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## Lehman Bankruptcy Decision Has Potentially Broad Reaching Effects

*Court Broadens Interpretation of Code Sections Invalidating Ipso Facto Contract Provisions*

Last week, the United States Bankruptcy Court for the Southern District of New York issued a decision in the Lehman Brothers bankruptcy proceedings holding invalid a subordination clause within a credit linked synthetic portfolio note transaction (the "Transaction") in connection with which one of the Lehman subsidiaries had entered into a swap agreement. The court issued a broad ruling that extended certain protections of the automatic stay upon the bankruptcy filing of not only the entity that is a party to the transaction at question, but also upon the bankruptcy filing of a related entity. The effect of this decision may reach beyond the Lehman proceedings and alter the early termination payout provisions of other similarly structured deals.

### Background

The summary judgment decision was issued on behalf of Lehman Brothers Special Financing Inc. ("LBSF"), a subsidiary of Lehman Brothers Holding, Inc. ("LBHI"), in the adversary proceeding, *Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Services Ltd.*, Ch. 11 Case No. 08-13555, Adv. No. 09-01242 (Bankr. S.D.N.Y. Jan. 25, 2010). The Transaction was governed by a certain Principal Trust Deed entered into by a predecessor of BNY Corporate Trust Services Limited ("BNY") with issuers of several classes of notes (the "Notes"). Each series of Notes was governed by a Supplemental Trust Deed (each the "Supplemental Trust Deed," and together with all other agreements underlying the Notes, the "Transaction Documents"). Under the Transaction Documents, BNY was trustee of collateral that secured each issuer's obligations under the Notes and a swap agreement to which LBSF was the swap counterparty (the "Swap Agreement").

The dispute centered around the enforceability of certain provisions of the Transaction Documents that reversed the priorities of payment so that holders of Notes would be entitled

to priority over amounts that would otherwise be payable to LBSF and modified the amounts payable upon early redemption of the Notes in the event LBSF defaulted under the terms of the Swap Agreement (the "Subordination Provisions"). Under the terms of the Swap Agreement, when an event of default occurs and an Early Termination Date is designated, a termination payment may be owed to LBSF by each issuer. Under normal circumstances, the Transaction Documents provided that LBSF, as swap counterparty, is to be paid before the holders of the Notes. The Subordination Provisions provided that when an event of default occurred under the Swap Agreement where LBSF is the defaulting party, then LBSF's priority for payment is subordinated to the holders of the Notes. The Swap Agreement provided that the filing of a bankruptcy petition by the swap counterparty or its credit support provider constituted an event of default thereunder, with the swap counterparty being the defaulting party.

On September 15, 2008, LBHI, the credit support provider for LBSF's payment obligations under the Swap Agreement, filed its Chapter 11 petition, followed by LBSF filing its petition on October 3, 2008. As a result of the event of default under the Swap Agreement, the issuer of the notes sent notice to LBSF on December 1, 2008, designating an early termination date, thereby terminating the Swap Agreement and giving rise to amounts payable to LBSF upon termination.

### The Adversary Proceeding

As the court explained, the central issue in this adversary proceeding is, "the priority of payment to beneficiaries (one a noteholder and the other a swap counterparty) that hold competing interests in collateral securing certain credit linked synthetic portfolio notes." In essence, the court decided whether the Subordination Provisions were enforceable.

The court held that, when activated by reason of the commencement of a bankruptcy case by LBSF, the Subordination Provisions were unenforceable as such provisions violated Sections 365(e)(1) and 541(c)(1)(B) (the provisions governing *ipso facto* clauses) of the Bankruptcy Code. In relevant part, Section 365(e)(1) provides:

An executory contract ... 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.

11 U.S.C. § 365(e)(1). Section 541(c)(1)(B) further invalidates *ipso facto* clauses providing that a debtor's interest in property:

Becomes property of the estate ... notwithstanding any provision in an agreement, transfer instrument, or applicable non-bankruptcy law ... that is conditioned on ... the commencement of a case under this title ... and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.

11 U.S.C. § 541(c)(1)(B).

BNY argued, on behalf of the holders of the Notes, that the court should find the Subordination Provisions were enforceable. First, BNY argued that Section 560 of the Code, which contains a post-petition safe harbor provision for swap agreements, protected the enforceability of the Subordination Provisions. The court dismissed this argument because the Subordination Provisions were not literally part of the Swap Agreement itself, but were instead contained in the

terms and conditions of the other Transaction Documents. In addition, BNY argued that the Subordination Provisions should be found enforceable because English courts had already found the provisions to be enforceable and, pursuant to Section 510(a) of the Code, the Subordination Provisions should be enforceable under the Bankruptcy Code to the extent that such agreements are enforceable under applicable non-bankruptcy law. The court discarded this argument as well, holding that the shift in payment priority upon the commencement of a bankruptcy case renders unenforceable this aspect of a subordination agreement.

The court reasoned that upon "the commencement of a case," meaning the filing of a petition, any clause in a contract that modifies or terminates the relationship of contracted parties based on the filing of a bankruptcy petition is invalid. By this rationale, the court invalidated the Subordination Provisions and found that any actions to enforce such provisions as a result of the filing of a bankruptcy violates the automatic stay. The court further reasoned that the Subordination Provisions were not activated until the issuer sent a notice of termination pursuant to the Swap Agreement. Since the issuer sent LBSF a notice of termination in December of 2008, well after LBSF's October filing date, such notice amounted to an attempt at post-petition modification or termination of a right under a contract, thereby violating the automatic stay and the *ipso facto* provisions of the Code.

The court then proceeded to define "the commencement of a case" as it is used in the *ipso facto* sections of the Code to include not just the commencement of a case by a party to the contract (here, LBSF), but also the commencement of a case by a party related to a party to the contract (LBHI). The court held that the degree to which the party seeking protection must be related to the filing party is fact specific with no bright line definition.

As the court explained, the effect of this finding is that the protections of the automatic stay and the *ipso facto* provisions predate LBSF's October filing, and instead, extend back to LBHI's September 15, 2008 filing. Acknowledging that there is no precedent for this interpretation, the court based its interpretation on legislative history, noting that previous drafts of the *ipso facto* provisions of the Code included the language, "the commencement of a case by or against the debtor," but were later revised to exclude reference to the debtor.

This additional reasoning regarding the "commencement of a case" has no real effect on the instant adversary proceeding as the termination notice here was filed after both the LBSF filing and the LBHI filing. However, in cases where actions are or were taken under swap agreements prior to a Lehman subsidiaries' filing but after the September 15 LBHI filing, then such actions may also be subject to the protections of the automatic stay and the *ipso facto* provisions of the Bankruptcy Code.

### Effects And Next Steps

The court expressly acknowledges that the issues addressed in this decision are "unique" and "unprecedented," particularly as it construes the *ipso facto* provisions of the Code to invalidate the Subordination Provisions after the filing of a petition by a related entity.

This result, if upheld on appeal, may have a broad reaching effect at a minimum throughout the rest of the Lehman bankruptcy proceedings, and perhaps in any situation where a contract party's parent entity has declared bankruptcy before the subsidiary or related party has filed.

Assuming that the court's decision is upheld, a greater effect is that many of the Lehman subsidiaries may receive significant recoveries with respect to early termination payments, that are contrary to the express terms of the governing documents and contrary to the par-

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## Lehman Bankruptcy Decision Has Potentially Broad Reaching Effects (cont'd.)

ties' expectations when entering into such contracts. As with the holders of the Notes in this proceeding, many contract parties may have relied upon the subordination clauses, which have now been rendered unenforceable, in deciding whether to enter the transaction. This raises additional issues when a Lehman entity marketed the transaction and arguably used such provisions to induce prospective investors to enter into the transaction itself.

Moreover, in non-Lehman actions, the court recognizes that the decision may have opened a "can of worms" where debtors will seek to extend the reach of the automatic stay back to the filing of related companies, and the question of how "related" such a company must be to the instant debtor will likely be an ongoing subject of bankruptcy litigation.

Although not the focus of this alert, it should be noted that this dispute was being decided in parallel proceedings, one before the United States Bankruptcy Court and the other by the High Court of Justice, Chancery Division in England. Prior to the United States Bankruptcy Court's opinion, the English court decided, and was affirmed by the Court of Appeal, that the subordination clause, prioritizing payment to the holders of the Notes over LBSF as swap-counterparty, was enforceable under English law. These now competing results add another layer of complexity to this dispute. The United States Bankruptcy Court acknowledged that the parties and the two courts will be required to work together towards resolution. The net effect of this decision on the instant adversary proceeding cannot reasonably be determined until negotiations between the United States Bankruptcy Court and English courts are completed and negotiations between the parties to the adversary proceeding have concluded. The effect of this decision, if not overturned on appeal, will be far-reaching for both the Lehman Bankruptcy proceedings and bankruptcy law in general. Accordingly, this appeal is one that we, and many others, will be monitoring closely.

**About the Authors**

Donna Burnett is a partner at Locke Lord. She represents participants in securities and structured finance transactions, including issuance (taxable and tax-exempt) as well as workouts and defaults on such transactions. Ms. Burnett has worked with a number of municipalities, energy companies, monoline insurers, trustee banks, custodians, servicers, collateral administrators, letter of credit banks and purchasers or holders to help issue (including structuring with special purpose vehicles) and secure debt (including collateralized debt obligations) and securities such as mortgage and other asset back certificates and to help pursue remedies and liquidate assets following default.

Joseph N. Froehlich is a partner in Locke Lord's New York office. He has experience in representing clients in complex commercial, business litigation and bankruptcy both in New York and throughout the country. Mr. Froehlich has extensive experience representing financial institutions, educational institutions and insurance companies in every step of the litigation process.

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