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Bankruptcy Court Rules “Flip Clause” Violates *Ipsa Facto* Provisions

In a matter of first impression arising in the largest corporate bankruptcy in history, *In re Lehman Brothers Holdings Inc.*, the Bankruptcy Court for the Southern District of New York invalidated a common contractual provision shifting payment priority upon the default of a swap counterparty (“Flip Clause”) in a credit-linked debt structure.¹ That structure included a credit default swap (“CDS”) with Lehman Brothers Special Financing Inc. (“LBSF”) as part of the collateral for notes and other secured obligations of a Lehman-created, special purpose issuer. Bankruptcy Judge James Peck held that the Flip Clause improperly altered the priority payment right of LBSF as the CDS counterparty, due solely to a bankruptcy filing, thereby violating the *ipso facto* and automatic stay provisions of the Bankruptcy Code.

Here’s more background: on September 15, 2008 (the “LBHI Petition Date”), LBHI filed for bankruptcy. Two weeks later, on October 3, 2008 (the “LBSF Petition Date”), LBSF also filed for bankruptcy. Both filings were events of default under the CDS and the debt documents. On December 1, 2008, the issuer notified LBSF that it was terminating the CDS based on the LBSF bankruptcy filing. That termination obligated the issuer to redeem the notes through the Bank of New York (“BNY”), the collateral trustee for the noteholders and LBSF.

With English law governing the transactions, one of the noteholders filed an action in an English court seeking to enforce payment under the Flip Clause.² The English court held that (i) the Flip Clause was valid, and therefore, LBSF’s payment rights could be subordinated to those of the noteholders under English law and (ii) the Flip Clause became effective on the LBHI Petition Date. LBSF, which had participated in the English litigation, appealed, but England’s Court of Appeal dismissed LBSF’s appeal in November 2009.

While the English litigation was pending, LBSF filed a complaint in the Bankruptcy Court against BNY challenging the Flip Clause under U.S. bankruptcy law. It sought a declaratory judgment that enforcement of the Flip Clause would violate the *ipso facto* provisions of the Bankruptcy Code and the automatic stay. LBSF and BNY cross-moved for summary judgment.

¹ *Lehman Brothers Special Financing Inc. v. BNY Corp. Services Ltd.*, Case No. 08-13555. Adv. No. 09-01242 (Bankr. S.D.N.Y. Jan. 25, 2010).

² *Perpetual Trustee Co. Ltd. v. BNY Corp. Trustee Services Ltd.*, [2009] EWCA (Civ) 1160 (Eng.).

Although the English court had upheld the Flip Clause, Bankruptcy Judge James Peck declined to give preclusive effect to that decision, finding that it did not “sufficiently consider[] the applicability and impact of section 365 of the Bankruptcy Code.”³ Judge Peck then ruled in LBSF’s favor.

He identified several grounds for his ruling which he described as “directly at odds” with the English court. First, he concluded that the debt documents containing the Flip Clause were executory contracts for purposes of the *ipso facto* prohibition of section 365(e)(1) of the Bankruptcy Code, inasmuch as both BNY and LBSF had material obligations that survived the transaction’s termination.

Next, Judge Peck held that the relevant date for determining LBSF’s property interest, if any, in the transaction was the LBSF Petition Date. He concluded that LBSF still had a protected property interest in the transaction within the meaning of section 541(c)(1)(B) on the LBSF Petition Date because (i) the transaction documents required affirmative acts to be taken, including the realization or sale of the collateral of the notes, and (ii) the relevant termination events occurred on December 1, 2008, a date *after* the LBSF Petition Date.

After finding for these reasons that the Flip Clause violated the *ipso facto* provisions when based on LBSF’s bankruptcy case, Judge Peck ventured into what he recognized was uncharted territory. He said that even if the relevant date for determining LBSF’s property interest was the LBHI Petition Date, the Flip Clause would nevertheless amount to an unenforceable *ipso facto* provision in the LBSF bankruptcy case because the plain meaning of sections 365(e)(1) and 541(c)(1)(B) “prohibits modification of a debtor’s right solely because of a provision in an agreement conditioned upon ‘the commencement of a case under this title.’” For these purposes, “a case” did not have to be the debtor’s case alone. Treating the chapter 11 cases of LBHI and its affiliates, including LBSF, as a “singular event,” Judge Peck held that the filing of LBHI’s bankruptcy case was enough to trigger the *ipso facto* protections in LBSF’s bankruptcy case.⁴ Thus, using either the LBSF Petition Date or the LBHI Petition Date, the priority shift under the Flip Clause was an unenforceable *ipso facto* provision. Along the way, Judge Peck rejected BNY’s argument that the Flip Clause was part of an integrated swap agreement and thus protected by safe harbor of section 560 of the Bankruptcy Code. He also held that the Flip Clause did not constitute a subordination agreement, given the Flip Clause’s contingent nature, which he found differed from an ordinary, fixed subordination agreement.

Labeling his decision a “controversial one,” and acknowledging that it placed BNY in the middle of a cross-border dispute between two courts, Judge Peck directed the parties to attend a status conference intended to sort out the next steps in the whole affair. While he expressly confined his decision to the specific business structure and circumstances involved in the adversary

³ Section 365(e)(1)(B) of the Bankruptcy Code provides that “[n]otwithstanding a provision in an executory contract . . . 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 anytime 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.

⁴ Judge Peck attributed the delay between LBHI’s bankruptcy filing and that of LBSF to unforgiving market forces.

proceeding before him, the ruling, if it stands, will undoubtedly reverberate much farther than that, and will likely affect future market expectations and transaction structuring.⁵

* * * *

This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any of the following:

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⁵ On January 28, 2010, Moody's Investors Service issued an announcement regarding the Bankruptcy Court's ruling, observing, in part, that it "may have profound effects on structured finance transactions because it challenges long-held assumptions relating to the subordination of swap termination payments to a swap counterparty following a swap counterparty bankruptcy." Moody's noted that the ruling might have rating implications for U.S. structured finance transactions that include swap agreements and that it was reviewing transactions which might be affected by the decision.