US Bankruptcy Court Enforces CDO Transaction Flip Clauses

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Introduction

On 28 June 2016, the US Bankruptcy Court for the Southern District of New York decided, in *Lehman Brothers Special Financing Inc. v. Bank of America National Association, et al*,[1] ("**BofA**") that provisions set out in various synthetic collateralized debt obligation ("**CDO**") transactions that altered or established the priority of payments upon the occurrence of certain specified insolvency events were enforceable and the distributions made under such provisions were protected by the US Bankruptcy Code safe harbors.

The court declined to adopt some of the reasoning of Judge Peck's earlier rulings in *Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Services Ltd. (In re Lehman Bros. Holdings Inc.)*[2] ("**BNY**") and *Lehman Brothers Special Financing Inc. v. Ballyrock ABS CDO 2007-1 Ltd. (In re Lehman Bros. Holdings Inc.)*[3] ("**Ballyrock**") which invalidated similar CDO transaction provisions that subordinated swap termination payments upon the occurrence of certain specified insolvency events.

Background

The US Bankruptcy Code

The decisions in BNY, Ballyrock and BofA all dealt with the applicability of three areas of the US Bankruptcy Code: the bankruptcy automatic stay, the anti-*ipso facto* provisions and the bankruptcy safe harbors.

Bankruptcy automatic stay

The US Bankruptcy Code contains an automatic stay which, among other things, generally prevents a party to certain contracts from exercising remedies, including termination rights, once its counterparty has entered bankruptcy proceedings.[4]

Anti-ipso facto provisions

Under the US Bankruptcy Code, an *ipso facto* clause is one that permits the termination or modification of either the rights or obligations of a debtor under an executory contract or the executory contract itself due to the filing of a bankruptcy petition under the US Bankruptcy Code. Such clauses are generally unenforceable pursuant to Sections 365(e), 541 and 363(1) of the US Bankruptcy Code (we have collectively referred to these provisions as the "**anti-*ipso facto* provisions**"). The anti-*ipso facto* provisions only apply where any such termination or modification occurs after the filing of a bankruptcy petition, not before.

For example, Section 365(e) provides as follows:

an executory contract… of the debtor may not be terminated or modified, and any right or obligation under such contract… may not be terminated or 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…
(emphasis added)

Bankruptcy safe harbors

The US Bankruptcy Code also contains a series of "safe harbors" from the operation of both the anti-*ipso facto* provisions and the automatic stay for the exercise of certain rights in respect of securities contracts, commodity contracts, forward contracts, repurchase agreements and swap agreements (each as defined therein).

Regarding swap agreements, Section 560 of the US Bankruptcy Code (the "**Swap Bankruptcy Safe Harbor**") relevantly provides as follows:

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 proceedings under this title. (emphasis added)

Section 365(e)(1) of the US Bankruptcy Code specifically refers to the insolvency or financial condition of a debtor and the commencement of case under the US Bankruptcy Code.

The Lehman bankruptcies

On September 15, 2008, Lehman Brothers Holdings Inc. ("**LBHI**") filed for bankruptcy protection (the "**LBHI Petition Date**") and on October 3, 2008 Lehman Brothers Special Financing Inc. ("**LBSF**") filed for bankruptcy protection (the "**LBSF Petition Date**"), in each case, under Chapter 11 of the US Bankruptcy Code.

These filings were central to the court's analysis of whether the anti-*ipso facto* provisions and/or the Swap Bankruptcy Safe Harbor were applicable to the transactions the subject of the BNY, Ballyrock and BofA decisions.

The BNY and Ballyrock decisions

BNY

Under a multi-issuer secured obligation program, one of the issuers thereunder, a special purpose vehicle, issued various series of credit-linked notes, two series of which were subject of the litigation in BNY (collectively, the "**BNY Notes**"). The BNY Notes were held by a single noteholder and secured by collateral which was held in trust. The issuer also entered into swap transactions with LBSF, under which the events of default included the bankruptcy filing of the issuer, LBSF and LBHI (who was LBSF's credit support provider).

LBSF held a right to payment in priority ahead of the noteholder that was fixed at the outset of the BNY Notes. However, if an event of default occurred under the swap transaction documents with respect to LBSF, the conditions for an alternative priority would be satisfied resulting in the noteholder having priority ahead of LBSF (i.e., LBSF would lose its payment priority).

As a result of the LBSF bankruptcy petition filing, the swap transactions were terminated and the issuer was obligated to redeem the BNY Notes.

The court held as follows:

Anti-ipso facto provisions

In examining the applicability of the anti-ipso facto provisions, the court first held that the threshold criterion that the swap agreements were "executory contracts" was met, because, as required under the relevant statutory requirements, each of LBSF and BNY had unsatisfied contractual obligations to make various payments thereunder.

As the swap transactions were terminated as a result of LBSF's bankruptcy filing, the court determined that the LBSF Petition Date was the relevant date for determining whether the anti-*ipso facto* provisions applied. The court found that the priority of payment provisions that purported to modify LBSF's right to a priority distribution over the noteholder solely occurred as a result of the bankruptcy filing of LBSF under the US Bankruptcy Code and were therefore unenforceable *ipso facto* clauses.

The court noted that, even if the LBHI Petition Date was instead the correct date, this would not have changed the analysis. Following a review of the legislative history of the anti-*ipso facto* provisions, the court noted that the words "a case" used in the anti-*ipso facto* provisions (e.g., the phrase "the commencement of a case under this title" in Section 365(e)(1)) were, in the court's view, not intended to limit the application of the anti-ipso facto provisions to the commencement of the bankruptcy case of the debtor counterparty. Rather, the language was broad enough to encompass the bankruptcy filing of a related entity. The court, however, declined to expand upon the types of relationships that would be sufficient to trigger the anti-*ipso facto* provisions beyond the circumstances subject of the proceedings (i.e., the Lehman Brothers bankruptcies) as the court considered this best determined on a case-by-case basis. Based on the integrated nature of LBHI and its affiliates, the court decided that the bankruptcy filings of LBHI and its affiliates (including LBSF) under the US Bankruptcy Code were a singular event for the purposes of the anti-*ipso facto* provisions (i.e., each such bankruptcy filing would together constitute "a case").

Swap Bankruptcy Safe Harbor

In the court's view, the *ipso facto* quality of the priority of payment provisions was outside the protection of the Swap Bankruptcy Safe Harbor for two reasons. First, none of the swap transaction documents referred to the agreements underlying the BNY Notes that contained the priority of payment provisions with the consequence that such provisions did not form part of a "swap agreement," being one type of contact that is subject to protection under the US Bankruptcy Code (i.e., under the Swap Bankruptcy Safe Harbor). Second, the court characterized the priority of payment provisions as an alteration of existing rights rather than as a liquidation, termination or acceleration, which are the only actions subject to protection under the Swap Bankruptcy Safe Harbor.

Ballyrock

A special purpose vehicle issued several classes of notes (the "**Ballyrock Notes**") to various noteholders. The Ballyrock Notes were secured by collateral which was held in trust. The issuer also entered into swap transactions with LBSF, under which the events of default included the bankruptcy filing of the issuer, LBSF and LBHI (who was LBSF's credit support provider).

LBSF held a right to payment in priority ahead of the noteholders that was fixed at the outset of the Ballyrock Notes. However, if an event of default occurred under the swap transaction documents with respect to LBSF or LBHI, then any subsequent termination payment under the swap transaction documentations was deemed to be a "Defaulted Synthetic Termination Payment" which was subordinated to the noteholders, capped in an amount of US$30,000 and, importantly, excluded from the high priority given to other termination payments.

As a result of the LBHI bankruptcy petition filing, the swap transactions were terminated, the Ballyrock Notes were accelerated and the collateral was liquidated.

Noting that the court's analysis in BNY (see above) was directly applicable, the court held as follows:

Anti-ipso facto provisions

Unlike in BNY where the swap transactions were terminated as a result of LBSF's bankruptcy filing, the swap transactions in Ballyrock were terminated as a result of LBHI's bankruptcy filing. As such, the court applied the "singular event" theory set out in its earlier decision in BNY - that is, the bankruptcy filings of LBHI and LBSF constituted a singular event for the purposes of the anti-*ipso facto* provisions. On the basis of this analysis, the court found that the changes to the priority of payment provisions resulting from the activation of the Defaulted Synthetic Termination Payment provisions resulted in a modification to LBSF's right to a priority distribution over the noteholders solely as a result of a bankruptcy filing under the US Bankruptcy Code and were therefore unenforceable *ipso facto* clauses.

Swap Bankruptcy Safe Harbor

Consistent with its decision in BNY, the court decided that the Defaulted Synthetic Termination Payment provisions, which changed the priority of payment in favor of the noteholders, were an alteration or elimination of LBSF's existing distribution rights and not a liquidation, termination or acceleration as required under the Swap Bankruptcy Safe Harbor. As such, they were not protected by the Swap Bankruptcy Safe Harbor.

The court specifically noted that the Swap Bankruptcy Safe Harbor should be narrowly construed to circumstances involving a liquidation, termination, acceleration or netting only.

The BofA decision

Background

The priority of payment provisions at issue in BofA were part of a series of CDO transactions. Although the CDO transactions had varied terms in certain respects, they all had the same general structure:

- An issuer issued one or more series of notes (the "**BofA Notes**") to a group of noteholders and used the proceeds to purchase certain liquid investments to provide investment income and serve as collateral.
- The issuer entered into one or more swaps with LBSF whereby the issuer sold synthetic credit protection to LBSF on certain reference entities. The issuer used the premium payments received from LBSF to enhance the interest payments to the noteholders under the BofA Notes.
- The collateral was used to secure or support the issuer's obligations to the noteholders under the BofA Notes and to LBSF under the swap transactions. The collateral was

held in trust by a trustee and the trustee held a lien on the collateral for the benefit of the noteholders, LBSF and other specified secured parties. All payments from the collateral were to be made by the trustee pursuant to the priority of payment provisions that became the subject of the litigation.

- LBHI guaranteed LBSF's obligations under each swap transaction and was designated as a "credit support provider" under the swap transactions documentation.

  Because LBHI was a "credit support provider" of LBSF under the swap transactions, the bankruptcy filing of LBHI resulted in an event of default under the swap transactions permitting the issuer to terminate the swap transactions prior to the LBSF Petition Date. Most were terminated prior to the LBSF Petition Date, but a handful of swap transactions were terminated after the LBSF Petition Date. As a result of the LBHI bankruptcy petition filing, the payment obligations under the BofA Notes were accelerated, the vast majority of the swap transactions were terminated and the collateral was liquidated and distributed in accordance with the priority of payment provisions (see below).

The priority of payment provisions

If an event of default occurred under the terms of the BofA Notes, an enforcement notice could be delivered by the trustee accelerating the payments due and owing under the BofA Notes, triggering an early termination of the swap transactions and permitting the collateral to be liquidated with any proceeds then required to be distributed in accordance with the applicable priority of payment provisions.

The CDO transactions used two different priority of payment provisions:

- Under the first type, LBSF held a right to payment in priority ahead of the noteholders that was fixed at the outset of the CDO transaction. However, if the conditions for an alternative priority were satisfied after this time, LBSF would lose its payment priority. CDO transactions with these provisions were referred to by the court as "**Type 1 Transactions**." Of the CDO transactions considered, only five were Type 1 Transactions. The priority of payment provisions in the Type 1 Transactions were similar to those applicable to the transactions subject of the BNY and Ballyrock decisions.
- Under the second type, the priority of payment was not fixed at the outset of the CDO transaction, but instead one of two potential priorities could become applicable. One of the options gave priority to LBSF whilst the other gave priority to the noteholders. LBSF did not have a right to payment priority ahead of the noteholders, only a right to be paid proceeds of the collateral pursuant to one of the applicable provisions. Which priority applied would remain unknown until a default occurred and the circumstances surrounding it were determined. CDO transactions with these provisions were referred to by the court as "**Type 2 Transactions**." The vast majority of the CDO transactions were Type 2 Transactions.

Importantly, both types of priority of payment provisions provided that, where an early termination of the swap transactions occurred as a result of the bankruptcy of LBHI or LBSF, the noteholders held payment priority ahead of LBSF. As a result of the bankruptcy filings of LBHI and LBSF, the priority of payment provisions giving the noteholders priority ahead of LBSF were applied. The proceeds of the liquidation of the collateral were insufficient to make any payments to LBSF.

Although the practical effect of the priority of payment provisions under the Type 1 Transactions and the Type 2 Transactions were the same, the differences in how these provisions were drafted (as set out above) was a material factor in the court's decision.

Anti-*ipso facto* provisions

Based on a review of the anti-*ipso facto* provisions, the court stated that in order to determine whether the priority of payment provisions constituted *ipso facto* clauses it would need to consider three factors:

- the nature of the rights held by LBSF prior to the relevant swap transaction early termination date;
- whether the enforcement of the priority of payment provisions modified any right of LBSF; and
- if there was a modification, when such modification occurred.

The court analyzed both the Type 1 Transactions and Type 2 Transactions against these factors. In addition, the court also made an alternate holding regarding the application of the anti-*ipso facto* provisions.

Type 1 Transactions

The court concluded that, because LBSF held a right to payment priority ahead of the noteholders that was fixed from the outset of the Type 1 Transactions, the subsequent removal of that right because of LBSF's default due to its bankruptcy filing was, absent any safe harbor protection, unenforceable as an *ipso facto* clause.

Type 2 Transactions

The court concluded that, because LBSF never held a right to payment priority ahead of the noteholders and instead only held a right to receive the collateral pursuant to the then prevailing priority of payment, the subsequent application of the payment priority that gave priority to the noteholders ahead of LBSF did not modify an existing right. Therefore, the priority of payment provisions were not an *ipso facto* clause and were enforceable.

With respect to the appropriate testing date, the court declined to adopt the "singular event" theory set out by Judg Peck in BNY and Ballyrock (see above). In the court's view, the words "a case" used in the anti-*ipso facto* provisions (which words were the focus of Judge Peck's analysis) referred only to the bankruptcy filing of the debtor (in this case, LBSF) and not any other entity's bankruptcy filing. To answer the question of when a modification of the contractual right must occur in order to fall within the ambit of the anti-*ipso facto* provisions, the BofA court turned to the lead-in paragraph of Section 365(e)(1) (and similar language in each of the other anti-*ipso facto* provisions), which stated that a contractual right may not be modified at any time after the filing of "the case," referring to the case of the debtor whose rights have been modified. Thus, the court concluded that the relevant testing date in this instance was the LBSF Petition Date.

If the "singular event" theory had been applied to the facts in BofA, the LBSF Petition Date and LBHI Petition Date would have been treated as a single event with the result that the relevant bankruptcy filing date for the purposes of testing the anti-*ipso facto* provisions would have instead been the earlier LBHI Petition Date (i.e., September 15, 2008, not October 3, 2008). By rejecting that theory, the court confirmed that LBSF's bankruptcy filing (and not that of LBHI) was the only reference point to which the anti-*ipso facto* provisions refer when requiring than an *ipso facto* event occur "at any time after the commencement of the case," as it was the rights of LBSF as counterparty to the swap transactions that were at issue, not those of LBHI.

Alternative holding regarding the anti-*ipso facto* provisions

The court in BofA classified the applicable swaps into three categories based on when they were terminated and when the associated collateral was liquidated and payments distributed, as follows:

- *Pre-Pre Transactions*: swaps where the termination, collateral liquidation and distribution of proceeds all occurred prior to the LBSF Petition Date;
- *Pre-Post Transactions*: swaps where the termination occurred prior to the LBSF Petition Date whilst the distribution of proceeds from the collateral liquidation occurred after the LBSF Petition Date; and
- *Post-Post Transactions*: swaps where the termination, collateral liquidation and distribution of proceeds all occurred after the LBSF Petition Date.

As it happened, the Type 1 Transactions consisted solely of Post-Post Transactions and the Type 2 Transactions consisted of Pre-Pre Transactions, Pre-Post Transactions and Post-Post Transactions.

Although the court had determined that no contractual right of modification had occurred in respect of the Type 2 Transactions, the court made an alternative holding that, had it instead decided that the rights of LBSF were modified, the fact that such modifications for the majority of the Type 2 Transactions occurred before the LBSF Petition Date meant that the priority of payment provisions did not violate the anti-*ipso facto* provisions as these provisions only apply where a modification of rights occurs after a debtor's bankruptcy filing (which, in this case, was the LBSF Petition Date). The court noted in a footnote, however, that this alternative holding only applied to Type 2 Transactions that were Pre-Pre Transactions and Pre-Post Transactions (as the termination date for these swaps occurred prior to the LBSF Petition Date). By extension, the alternative holding would not apply to any Type 1 Transactions as they were all Post-Post Transactions.

As a result of the court limiting the application of its alternative ruling, its ruling did not include a decision on how the anti-*ipso facto* provisions would apply to swaps that contain priority of payment provisions similar to those used in the Type 1 Transactions and that are terminated and liquidated in the same manner as the Pre-Pre Transactions and the Pre-Post Transactions (i.e., termination occurs prior

to the applicable debtor's bankruptcy petition date resulting in a collateral liquidation and distribution of proceeds before or after such date). However, it is likely that the court's analysis in BofA would be considered persuasive in any future cases regarding the application of the anti-*ipso facto* provisions to transactions similar to such transaction types.

Swap Bankruptcy Safe Harbor

After finding that the Type 2 Transactions did not violate the anti-*ipso facto* provisions, the court turned to whether the Type 1 Transactions (and, under its alternative holding, any Type 2 Transactions that were Post-Post Transactions), which it held did violate such provisions, were nonetheless within the scope of the Swap Bankruptcy Safe Harbor.

In declining to adopt the rulings of Judge Peck in BNY and Ballyrock, the court noted that the safe harbors contained in the US Bankruptcy Code (including the Swap Bankruptcy Safe Harbor) are to be interpreted broadly and literally. In the court's view, this was consistent with its prior decisions which emphasized that the various safe harbors are intended to protect the stability and efficiency of the financial markets.

In light of this, the court made the following three findings:

First, the use of the terms "termination" and "liquidation" in the Swap Bankruptcy Safe Harbor should be interpreted to each have a distinct meaning - the term "termination" covered the actual termination of the swap transactions and the plain meaning of the term "liquidation" was broad enough to cover the subsequent sale of the collateral as well as the distribution of the proceeds, which necessarily included calculation of amounts to be distributed pursuant to the priority of payment provisions. It was not a relevant consideration that the priority of payments in effect gave the noteholders priority ahead of LBSF, even though the result in the circumstances present in BofA was that LBSF would not be entitled to any distribution. Nor was it relevant that the trustees had discretion not to liquidate the collateral.

Second, because the priority of payment provisions were either explicitly part of the swap transactions documentation or incorporated through schedules, they formed part of the swap transactions and were therefore rights of "swap participants."

Third, the enforcement of the priority of payment provisions was a right of the issuers, being counterparties to the swap transactions and therefore "swap counterparties," that was protected by the Swap Bankruptcy Safe Harbor. The fact that the termination of the swap transactions and the liquidation and distribution of the collateral were rights that could be exercised by the issuer was sufficient for those rights to be protected, notwithstanding that it was the trustee, acting on behalf of the issuers, who actually exercised such rights.

The court concluded that enforcement of the priority of payment provisions satisfied the elements of the Swap Bankruptcy Safe Harbor and thus those provisions could not be stayed, avoided or otherwise limited by the US Bankruptcy Code (including by application of the anti-*ipso facto* provisions) or any court order. Therefore, even though the priority of payment provisions in the Type 1 Transactions would have been unenforceable under the anti-*ipso facto* provisions, the distributions made pursuant to such provisions were nonetheless enforceable because of the Swap Bankruptcy Safe Harbor. The same conclusion would likely have applied to the distributions made pursuant to the priority of payment provisions of the Type 2 Transactions that were Post-Post Transactions. The court did not need to consider this, however, as the Type 2 Transactions were not unenforceable under the anti-*ipso facto* provisions and, as such, the distributions needed no safe harbor protection.

ENDNOTES:

[1]553 B.R. 476 (Bank. S.D.N.Y. 2016).

[2]422 B.R. 407 (Bankr. S.D.N.Y. 2010).

[3]452 B.R. 31 (Bankr. S.D.N.Y. 2011).

[4]11 U.S.C. § 362(a).

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