

LEHMAN DECISION HOLDS CERTAIN SWAP AGREEMENT PROVISIONS UNENFORCEABLE IN BANKRUPTCY

On January 25, 2010, the United States Bankruptcy Court for the Southern District of New York issued a decision declaring that provisions that subordinate a swap counterparty's rights to payment when the swap counterparty or one of its close affiliates files for bankruptcy are unenforceable. These types of provisions are used in many structured finance transactions, and thus this decision may have implications for the structured finance markets and the ratings of structured finance transactions.

The dispute arose out of a credit-linked note program known as "Dante." Under the Dante program, a special purpose entity issued notes, and Lehman Brothers Special Financing Inc. ("LBSF") entered into a swap agreement in connection with the program.

Pursuant to the terms of the Dante transaction documents, the rights of LBSF to payment as swap counterparty generally had priority over payments to the noteholders. The documents also provided, however, that upon the occurrence of the bankruptcy of LBSF or its credit support provider (which was Lehman Brothers Holdings Inc. ("LBHI")), the noteholders were to receive payment before any payments were made to the swap counterparty. The court held that these subordination provisions constitute unenforceable ipso facto clauses under Sections 365(e)(1) and 541(c)(1)(B) of the United States Bankruptcy Code (the "Bankruptcy Code"). The court further determined that any action to enforce the subordination provisions would violate the automatic stay provisions of Section 362 of the Bankruptcy Code.

The court first determined that the swap agreement constituted an executory contract because both parties still had payment obligations even after the Lehman bankruptcy filings occurred. The Bankruptcy Code prohibits provisions in executory contracts that alter a party's rights because the party has filed for bankruptcy; such provisions are known as "ipso facto clauses." Because the swap agreement was an executory contract, the Bankruptcy Code's prohibition of ipso facto clauses was applicable.

The court then rejected the argument that there was no ipso facto clause because LBSF's rights were being altered as a result of LBHI's bankruptcy filing, and not as a result of LBSF's bankruptcy filing. The court concluded that because LBHI was LBSF's parent corporation, LBHI was LBSF's credit support provider under the swap agreement, and Lehman's operating structure inextricably linked LBSF and LBHI, the Bankruptcy Code's prohibition of ipso facto clauses prohibited an alteration of LBSF's rights as a result of LBHI's bankruptcy.

The court recognized that the Dante transaction documents, including the swap agreement, are governed by English law and that the same dispute was also being litigated in English courts. In particular, the English courts had recently held that the subordination provisions were valid and enforceable. The bankruptcy court refused to defer to the English court decisions because the English courts did not take into account the provisions of the Bankruptcy Code in connection with their decisions and because the issue of the enforceability of ipso facto clauses was an important issue of public policy in the United States. The bankruptcy court proposed a

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status conference for the parties to explore ways to harmonize the divergent judgments of the United States and English courts.

This decision may have implications in the structured finance market and with respect to standard forms of swap documentation, especially in connection with the many rated transactions that contain subordination provisions similar to those found in the Dante transaction documents. For evaluation of your documents or further information, please contact Thomas Mitchell, Nik Mathews or Courtney Rogers.