HUNTON& WILLIAMS

CLIENT ALERT

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Bankruptcy Court Rules for Lehman on Flip Clause

In a recent Hunton & Williams client alert, we discussed some of the issues relating to the termination of credit default swap agreements that were pending before the Lehman bankruptcy court, including the enforceability of so-called "flip clauses." ("Swap Termination and the Subordination of Termination Payments in the Lehman Bankruptcy," December 2009.) Recently, the court ruled for Lehman on many of these issues.
The court's ruling (*Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Services Inc.*, January 25, 2010) threatens the enforceability of rated structures designed to insulate investors from counterparty credit risk. If a counterparty or guarantor is subject to U.S. bankruptcy law, the court's ruling creates uncertainty about the vitality of commonly employed structures, and could operate to move structured deals to markets that employ English law, where courts have upheld the enforceability of flip clauses.

The Flip Clause and the *Ipso Facto* Doctrine

The September 15, 2008, bankruptcy of Lehman Brothers Holdings Inc. ("LBHI") was an event of default under thousands of derivative contracts to which a Lehman entity was a party and for which LBHI was the guarantor. This default allowed Lehman's counterparties to terminate these contracts. Provisions in related transactional documents provided that, in the event of a Lehman default, Lehman's right to an early termination payment became subordinated to the rights of parties holding securities issued by Lehman's counterparties. If these subordination provisions or "flip" clauses were upheld, Lehman would receive no termination payments in many of these deals, even though it was "in-the-money" when the deals were terminated.

Lehman argued to the bankruptcy court that these flip clauses were contrary to the *ipso facto* doctrine — the doctrine of U.S. bankruptcy law that prohibits the modification of a debtor's contractual rights because of the debtor's bankruptcy.[1] The court agreed with Lehman, holding that the flip clause is unenforceable under the *ipso facto* doctrine. The court reached this conclusion despite acknowledging that Lehman itself had structured many of these deals and had agreed to the flip clauses, and that "[c]apital was committed with this concept embedded in the transaction."[2]

The Flip Clause Under English Law

Earlier in 2009, the enforceability of flip clauses under English law was litigated by the same parties in the English courts. The English High Court held that the change in payment priority was enforceable under English law. That decision was upheld by the English Court of Appeal. In the U.S. litigation, BNY

Corporate Trustee Services ("BNY") argued that the bankruptcy court should defer to the ruling from the English courts. But the court declined to do so because the English courts "did not take into account principles of United States bankruptcy law," and limited their analyses to whether the switch in priorities was consistent with English law. Because "the United States has a strong interest in having a United States bankruptcy court resolve issues of bankruptcy law," the court held that it should not give preclusive effect to the English courts' rulings.[3]

The Bankruptcy Court's *Ipso Facto* Analysis

Lehman Brothers Special Financing ("LBSF") filed for bankruptcy more than two weeks after LBHI filed its petition. BNY took the position that, under the swap agreement, the switch in priorities brought about by the flip clause was a consequence of LBHI's filing, so that the change in the priority of payments had occurred before LBSF's filing. Therefore, BNY argued, because the change had already occurred, there was no modification of LBSF's rights as a result of LBSF's bankruptcy.

The court rejected this argument, holding that the change in priority did not occur, if at all, until after LBSF's filing. The court noted that BNY did not terminate the swap until after LBSF's filing. The court also noted that the change in priority would not occur until the collateral to be used to make the disputed payment is liquidated.[4]

This holding rests on the court's analysis of the BNY documents, which suggest that the change in priority may not happen until the collateral was sold. The court's opinion allows that, in other cases, it might hold that the change occurred before LBSF's petition, if the documents in those cases explicitly state that the change occurs on the event of default.

In the alternative, the court also held that the *ipso facto* doctrine protected LBSF as of the date of LBHI's earlier bankruptcy filing, because both entities were part of an "integrated enterprise," such that "the financial condition of one … affect[ed] the other."[5] Hence, even if the swap had terminated automatically based on LBHI's bankruptcy, and even if such termination had automatically effected the change in priority, the *ipso facto* doctrine would apply.

With respect to the "integrated enterprise" holding, the court was careful to avoid stating any rule that might be used in other cases to determine whether two entities are sufficiently integrated so that the bankruptcy of one triggers the *ipso facto* doctrine with respect to the other. Rather, the court held that, on the facts before it, a sufficient relationship existed to trigger the *ipso facto* protections of the U.S. Bankruptcy Code for LBSF more than two weeks before LBSF filed for bankruptcy. The court's careful limitation of its decision to the Lehman facts, as well as its disinclination to announce a general rule, may increase the uncertainties created for market participants.

The Swap Safe Harbor Does Not Apply To The Flip Clause

Section 560 of the Bankruptcy Code provides a safe harbor against the operation of the *ipso facto* doctrine, allowing a swap participant "to cause the liquidation, termination or acceleration" of a swap agreement because of its counterparty's bankruptcy, notwithstanding the operation of the *ipso facto* doctrine. But the court denied BNY the benefit of this safe harbor to the flip clause because, it held, the flip clause was not in the swap agreement itself. Rather, the court held, because the flip clause was found in the indenture and was not integrated into the swap agreement, § 560 does not apply.

If the court had stopped there, it might be that clearer drafting could cure the problem — that is, going forward, swap parties could make sure that the swap agreement refers to and integrates the flip clause. But the court also noted (seemingly in passing) that the safe harbor "deal[s] expressly with liquidation, termination or acceleration (not the alteration of rights as they then exist)."[6] The court here seems to be agreeing with Lehman's argument that the safe harbor cannot be read to protect the flip clause's change in priority of payments, even if it is uncontroversially located in the swap agreement itself.

Where Does This Leave The Swap Market?

The court's decision is subject to appeal to the U.S. District Court for the Southern District of New York and the U.S. Court of Appeals for the Second Circuit, and we believe that there are significant arguments that the decision is wrong in a number of respects. Nevertheless, any appeal may take a while to be resolved, and, of course, might affirm the bankruptcy court's decision.

What, then, if this is the law?

Market participants will need to study to what extent they can safeguard

against the court's rulings by careful drafting. Explicit reference in swap agreements to flip clauses in other agreements should be able to avoid the criticism that such clauses are not integrated into the swap agreements. But we are skeptical that the consequences of the court's decision can be avoided by wordsmithing, for the reasons described above. Rather, we think market participants have to face the fact that, if the court's opinion stands, flip clauses might be held to be unenforceable in a U.S. bankruptcy court, and that choosing a U.S. counterparty and/or selecting U.S. law present counterparty credit risks that, until now, have been assumed to have been addressed.

Rating agencies have announced that they are studying whether the court's decision requires them to modify ratings for securities in deals with flip clauses. Downgrades might threaten to unravel existing deals, and might make new deals more expensive. The court's ruling is thus likely to have serious consequences for structured transactions, and the next few weeks likely will be very fluid in the structured finance markets.

Endnotes

1 *See* 11 U.S.C. §§ 541(c), 365(e)(1).

2 Jan. 25 Decision at 23 n.9.

3 *Id.* at 14-15.

4 *Id.* at 16-17.

5 *Id.* at 19-21.

6 *Id.* at 22.

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