

Enforceability of Subordination Provisions in Synthetic CDOs — A Lehman Perspective

On January 25, 2010, the U.S. Bankruptcy Judge Peck struck down a provision that used the bankruptcy of Lehman Brothers Holdings, Inc. (“LBHI”) to trigger subordination of a Lehman subsidiary’s swap claim against a securitization vehicle in the United Kingdom.¹

The opinion invalidates a standard clause designed to subordinate or “flip” the priority of a swap counterparty’s claim upon default. Specifically, Judge Peck held that the “flip” may not be enforceable if triggered by the bankruptcy filing of either the swap counterparty (here, Lehman Brothers Special Financing, Inc. (“LBSF”)) or its guarantor (LBHI). Judge Peck’s opinion contradicts decisions by English courts which had previously upheld the enforceability of the very same provisions at issue in *Lehman*.

Subordination Provisions and Events of Default

In a synthetic collateralized debt obligation (“CDO”), priority of payments is addressed in a so-called waterfall provision, which lists the parties that will be entitled to payments from the securitization vehicle and the priority in which they will be paid. The collateral is held by a trustee on behalf of both the noteholders and the swap counterparty. Typically, amounts payable to the noteholders are subordinated to amounts payable to the swap counterparty (“*Swap Counterparty Priority*”), except if the swap counterparty is affected by an event of default, in which case the priority of payment is reversed and the swap counterparty becomes subordinated to the noteholders (“*Noteholder Priority*”).²

In the CDO at issue in *Lehman* (“*Dante*”), the collateral document, a Trust Deed governed by English law, secured the securitization vehicle’s obligations to Perpetual Trustee Company Limited (the “*Noteholder*”) and to LBSF (the “*Swap Counterparty*”). The Trust Deed contemplated the standard waterfall: if the Trust Deed were to be enforced against the collateral, Swap Counterparty Priority would prevail unless LBSF was affected by an event of default, in which case Noteholder Priority would prevail.

¹ *Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Services Ltd. (In re Lehman Brothers Holdings, Inc.)*, Ch. 11 Case No. 08-13555. Adv. No. 09-01242 (Jan. 25, 2010).

² Rating agency criteria is the main reason for such a subordination as rating of the notes is conditioned upon a so-called “de-linking” of the swap counterparty’s rating in order to ensure that the securitization vehicle’s liabilities are, as much as possible, independent from the creditworthiness of the swap counterparty (otherwise it would be difficult for structured notes to have a higher rating than that of the swap provider (or its guarantor)). See *Framework for De-Linking Hedge Counterparty Risks from Global Structured Finance Cashflow Transactions* Moody’s Methodology, Moody’s Investors Service (May 10, 2007).

LBHI filed its chapter 11 petition on September 15, 2008. Because LBHI was a “credit support provider” of LBSF, this filing constituted an event of default with respect to LBSF under the swap agreement. On October 3, 2008, LBSF filed its chapter 11 petition, which also constituted an event of default under the swap agreement. On December 1, 2008, the securitization vehicle sent a notice to LBSF terminating the swap agreement, citing LBSF’s bankruptcy filing as the relevant event of default. That termination forced the securitization vehicle to liquidate and redeem the notes through the distribution of the collateral held by BNY Corporate Trustee Services Ltd. (“BNY”), a U.K. affiliate of Bank of New York Mellon.

The English Decisions

English courts, both at trial and on appeal, applied English law and upheld the “flip.”³ In its unanimous affirmance on appeal, the Court of Appeal held that the “anti-deprivation principle” — the English analog to the Bankruptcy Code’s prohibition on *ipso facto* clauses — was not implicated because LBHI’s interest in the collateral had always been limited and conditional. In addition, the English court specifically held that the relevant date for purposes of testing whether any shifting of priorities occurred under the securitization documents was LBHI’s bankruptcy filing on September 15, 2008, upon which date Noteholder Priority automatically took effect. Thus, as of LBSF’s filing three weeks later, the shifting of priorities from Swap Counterparty Priority to Noteholder Priority had already occurred, thereby entitling the Noteholder to the proceeds of the disposition of the collateral.

The Bankruptcy Court Decision

Judge Peck respectfully disagreed, finding that the Bankruptcy Code’s invalidation of bankruptcy forfeitures was a fundamental principle of American law justifying a refusal to accord comity to the English decisions. He held that the Swap Counterparty Priority governed. Judge Peck reasoned that any purported alteration of that priority was either violative of the automatic stay (assuming the purported flip occurred post-petition) or violative of the Bankruptcy Code’s prohibition on *ipso facto* clauses (assuming the purported flip occurred pre-petition upon LBHI’s bankruptcy filing).

Notwithstanding the English courts’ interpretation of the Trust Deed and related securitization documents, Judge Peck found that, as of the LBSF filing, the securitization documents required certain affirmative acts to be taken in order for the flip of priorities to take effect — that is, no provision in any of the securitization documents automatically caused a change in legal rights immediately upon the occurrence of an event of default (such as LBHI’s earlier bankruptcy). As a result, as of its petition date, LBSF still held a valuable property interest in the underlying assets and such interest became part of the LBSF bankruptcy estate and was protected by the automatic stay.

³The securitization documents are governed by English law. The Noteholder had commenced litigation in the U.K. against BNY seeking priority payment pursuant to Noteholder Priority in order to get access to the collateral.

Alternatively, if LBHI's earlier bankruptcy filing had triggered an automatic flip in priority of payment, Judge Peck held that such a flip would have been in violation of the Bankruptcy Code's prohibition on *ipso facto* clauses and, as a result, would have been unenforceable.⁴

In reaching this holding, the Judge Peck relied on a literal interpretation of sections 365(e)(1) and 541(c)(1)(B) of the Bankruptcy Code, which invalidate defaults conditioned upon the commencement of a case under the Bankruptcy Code — i.e., not necessarily the swap counterparty's *own* bankruptcy case. Judge Peck held that, given the legislative history of the statutes — which showed that Congress had previously considered using debtor-specific language — the absence of such limiting language was significant.

Judge Peck recognized that his decision had the potential of opening up the proverbial can of worms in future disputes regarding the scope of the protections provided by sections 365(e)(1) and 541(c)(1)(B). As a result, he cautioned that his opinion should not be read as making any broad pronouncements concerning the circumstances under which it may or may not be appropriate for one debtor to invoke *ipso facto* protection due to the bankruptcy filing of an affiliate.

Judge Peck signaled, however, that cross-default provisions are not likely to be enforceable where various corporate entities comprise an “integrated enterprise” and where “the financial condition of one affiliate affects the others.”⁵ Also, Judge Peck made clear that, regardless of how this language may be interpreted in other settings, he would view the bankruptcy cases of LBHI and its affiliates as a singular event for purposes of interpreting *ipso facto* language.

Looking forward

BNY has announced that it will appeal Judge Peck's order. This is not surprising. Judge Peck's ruling in *Lehman* is consistent with — and relied upon — his opinion a few months ago in *Charter Communications*, where he held that a debtor subsidiary could “unimpaired” and reinstate its bank credit agreement notwithstanding a default caused by the bankruptcy of a debtor parent.⁶ The *Charter Communications* banks have appealed Judge Peck's decision in their case, so it makes sense for BNY to appeal the *Lehman* decision. BNY's appeal will in turn hang over numerous other Lehman litigations where subsidiary creditors have tried to enforce *ipso facto* clauses based on LBHI's chapter 11 filing.

⁴ This aspect of Judge Peck's opinion was arguably dicta, in light of the fact that Judge Peck had already determined, as a matter of contract interpretation, that the shift from Noteholder Priority to Swap Counterparty Priority did not occur automatically upon LBHI's bankruptcy.

⁵ In light of Judge Peck's prior decision in *Charter Communications*, this aspect of the ruling in *Lehman* was not unexpected.

⁶ Kramer Levin represented a group of bank creditors who argued against Judge Peck's decision in *Charter Communications*. The case is currently on appeal.

Judge Peck's ruling in the Dante litigation is also consistent with his previous bench ruling on the swap agreement in the *Metavante* litigation, where he held that Section 560 of the Bankruptcy Code, which validates swap clauses permitting a counterparty to *terminate* upon default, does *not* validate swap clauses providing for a counterparty to withhold payments upon default. *Metavante* has also been appealed; we expect to provide commentary on *Metavante* in the future.

Judge Peck's decision has international implications because, as Judge Peck acknowledged, BNY is now subject to conflicting U.S. and U.K. rulings.

The English courts will likely be asked to take Judge Peck's opinion into account and a formal application may be made in the U.K. to have Judge Peck's decision recognized under the UNCITRAL Model Code (probably only once it has become final).

If a conflict persists once all appeals have been exhausted in the U.S. and in the U.K., the English courts will likely have the last word in resolving this dispute and the related jurisdictional conflict with respect to distribution of *Dante* assets in the U.K. We understand that the Dante assets are in any event not located in the U.S.

This case may also have ratings implications for U.S. synthetic structured finance transactions. Moody's Investors Service recently announced that it is in the process of determining which of its rated transactions include similar provisions and could be impacted by Judge Peck's decision.⁷ One possible outcome is that securitization vehicles may enter into swap agreements with entities set up in a jurisdiction where the laws would favor noteholders by upholding the enforceability of subordination provisions if the swap counterparty (or its guarantor) were to become insolvent. U.K. counterparties seem to be fairly well positioned in that respect given the *Dante* ruling in the U.K. In turn, this may affect the pricing of underlying swaps as the certainty of being able to maintain payment priorities will come at a price to the securitization vehicle (and, eventually, the noteholders). Recent initiatives to develop a contingent credit default swap market may enable securitization vehicles to hedge against *ipso facto* exposure and permit U.S. counterparties to remain swap providers to securitization vehicles as the risk of a swap counterparty's default could be offloaded to other (hopefully not correlated) market participants.

⁷ See *U.S. Bankruptcy Court Ruling on Lehman Swap Termination Requires Deliberate and Case-Specific Analysis*, Moody's Investors Service (January 28, 2010).

If you have any questions or need additional information, please feel free to contact any member of our Financial Institutions Group.

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