDO Criteria*, Mar. 21, 2002, at 22 ("Standard & Poor's has required that mitigation of the counterparty risk be addressed …. Typically, solutions include subordinating the termination [payment] in the waterfall to the rated noteholders…."); Rudolph Bunja & William May, *Moody's Approach to Assessing Secondary Risks in Synthetic CDOs*, Moody's Investors Service, Mar. 17, 2003, at 3 (assumption in evaluating synthetic CDOs is that "any termination payments due to the counterparty are either waived or subordinated as a result").

clauses because they subordinated LBSF's payment priority to the collateral as a consequence of LBHI's bankruptcy filing, and seeking recovery of the collateral distributed to the noteholders.

The Bankruptcy Court Decision

A. No Violation of Bankruptcy Code Sections 365(e)(1), 541(c)(1) and 363(*l*).

Judge Chapman held that for the majority of the transactions at issue, the Priority Provisions in the Indentures were not *ipso facto* clauses rendered unenforceable by sections 365(e)(1), 541(c)(1) and 363(*l*) of the Bankruptcy Code (the "*ipso facto* provisions").[5] By way of example, Section 365(e)(1) in relevant part provides:

> Notwithstanding a provision in an executory contract … an *executory contract… of the debtor* may not be … *modified*, and any right or obligation under such contract … may not be … *modified*, at any time *after* the commencement of *the case* solely because of a provision in such contract … that is conditioned on … the commencement of a case under this title … .

11 U.S.C. § 365(e)(1) (emphasis added).[6]

As an initial matter, for the *ipso facto* provisions to apply, the debtor's rights must have been "modified." Judge Chapman therefore first analyzed whether the Priority Provisions in the 44 transactions at issue "modified" LBSF's rights by changing its payment priority to the collateral. Judge Chapman separated the transactions into two groups, "Type 1" and "Type 2" transactions, based upon the specific language of the Priority Provisions in the relevant Indentures.[7] For the five transactions classified as Type 1, Judge Chapman concluded that LBSF's rights had been modified because those Priority Provisions provided LBSF with a fixed right to payment priority ahead of the noteholders at the outset, and then divested LBSF of its payment priority when LBSF defaulted due to LBHI's bankruptcy filing.[8]

As to the vast majority of the transactions under consideration, Judge Chapman found no modification had occurred.[9] In these so-called Type 2 transactions, "LBSF never enjoyed a right to payment ahead of the Noteholders and thus LBSF held no priority right that could have been modified."[10] Rather, in these transactions, LBSF only held contingent rights either to senior or junior payment priority, with its actual rights to payment determined when the swap termination occurred.[11] The fact that LBSF's default resulted in its having junior payment priority status did not accordingly mean that it's otherwise non-existent right to senior payment priority had somehow been "modified."[12]

Moreover, the Court concluded that, even if the Type 2 transactions had modified LBSF's rights, any such modification for the majority of the transactions occurred before the commencement of LBSF's bankruptcy case and therefore did not violate the *ipso facto* provisions.[13] The *ipso facto* provisions apply, by their terms, only if there is a modification of rights *after* the debtor's bankruptcy filing.[14] For these transactions, Judge Chapman held that the alleged modification of LBSF's rights occurred *before* LBSF's bankruptcy filing because any purported change in LBSF's payment priority was immediately effective upon the termination date of the swaps (which occurred before LBSF's October 3 bankruptcy

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5 Decision at 23, 26-27.

6 Sections 541(c)(1) and 363(*l*) contain substantially similar language to section 365(e)(1), in the context of defining what is included as property of the debtor's estate and what can be used, sold or leased as property of the debtor's estate, respectively.

7 Decision at 20-23 & App. B.

8 *Id.* at 23-26.

9 *Id.*

10 *Id.* at 25.

11 *Id.* at 25-26

12 *Id.*

13 *Id.* at 26-35.

14 *Id.* at 27.

filing).[15] The modification was not, as LBSF argued, only effective upon the sale and distribution of the collateral proceeds.[16]

In so holding, the Court declined to adopt what was viewed by many as the most novel and controversial aspect of Judge Peck's *BNY* decision, namely his articulation of the so-called "singular event" theory, under which, because of the circumstances of the Lehman bankruptcy cases, LBSF's October 3 bankruptcy filing was treated as a single event with LBHI's earlier September 15 bankruptcy filing.[17] Invoking this theory, LBSF argued that the alleged modifications to its rights had in fact occurred "after" the commencement of its bankruptcy case, since treating the Lehman filings as a singular event meant the relevant filing date became the LBHI September 15 date. In refusing to adopt the "singular event" theory, which is not otherwise supported by anything in the text of Chapter 11, Judge Chapman held that the phrase "the case" in the *ipso facto* provisions only can refer to the case of the debtor that is party to the relevant contract at issue, which here was LBSF.[18] Furthermore, Judge Chapman observed that Judge Peck himself declined to extend the "singular event" theory to other legal issues relating to the separate petition dates of LBHI and LBSF, as well as other Lehman affiliates.[19] Thus, the Court held, "any modification of LBSF's rights that occurred prior to the LBSF Petition Date cannot be the basis of a violation" of the *ipso facto* provisions.[20]

15 *Id.* at 33-35.

16 *Id.*

17 *Id.* at 29-31

18 *Id.* at 30.

19 *Id.* at 31.

20 *Id.* at 30. The Court also dismissed LBSF's tag-along state law claims, both in light of LBSF's failure to demonstrate a violation of the *ipso facto* provisions, as well as for other reasons explained by the Court. *See id.* at 46-51.

B. Bankruptcy Code Section 560 Safe Harbor Protects the Distributions to Noteholders.

In another departure from the *BNY* decision, Judge Chapman held that to the extent enforcement of the Priority Provisions for any of the transactions were considered to have violated the *ipso facto* provisions (including for transactions that were terminated after LBSF's October 3 bankruptcy filing), all distributions made to the noteholders pursuant to the Priority Provisions are protected by the safe harbor in section 560 of the Code.[21] In relevant part, this section 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… 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.

11 U.S.C. § 560. Applying Second Circuit precedent decided since *BNY*, Judge Chapman explained that courts must give a "broad and literal interpretation" of the Code's safe harbors.[22]

First, Judge Chapman stated that since Congress added "liquidation" to the statute, Congress' intent must have been for "liquidation" and "termination" to mean different things.[23] Accordingly, "liquidation" means something more than merely the right to terminate a swap transaction and, given the plain meaning of "liquidation," must include "the enforcement of the Priority Provisions and the distribution of the proceeds of the sale of the Collateral as part of the exercise of the right to liquidate the Swaps."[24] *Second*, Judge Chapman found that because

21 *Id.* at 36.

22 *Id.* at 37 (citations omitted).

23 *Id.* at 42.

24 *Id.* at 41-42.

the Priority Provisions here were either explicitly part of the swap agreements or incorporated into the swap agreements through schedules, they were rights of "swap participants."[25] (In *BNY*, Judge Peck had observed that, in the context of differently worded and structured transaction documents, the priority provisions at issue there "did not comprise part of the swap agreement."[26]) *Finally*, Judge Chapman held that the issuers are "swap participants" as defined in the Code, and that enforcement of the Priority Provisions was a right of the issuers.[27] LBSF had resisted this conclusion based on the argument that the trustees acted on behalf of the issuers in exercising such rights.[28]

Broader Implications

— This decision significantly increases certainty regarding the enforceability of market-standard payment priority provisions and protects commercial expectations of CDO noteholders and other participants in structured finance transactions.

— This decision provides clarification regarding the broad application of the section 560 safe harbor to protect CDO termination payments made pursuant to market-standard payment priority provisions.

— This decision rejects the "singular event" theory stated in *dicta* by Judge Peck in *BNY*, and makes clear that the relevant date for application of the *ipso facto* provisions of the Code is the bankruptcy filing of the debtor that is party to the relevant contract at issue, not the bankruptcy filing of its affiliate.

— This decision provides clarification regarding the language and timing of enforcement required for payment priority provisions to constitute unenforceable *ipso facto* clauses. Drafters of CDOs in the future should be cognizant of the Court's distinction between Type 1 transactions (which were deemed to entail a modification of LBSF's rights) and Type 2 transactions (which the Court concluded did not effect a modification of LBSF's rights).

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25 *Id.* at 42-43.

26 *BNY*, 422 B.R at 421

27 Decision at 44-46.

28 *Id.* at 44.