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## Bankruptcy Law

### Collateral

#### Lehman Brothers: Priority of Collateral Conflicts

*Article contributed by: Robert Albergotti, Mark Elmore, and Jarom Yates of Haynes and Boone, LLP*

On February 5, 2010, the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court") issued a ruling (the "Memorandum Opinion") creating a new wrinkle in the Lehman Brothers bankruptcy cases.<sup>1</sup> The Memorandum Opinion is 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." Participants to derivative transactions should take notice of the Memorandum Opinion because of its impact on the following issues: (1) the non-effectuating interpretation of perceived self-effectuating provisions in the transaction documents; (2) possible expansion of the protections of the anti-*ipso facto* provisions in the U.S. Bankruptcy Code; and (3) the narrow reading of the "safe harbor" provisions of the U.S. Bankruptcy Code intended to protect participants to derivative transactions.

#### *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 creditworthy collateral (the "Collateral") with funds advanced by the purchaser of the Notes (the "Holder"). The trustee (herein so called) held the Collateral pursuant to a trust deed between itself, the SPE, and the Holder, as supplemented with each issuance of new Notes (the "Supplemental Trust Deed"). The SPE simultaneously entered into a swap agreement (together with the Supplemental 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.<sup>2</sup>

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 of the Notes issued by the SPE, Saphir Finance Public Limited Company, commenced litigation in the English 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.<sup>3</sup> Perpetual argued that an event of default was triggered under the swap agreement when Lehman Brothers Holdings Inc. (“LBHI”), the credit support provider under the swap agreement, filed for chapter 11 bankruptcy protection, and thus a reprioritization of the rights in the Collateral had occurred.

LBSF commenced parallel litigation in the 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.<sup>4</sup> On November 6, 2009, the English Court of Appeal (the “Court of Appeal” and, together with the High Court, the “English Courts”) issued an opinion (the “English Opinion”) upholding the High Court’s finding that the commencement of the LBHI bankruptcy case effected a default under the Transaction Documents triggering the Priority Provisions. The English Courts did not consider U.S. bankruptcy law in reaching their decisions, but grounded their decision in English law, the governing law under the Transaction Documents.

### *The Memorandum Opinion*

#### *A. Divergent Views on Perceived Self-Effectuating Contractual Provisions*

The English Courts had held that the relevant day upon which the payment priority had been reversed (*i.e.*, the date on which the Priority Provisions were triggered) was September 15, 2008 (the “LBHI Petition Date”). In the U.S. proceeding, the Trustee argued that the Bankruptcy Court should defer to the English Courts’ findings under principles of *res judicata*. The High Court had determined that “the effect of the ‘flip’ provisions was thus not to divest LBSF of monies, property, or debts, currently vested in it, and to re-vest them in the [Holders], nor even to divest LBSF of the benefit of the security rights granted to it. It was merely to change the order of priorities in which the rights were to be exercised in relation to the proceeds of sale of the [C]ollateral in the event of a default.” English Opinion at ¶ 62. In other words, the Priority Provisions were self-effectuating provisions that provided the mechanism for making distributions of the Collateral upon an event of default

under the swap agreement. The Trustee was not required to take additional steps in order to re-prioritize the distribution of proceeds among the parties, such as sending a notice of default, calculating an early termination payment or selling the Collateral, but rather reprioritization was automatic if an event of default under the swap agreement had occurred.

The Bankruptcy Court declined to follow these findings or to extend comity to the English Courts, instead determining that under the Transaction Documents, the Priority Provisions were not self-effectuating but rather required certain affirmative actions to be taken before any modification of payment priority would be effective. The Bankruptcy Court focused on the fact that the Priority Provisions were triggered “in connection with the realization or enforcement of the [Collateral].” Memorandum Opinion at 17. The Bankruptcy Court noted that no such actions to foreclose on the Collateral had taken place as of the filing of the LBSF bankruptcy case. As a result, the Bankruptcy Court concluded that 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 and were therefore subject to protection by the Bankruptcy Court.

The divergence in the English Courts’ and the Bankruptcy Court’s interpretation of the Priority Provisions is interesting in that the Bankruptcy Court could have easily deferred to the English Courts’ analysis of contracts governed by English law. The Bankruptcy Court’s conclusions may cast doubt on whether provisions such as the Priority Provisions can be self-effectuating (*i.e.*, triggered automatically upon the occurrence of an event of default). Will this conclusion impact future negotiations of similar provisions? Can a contract counterparty continue to rely on the self-effectuation of such provisions?

#### *B. Expansion of the Anti-Ipso Facto Provisions*

More interesting and potentially far reaching, the Bankruptcy Court went a step further with an alternative holding, 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. Notably, LBSF did not file for bankruptcy until a full two weeks later. The Bankruptcy Court determined that the Transaction Documents constituted executory contracts, thus making section 365(e)(1) of the U.S. Bankruptcy Code’s anti-*ipso facto* provision applicable. The 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* (in the case of the Dante Program, the SPE who issued and was obligated on the Notes), but rather might be applied more broadly to void language that modifies rights on the basis of the filing of a related entity. Thus, the *ipso facto* protections afforded to LBHI upon its filing can operate to invalidate *ipso facto* provisions in the contracts of LBHI subsidiaries and affiliates. In effect, U.S. Bankruptcy Code relief is extended to entities even though they have not subjected themselves

to bankruptcy court jurisdiction. The 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 [to wit, LBHI] under this title."

As there does not appear to be any supporting opinion issued by another court, the Bankruptcy Court relied on the legislative history for its expansion of the anti-*ipso facto* clauses. In early stages of drafting sections 365(e)(1) and 541(c)(1), Congress had included the phrase "by or against the debtor" for section 365(e)(1) and the phrase "concerning the debtor" for section 541(c)(1), not the "commencement of a case under this title," which was the wording ultimately included in the bill as adopted in 1978. The Bankruptcy Court found persuasive that the final versions of sections 365(e)(1) and 541(c)(1) did not contain such phrases, interpreting this to mean that Congress had "rejected drafting sections 365(e)(1) and 541(c)(1) in a manner that would have expressly restricted their application to the bankruptcy case of the debtor counterparty." Memorandum Opinion at 18. 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 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." Memorandum Opinion at 18–19. Nevertheless, the 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 even though LBSF had not sought protection. In a footnote, the Bankruptcy Court pointed to other instances that may warrant the broad application of the anti-*ipso facto* clauses. These include, but are not necessarily limited to, multiple subsidiaries under common control or counterparties and their credit support providers under swap agreements. Although careful to note that the expansion of the anti-*ipso facto* provisions was limited to the facts at hand in the Lehman cases, the door has certainly been left open for further expansion. This ruling is especially troubling if the contracts in question do not fall within the safe harbor provisions of the U.S. Bankruptcy Code, where arguably the termination would be authorized notwithstanding a perceived violation of an *ipso facto* clause.

### C. Narrow View of the Safe Harbors

The Trustee finally argued that, even if the Priority Provisions did not take effect until after the LBSF bankruptcy filing, the Trustee's actions would still be protected as falling under the safe harbor provisions of the U.S. Bankruptcy Code. The Trustee contended that the Priority Provisions were part of an integrated "swap agreement" and, thus, any action to liquidate

was valid under [section 560](#) of the U.S. Bankruptcy Code.<sup>5</sup> The Bankruptcy Court disagreed and concluded that the Priority Provisions had not been incorporated into the swap agreement because none of the components of the swap agreement (*i.e.*, the ISDA Master Agreement, schedules, and confirmations) expressly incorporated the Priority Provisions by cross reference. The Bankruptcy Court reasoned that since the Priority Provisions had not been expressly incorporated into the swap agreement, the Priority Provisions did not fall within the definition of "swap agreement" and could not be subject to the safe harbor protections under section 560 of the U.S. Bankruptcy Code that apply only to swap agreements. Query, had there been an explicit incorporation of the Priority Provisions in the swap agreement, would the result in the U.S. proceeding have been any different?

Although the Bankruptcy Court did not address this argument in the Memorandum Opinion, the U.S. Bankruptcy Code contains an additional safe harbor in [section 362\(b\)\(17\)](#) of the U.S. Bankruptcy Code.<sup>6</sup> Certainly, an argument can be made that the Supplemental Trust Deed was a "security agreement," "arrangement" or "credit enhancement" forming part of or related to the swap agreement. The exercise of any contractual right under the Supplemental Trust Deed, including the exercise of the Priority Provisions, would seem to fit squarely within the safe harbor provided in section 362(b)(17) of the U.S. Bankruptcy Code. Isolating the Supplemental Trust Deed from the swap agreement would seem to be contrary to the highly integrated nature of these types of transactions and the broad immunities for derivative transactions from the effects of bankruptcy.

### Conclusions

The Bankruptcy Court recognized that its decision places the Trustee in the difficult position of now being subject to contrary trans-Atlantic judicial determinations. The question remains 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. The 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 Bankruptcy Court's narrow application of the safe harbor provisions and its apparent failure to consider section 362(b)(17) of the U.S. Bankruptcy Code. At the very least, the Memorandum Opinion should encourage practitioners to carefully examine the cross references in deal documents to ensure their clients' ability to take full advantage of the U.S. Bankruptcy Code's safe harbor provisions.

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<sup>1</sup> The Memorandum Opinion is [No. 86](#) on the Adversary Docket, Adversary Proceeding No. [09-01242](#). The Lehman Case No. is [08-13555](#) in the Bankruptcy Court for the Southern District of New York.

<sup>2</sup> Each of the Transaction Documents was governed by English law.

<sup>3</sup> 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.

<sup>4</sup> 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.

<sup>5</sup> As explained by the Bankruptcy Court, the safe harbor provisions “protect a non-defaulting swap participant’s contractual rights to (i) liquidate, terminate or accelerate ‘one or more swap agreements because of a condition of the kind specified in section 365(e)(1)’ or (ii) ‘offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of one or more swap agreements.’” [11 U.S.C. § 560](#). These provisions allow termination as a result of the insolvency of the debtor notwithstanding the Bankruptcy Code’s general prohibition under the *ipso facto* clauses.

<sup>6</sup> The Bankruptcy Code protects the “exercise by a swap participant... of any contractual right (as defined in section 560) under any security agreement or arrangement or other credit enhancement forming a part of or related to any swap agreement, or any contractual right (as defined in section 560) to offset or net out any termination value, payment amount or other transfer obligation arising under or in connection with 1 or more such agreements, including any master agreement for such agreements.” [11 U.S.C. § 362\(b\)\(17\)](#).

## Exemptions

### Eighth Circuit B.A.P. Affirms Finding that Claimed Exemption in Real Property in Which Debtor Held No Legal Interest Was Legal Nullity

[Stephens v. Hedback \(In re Stephens\), No. 09-6083, 2010 BL 53992 \(8th Cir. Mar. 12, 2010\)](#)

On March 12, 2010, the United States Bankruptcy Appellate Panel for the Eighth Circuit (“B.A.P.”) affirmed a bankruptcy court’s decision approving a settlement entered into between a chapter 7 trustee in a debtor’s case and the trustee in her husband’s separate chapter 7 proceeding. Specifically, the B.A.P. held that the debtor’s attempt to

claim an exemption in real property in which she held no legal interest constituted a legal nullity.

#### 2006 Order

In August 1998, G. Yvonne Stephens (“Debtor”) filed a petition for chapter 7 bankruptcy protection, which was related to a separate case that had been filed that same year by her then-husband, Larry Kenneth Alexander (“Alexander”). On January 4, 2006, the bankruptcy court issued an order (“2006 Order”), finding that neither Debtor nor Alexander were entitled to claim an ownership interest in real property in St. Paul, Minnesota that Debtor utilized as her primary residence (“Property”), and that neither Debtor nor Alexander had properly claimed a homestead in the Property. Additionally, the bankruptcy court decided that Debtor’s trustee had not abandoned the estate’s interest in the Property and that, as a result, the dispute concerning the residence existed between the trustees of the respective estates. This dispute depended on whether Alexander had properly conveyed an interest in the Property to Debtor by virtue of a March 1998 deed (“1998 Deed”) and whether such transfer could be avoided by Alexander’s trustee. Moreover, having determined that neither Debtor nor Alexander had any exemption in or any ownership interest in the Property, the bankruptcy court directed that the Property should be sold, with the net proceeds to be held by Alexander’s trustee pending a final decision on the remaining issues of contention between the two trustees.

#### District Court Affirms 2006 Order and Deems Debtor and Alexander Vexatious Litigants

After Debtor appealed the bankruptcy court’s decision, the district court affirmed the 2006 Order, explicitly agreeing that neither Alexander nor Debtor had any ownership interest or exemption in the Property. In addition, the district court deemed Debtor and Alexander to be vexatious litigants and prohibited them from making any further filings in either the bankruptcy court or the district court in connection with the Property, Debtor’s bankruptcy case, the Alexander bankruptcy case, or the adversary proceeding between the trustees unless the filing had been signed by an attorney in accordance with Federal Rule of Civil Procedure [11](#) or unless they had obtained explicit previous approval by the court.

Thereafter, Debtor appealed the lower courts’ decisions to the United States Court of Appeals for the Eighth Circuit, which affirmed in all respects.

#### Debtor’s Amended Schedules Claiming Property as Exempt

At the same time, on March 28, 2006, while the 2006 Order was pending on appeal, Debtor filed amended schedules, claiming the Property to be exempt as her homestead. Although both trustees objected to Debtor’s claimed exemption, the objections were stayed by the bankruptcy court pending the outcome of the appeal of the 2006 Order. Ultimately,