

March 17, 2010

WEATHERING THE STORM Priority of Collateral Conflicts

A new wrinkle in the Lehman Brothers bankruptcy cases emerged recently when a U.S. bankruptcy judge issued an opinion directly at odds with the decisions previously rendered by certain English courts regarding priority of payment provisions (the "Priority Provisions") with respect to collateral under the "Dante Program."

The Dante Program

Under the Dante Program, Lehman Brothers International (Europe) created special purpose entities who issued various credit-linked synthetic portfolio notes (the "Notes"). Through the Dante Program, the special purpose entity (the "SPE") would purchase government backed bonds or some other form of credit worthy collateral (the "Collateral") with funds advanced by the purchaser of the Notes (the "Holder"). BNY Corporate Trustee Services, as trustee (the "Trustee"), held the Collateral pursuant to a trust deed (the "Trust Deed") between itself, the SPE and the Holder. The SPE simultaneously entered into a swap (together with the Trust Deed, the "Transaction Documents") with Lehman Brothers Special Financing ("LBSF") whereby LBSF agreed to pay the interest and principal due under the Notes in exchange for any yield received from the Collateral. The Collateral secured the SPE's obligations under both the swap agreement and the Notes.¹

The Transaction Documents governed the priority rights of LBSF and the Holder with respect to the Collateral. LBSF generally had a superior distribution right in the Collateral; however, in the event of default by LBSF under the swap agreement, the Priority Provisions effected a reversal in priorities entitling the Holder to a superior distribution right in respect of the Collateral.

The Perpetual Dispute

The dispute at hand arose when Perpetual Trustee Company Limited ("Perpetual"), a Holder under the Dante Program, commenced litigation in the High Court of Justice, Chancery Division (the "High Court") against the Trustee seeking priority payment through the application of the Priority Provisions. LBSF intervened arguing that the "anti-deprivation rule" (the "Rule") prohibited the reprioritization of LBSF's and Perpetual's relative rights in the Collateral.² Perpetual argued that the act of Lehman Brothers Holding Inc. ("LBHI"), the credit support provider under the swap agreement, filing for bankruptcy protection had triggered a default by LBSF under the Transaction Documents and thus a reprioritization of the rights in the Collateral had occurred.

LBSF commenced parallel litigation in the U.S. Bankruptcy Court seeking a declaratory judgment that the reprioritization provisions are unenforceable "ipso facto" provisions violating sections 365(e)(1) and 541(c)(1)(B) of the U.S. Bankruptcy Code.³

¹ Each of the Transaction Documents was governed by English law.

² Not unlike the concept that ipso facto clauses are unenforceable under the U.S. Bankruptcy Code, the Rule stands for the proposition that "there cannot be a valid contract that a man's property shall remain his until his bankruptcy, and on the happening of that event shall go over to someone else, and be taken away from his creditors." *Ex p Jay; In re Harrison* (1880) 14 CH D 19, 26, by Cotton LJ.

³ An ipso facto provision is essentially any provision that seeks to modify the relationship of contracting parties because of insolvency or the filing of a bankruptcy petition.

On November 6, 2009, the English Court of Appeal (the “Court of Appeal” and together with the High Court, the “English Courts”) upheld the High Court’s finding that the commencement of the LBHI bankruptcy case effected a default under the Transaction Documents causing the priority in the Collateral to shift from LBSF to Perpetual. In addition, the Court of Appeal found that LBSF’s right to the Collateral had always been contingent and therefore the application of the Priority Provisions did not deprive LBSF of any right in the Collateral. The English Courts did not consider U.S. bankruptcy law in reaching their decisions.

U.S. Bankruptcy Court Issues Contradictory Decision

On January 25, 2010, the U.S. Bankruptcy Court issued its Memorandum Decision Granting Motion for Summary Judgment and Declaring Applicable Payment Priorities in direct contravention of the decisions reached by the English Courts. While the U.S. Bankruptcy Court recognized that the Transaction Documents were governed by English law, it also noted that where United States bankruptcy law provides greater protection than applicable provisions of foreign law “the United States has a strong interest in having a United States bankruptcy court resolve issues of bankruptcy law.” The U.S. Bankruptcy Court’s decision focused on the effectiveness of the Priority Provisions and the application of certain ipso facto provisions in the Transaction Documents.

The English Courts had held that the relevant day upon which the payment priority had been reversed (*i.e.*, the date certain for the effect of the Priority Provisions) was September 15, 2008 (the “LBHI Petition Date”), and the Trustee argued that the U.S. Bankruptcy Court should defer to the English Courts’ findings. The U.S. Bankruptcy Court declined to follow these findings, instead determining that under the Transaction Documents certain affirmative acts (*e.g.*, certain termination notices must have been sent under the swap agreement prior to the filing of the LBSF bankruptcy case) were required to be taken before any modification of payment priority became effective. The U.S. Bankruptcy Court concluded that these affirmative acts did not occur in connection with the LBHI Petition Date, but rather after LBSF filed for bankruptcy protection. As a result, the rights to LBSF’s superior distribution of Collateral under the Priority Provisions constituted property of LBSF’s bankruptcy estate as of its petition date, subject to protection by the U.S. Bankruptcy Court.

More interesting and potentially far reaching, the U.S. Bankruptcy Court went a step further, noting that even if the operative date for claiming a reversal of payment priority had been the LBHI Petition Date, the outcome would remain the same. The U.S. Bankruptcy Court determined that the Transaction Documents constituted executory contracts, thus making section 365(e)(1) of the Bankruptcy Code’s anti-ipso facto provision applicable. The U.S. Bankruptcy Court held that the anti-ipso facto language of the U.S. Bankruptcy Code was not necessarily limited to modifications occasioned by the commencement of a case *by or against the debtor*, but rather might be applied more broadly to void language which modifies rights on the basis of the filing of a related entity. The U.S. Bankruptcy Court relied on the language of both sections 365(e)(1) and 541(c)(1)(B) of the U.S. Bankruptcy Code prohibiting the modification of LBSF’s rights upon “the commencement of a case under this title.” In other words, the anti-ipso facto provisions were not solely limited to *LBSF’s* bankruptcy filing, but could be triggered by the commencement of *another* entity’s bankruptcy case. The U.S. Bankruptcy Court noted that “opening up the subject to cases filed by debtors other than the counterparty itself has the potential of opening up a proverbial ‘can of worms,’” and emphasized that such a determination “is best left to a case-by-case determination.” Nevertheless, the U.S. Bankruptcy Court concluded that because of the extremely complex and integrated nature of the Lehman Brothers’ entities, the anti-ipso facto provisions would bar a modification of LBSF’s contractual rights on the basis of LBHI filing for bankruptcy protection.

Can There be a Reconciliation of the U.S. Bankruptcy Court's Decision?

The U.S. Bankruptcy Court recognized that its decision places the Trustee in a difficult position of now being subject to contrary trans-Atlantic judicial determinations and directed the parties to identify means to reconcile the conflicting judgments. Notwithstanding any protocol established with respect to the Collateral, the question will remain as to what degree of relatedness to a debtor will be required before a debtor can rely on the anti-ipso facto provisions triggered by another entity's bankruptcy filing. Although not opining on such possibilities, the U.S. Bankruptcy Court offered examples that subsidiaries under common control or swap counterparties and their credit support providers may have sufficient relatedness to require an application of anti-ipso facto provisions. The U.S. Bankruptcy Court left that door open by simply stating that such determination will be made on a "case by case" basis. This result begs questions such as "can a party continue to rely on a guarantor's bankruptcy filing as an actionable event of default under certain credit documents?" These questions and others remain, including the U.S. Bankruptcy Court's application (or non-application) of the safe harbor provisions to validate the debtor's position.

For more information, please contact:

[Robert Albergotti](#)

214.651.5613

robert.albergotti@haynesboone.com

[Mark Elmore](#)

214.651.5265

mark.elmore@haynesboone.com

[Sue Murphy](#)

214.651.5602

sue.murphy@haynesboone.com

[Lenard Parkins](#)

212.659.4966

lenard.parkins@haynesboone.com

[Lawrence Mittman](#)

212.659.4977

lawrence.mittman@haynesboone.com

[Craig Unterberg](#)

212.659.4987

craig.unterberg@haynesboone.com

[Charles Beckham, Jr.](#)

713.547.2243

charles.beckham@haynesboone.com

[Stephen Pezanosky](#)

817.347.6601

stephen.pezanosky@haynesboone.com

[Sarah Foster](#)

512.867.8412

sarah.foster@haynesboone.com

[Eric Terry](#)

210.978.7424

eric.terry@haynesboone.com