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Swap Termination and the Subordination of Termination Payments in the Lehman Bankruptcy

Lehman Brothers Holdings Inc.'s September 15, 2008 bankruptcy was an event of default under thousands of derivatives contracts to which a Lehman entity was a party and for which Lehman Brothers Holdings was the guarantor. This default entitled the vast majority of Lehman's counterparties to terminate these contracts, and almost all were terminated. The Lehman bankruptcy court will soon address a number of issues related to the termination of these contracts, including the enforceability of "flip clauses" subordinating amounts payable to Lehman on the termination of credit default swaps backing synthetic collateralized debt obligations (CDOs).

Synthetic CDOs — many of which were structured by Lehman — typically included a subordination feature that, in the event of an early termination of the underlying swap because of a Lehman default, placed Lehman below CDO noteholders in the termination payment waterfall. Notwithstanding the widespread use of such flip clauses to mitigate counterparty credit risk in deals Lehman itself structured, Lehman now contends that the subordination feature is barred by the *ipso facto* doctrine of bankruptcy law. Lehman also argues that it is inequitable and against public policy for it to be denied its "in-the-money" early termination payments because of the flip clauses.[1]

Generally, the *ipso facto* doctrine bars the modification or termination of a contract based on the bankruptcy of a debtor.

Sections 541(c) and 365(e)(1) of the Bankruptcy Code establish the contours of the *ipso facto* doctrine, which prohibits the modification or termination of a debtor's contractual rights because of the debtor's bankruptcy or financial condition. Section 541(c) invalidates clauses that would keep a debtor's interests in property from becoming part of its bankruptcy estate. Once the debtor is in bankruptcy, § 365(e)(1) prohibits the termination or modification of the debtor's rights because of the debtor's bankruptcy or financial condition.

However, § 560 of the Code contains an exception to the *ipso facto* doctrine. Notwithstanding the *ipso facto* provisions of the Code, § 560 permits the "liquidation, termination, or acceleration" of swap agreements upon a counterparty's bankruptcy, thus allowing the termination of a swap agreement even after the counterparty has filed for bankruptcy. Congress created the § 560 safe harbor in 1990 to avoid disruptions and inefficiencies in the capital markets flowing from the inability of swap parties to close out contracts on their counterparties' bankruptcies.[2]

Lehman's *ipso facto* argument

Among Lehman's arguments in bankruptcy court is that CDO flip clauses are contract modifications conditioned on a bankruptcy filing that violate §§ 541(c) or 365(e)(1) and are not saved by the § 560 safe harbor. This argument turns on timing: when the bankruptcy filing occurred and when subordination occurred.

Two bankruptcy filings are at issue. Lehman Brothers Holding Inc. ("LBHI") filed for bankruptcy protection on September 15, 2008. Lehman Brothers Special Financing Inc. ("LBSF") — the LBHI subsidiary that is the counterparty to most of the derivative contracts — filed for bankruptcy on October 3, 2008. LBHI

guaranteed LBSF's obligations, and LBHI's bankruptcy was an event of default on these contracts. This default had two consequences: first, it gave LBSF's counterparties the right (but not the obligation) to terminate their contracts; and second, it triggered the subordination provision (in those deals with such a provision), thereby relegating LBSF's entitlement to an early termination payment to a position below that of noteholders in the payment waterfall. Lehman is arguing that subordination took place after its contractual rights were protected by the *ipso facto* doctrine. Lehman makes two different arguments to this end.

Whose bankruptcy is relevant to the *ipso facto* doctrine?

Under a conventional understanding of the Bankruptcy Code, if a subordination provision in LBSF's contracts was triggered by the bankruptcy of an entity other than the debtor, LBSF's right to receive an early termination payment ahead of payments to CDO noteholders would have been modified *before* LBSF's own bankruptcy a couple of weeks later, and so the *ipso facto* doctrine would not be implicated. But Lehman is arguing that the *ipso facto* doctrine was in play for LBSF upon LBHI's September 15th bankruptcy because § 541(c)(1) prohibits the modification of a debtor's rights on "the commencement of a [bankruptcy] case." Lehman argues that "a case" should be understood to refer not just to LBSF's bankruptcy case, but also to LBHI's bankruptcy.[3] So, Lehman argues, LBSF's contract rights were modified after the commencement of LBHI's bankruptcy case, and that is enough to implicate the *ipso facto* doctrine for another entity, LBSF.

Recognizing that its textual interpretation would make the *ipso facto* doctrine far too broad — i.e., no termination or modification could be conditioned on the bankruptcy of *any* entity — Lehman attempts to find a limiting principle in an argument based on public policy. Hence, Lehman argues that it is good public policy to use the *ipso facto* doctrine to prohibit modification or termination of a debtor's contracts because of the bankruptcy or financial condition of its guarantor or corporate parent. Lehman argues in support of this interpretation that when a guarantor or parent files for bankruptcy, subsidiary entities within the same corporate structure are also likely to file. Lehman then concludes that a rule allowing a party to terminate or modify a contract with one entity because of the bankruptcy of a closely linked entity would in effect allow parties to "contract around important bankruptcy protections."[4]

The little case law on point does not support Lehman's position that "commencement of a case" refers to a case commenced by the affiliates of a debtor and not just the debtor itself. Nor is Lehman's policy argument compelling. It is of course true that the earlier the *ipso facto* clause is implicated, the greater the protection afforded debtors (and their creditors). The effect of barring a debtor's counterparty from terminating or modifying a contract from the time of a related party's bankruptcy filing is to shift from that point onwards to the debtor and away from its counterparty the choice of whether to assume or terminate a contract. But such a shift is not costless. Lehman's position would bar a party from terminating or modifying a contract when the other party's guarantee becomes worthless because of the guarantor's financial condition or bankruptcy. But under such a rule, guarantees of performance would become correspondingly less valuable than they presently are, so causing parties to look to alternative (and likely more expensive) means of credit support.

In another recent bankruptcy case, *In re Charter Communications*, decided by Judge Peck, who is presiding in the Lehman bankruptcy, the court held that the *ipso facto* doctrine barred a creditor from using an event of default to block confirmation of the debtors' reorganization plan. The event of default in this case was the alleged insolvency of the debtors' holding companies. The debtors argued that their close connection with their holding companies required imputing the financial condition of the holding companies to them, and so an objection to confirmation ostensibly based on the holding companies' financial condition would in fact rest on the financial condition of the debtors, in violation of the *ipso facto* doctrine.[5] The court agreed, holding that the alleged default would relate to the financial condition of the debtors, and so be an *ipso facto* default that need not be cured before confirming a reorganization plan.[6]

Charter Communications is factually distinct from the derivatives cases before the court, since it concerned a fact-intensive inquiry by the court regarding confirmation of a reorganization plan of a debtor, rather than the modification of an ISDA swap. Still, in the absence of other relevant case law, the decision might be a clue to how the court will respond to Lehman's argument.

When were LBSF's rights modified?

Lehman argues in the alternative that even if the *ipso facto* doctrine were implicated only by LBSF's own bankruptcy filing, the court should conclude that LBHI's bankruptcy did not trigger the subordination provisions. Rather, Lehman argues, subordination could not occur (so LBSF's contract rights were not modified) until *after* LBSF's bankruptcy, when the termination payment is to be made. Lehman's counterparties argue that LBHI's bankruptcy petition automatically triggered the flip clause, switching "Swap Counterparty Priority" in the distribution of funds to "Noteholder Priority."[7] But Lehman responds that LBHI's filing by itself did not trigger this modification, because, according to its reading of the documents, subordination would not occur until the swap was terminated and the collateral was sold and distributed.[8] Thus, Lehman concludes, modification would not occur until after LBSF's bankruptcy filing (indeed, it still has not occurred), so subordination of necessity runs afoul of the *ipso facto* doctrine.

LBSF's argument appears to confuse a modification changing the parties' relative priority to receive payment with a subsequent payment made in accordance with the changed priority. A less strained account of events is that LBHI's bankruptcy triggered a change in the parties' respective rights to the payment they would receive in the event of any early termination, and when that termination later occurs and the collateral

is sold and distributed, payments are to be made in accordance with the respective rights determined at the time of LBHI's filing. (In the same way, when a will is amended to benefit some beneficiaries over others, it is natural to say that the amendment modified the beneficiaries' expectations at the time of amendment, even though no distribution could be made pursuant to the amended will until the testator died.)

Still, the bankruptcy court, may be more concerned with the impact of a rule of law that a contract is not in fact modified until all the consequences of the modification — up to and including all payments made according to the modification — come to pass. Were such a rule adopted, it would incite a rush to early termination, liquidation and distribution on a guarantor's bankruptcy filing as counterparties sought to "fully" modify the contracts before the swap counterparty itself filed for bankruptcy. Lehman's own bankruptcy shows that there is every reason to allow swap parties to proceed deliberately with liquidation and distribution rather than, in haste to beat their counterparties' filings, further destabilize already-shaken capital markets.

But what about the safe harbor?

Lehman's attempts to shift the timeline back or forward to invoke the *ipso facto* doctrine are of course to no avail if the modifications in question are saved by § 560's safe harbor. Lehman argues that subordination does not fall within the safe harbor because § 560 only allows swap participants to cause the "liquidation, termination, or acceleration" of a swap. This list does not expressly protect subordination or modification, so Lehman concludes that they are not protected by the safe harbor.[9]

Lehman's counterparties dispute this reading, contending that subordination is "an integral part" of the liquidation of a swap and so is within § 560's safe harbor.[10] BNY, for instance, argues that the documents containing the subordination clauses are part of the swap agreement, and provide the "liquidation mechanism" for enforcing the swap parties' rights.[11] Hence, because the common meaning of "liquidate" includes the act of settling a debt by payment, the subordination clause governing how those payments are made should fall within § 560's safe harbor. Lehman responds that the subordination provision — typically included as part of the CDO trust indenture rather than in the swap agreement itself — should not be considered part of the swap and, therefore, should not be saved by the § 560 safe harbor. Lehman also argues that, in the context of derivative contracts, "liquidation" refers only to calculating termination payments, not making the actual payments, and that because a distribution in accordance with a subordination clause is at most ancillary to termination, it is not protected by the safe harbor.[12]

The parties' briefs on this issue cite only one case, *In re Calpine Corp*., in which a creditor terminated a forward contract on the bankruptcy of the debtor. That termination was allowed by an *ipso facto* clause that fell within § 556's safe harbor for such contracts, but the creditor also sought to enforce another provision of that contract under that same safe harbor.[13] The *Calpine* court held that that provision was "ancillary" to the *ipso facto* clause that allowed for termination and liquidation of the contract, and so was not protected by § 556's safe harbor. Implicitly, however, the court held that another provision requiring the non-defaulting party to provide an explanation for how to calculate the termination payment was saved by that safe harbor.[14] BNY claims that the subordination clause "serves the same function" as the provision enforced in *Calpine*, since both "govern[ ] payment in connection with liquidation of the swap agreement." BNY concludes that because the *Calpine* court treated the calculation clause as integral enough to the liquidation process to make § 556's *ipso facto* safe harbor apply to it, a subordination clause deserves the same treatment under § 560's safe harbor.[15]

How long does the safe harbor remain open?

The bankruptcy court addressed the scope of the safe harbor in *Metavante*. Metavante Corporation had an interest rate swap with LBSF, and LBHI's and LBSF's bankruptcies entitled Metavante to terminate the swap. Metavante, being out of the money, did not terminate. However, § 2(a)(iii) of the parties' ISDA Master Agreement allowed Metavante to suspend its performance, which it did.

By May 2009 Metavante owed more than $6.6 million to Lehman, and Lehman moved to compel Metavante to perform, arguing that Metavante should not be allowed to sit back without paying and wait until interest rates changed to its advantage.[16] The court agreed, holding that, notwithstanding its contractual right (but not obligation) to terminate, and § 2(a)(iii), Metavante could not "ride the market" for a year, neither performing nor terminating. The court held that Metavante should have either terminated "fairly contemporaneously" with the filings, or continued to perform its obligations under the swap.[17]

While there was little case law on point, until the *Metavante* decision, parties had reason to think they could rely on the terms of the ISDA Master Agreement, which on its face allows an out-of-the-money, non-defaulting party to suspend performance and terminate only when it was in the money.[18] *Metavante* changes that by holding that the safe harbor closes soon after the debtor's bankruptcy filing.[19] The holding is in keeping with Judge Peck's comments from the bench in several contexts that he is wary of "bankruptcy opportunism." However, the *Metavante* decision has been appealed, so the bankruptcy court's decision may not be the final word on this issue.

Subordination and public policy

Finally, Lehman argues that subordination of LBSF's payment priority when it is in the money unfairly denies it an early termination payment and confers a windfall on noteholders. Lehman further argues that subordination is in reality an unenforceable penalty that bears no reasonable relationship to any anticipated damages resulting from LBHI's bankruptcy.[20]

These arguments aim to persuade the court that the parties' contracts should not be enforced as written. Not surprisingly, Lehman's counterparties respond that because the parties involved are sophisticated and the contracts involved

are unambiguous, the court should reject Lehman's arguments.[21] They also argue that subordination is enforceable since it just modifies LBSF's contractual rights and is not a penalty.[22]

Existing case law of course supports the expectation that swap agreements — and subordination clauses — should be enforced as written.[23] Consideration for the efficient functioning of capital markets supports that as well. There is, after all, a reason why Lehman — the architect of many of these deals — would want to include subordination clauses, for without them, the price of a swap transaction would depend on both the risk of a default in the reference securities *and* the independent risk of a Lehman default when it was in the money. Subordination clauses in effect remove that second factor from consideration, thereby simplifying the task of pricing swaps and facilitating Lehman's ability to market them.

Despite this, the court held in *Metavante* that bankruptcy law and policy could trump clear and unambiguous contract language. But the consequences of the court's entertaining equitable arguments undercutting the parties' contracted-for expectations with respect to payment priority on a Lehman default would be vast, and it is not clear that the bankruptcy court will be willing to throw such a wrench so deeply into the workings of the swap market.

Rewriting the law of modification and termination?

Lehman's arguments invite the bankruptcy court to reject decades of common industry practices designed to foster the free flow of capital by mitigating counterparty credit risk. Lehman's counsel is of course obliged to advance arguments that maximize the bankruptcy estate, and so advocate with relatively little regard for whether the positions being advocated are good law or policy. Such considerations are for the court. And although the court's *Metavante* decision has made many industry participants nervous, Lehman's arguments against swap termination flip clauses seem at odds with time-honored practices in the capital markets and with Congress' intention to promote the free flow of capital through the derivatives markets. Nonetheless, participants in the relevant markets should pay careful attention to the Lehman cases, because Judge Peck's decisions, and any subsequent decisions on appeal, will certainly affect industry practice going forward.

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1 Only a few cases are currently being litigated in Bankruptcy Court, but the outcome of these cases will certainly affect the law that will apply to the numerous contracts as to which there is not yet any litigation. The principal proceedings referred to herein are *Lehman Brothers Special Financing, Inc. (LBSF) v. Ballyrock ABS CDO 2007-1 Limited and Wells Fargo Bank, N.A., Trustee*, Case No. 1:09-ap-01032 (filed Feb. 3, 2009) *("Ballyrock"), Lehman Bros. Holding Inc. (LBHI) and LBSF v. Libra CDO Limited, Bank of America, N.A., Trustee, LaSalle Bank National Association, Trustee, Société Générale, New York Branch*, Case No. 1:09-ap-01178 (filed May 5, 2009) (*"Libra"*); *LBSF v. BNY Corporate Trustee Services Limited*, Case No. 1:09-ap-01242 (filed May 20, 2009) *("BNY")*; and Lehman's Motion to Compel Performance by Metavante Corporation (filed May 29, 2009) (*"Metavante"*).

2 *See* H.R. Rep. No. 101-484 (1990), as reprinted in 1990 U.S.C.C.A.N. 223, 224-25.

3 *See*, e.g., LBSF Mem. Opp'n Ballyrock Mot. to Dismiss 36-37; LBSF's Mem. Opp'n BNY's Mot. for Summ. J. 19-23.

4 LBSF's Mem. Opp'n BNY's Mot. for Summ. J. 20-21.

5 Debtors' Mem. Opp'n Mot. to Stay Pending Appeal 43-44, *In re Charter Commc'ns, Inc.*, Case No. 09-11435 (JMP).

6 Findings Of Fact, Conclusions Of Law, And Order Confirming Debtors' Joint Plan Of Reorganization Pursuant To Chapter 11 Of The United States Bankruptcy Code ¶ 98, *In re Charter Commc'ns, Inc.*, Case No. 09-11435 (JMP) (Bankr. S.D.N.Y. Nov. 17, 2009); see also LBSF's Mem. Opp'n BNY's Mot. for Summ. J. 21-22.

7 BNY Mem. Supp. Summ. J. 20-24.

8 LBSF's Mem. Opp'n BNY's Mot. for Summ. J. 12-15.

9 LBSF's Mem. Opp'n BNY's Mot. for Summ. J. 48-52.

10 BNY's Mem. Supp. Summ. J. 33.

11 *Id.* at 29-31.

12 LBSF's Mem. Opp'n BNY's Mot. for Summ. J. 48-52.

13 2009 WL 1578282, at *6 (Bankr. S.D.N.Y. May 7, 2009) (describing creditor's argument that a contract provision was enforceable against the debtor because of § 556's safe harbor allowing liquidation, termination or termination for reasons specified in § 365(e)(1)).

14 *Id.* at *1, 7.

15 BNY's Mem. Supp. Summ. J. 33 n.30.

16 LBHI's Mem. Supp. Mot. to Compel 9-12.

17 Mot. to Compel Hr'g Tr. 111, Sept. 15, 2009.

18 For instance, in a widely discussed case interpreting § 2(a)(iii), *Enron Australia v. TXU Electricity Ltd.* [2003] NSWSC 1169, an Australian court allowed TXU to suspend its performance without terminating the swap.

19 The court has also held that Lehman does not have to provide Metavante any assurances that it will continue to satisfy its obligations up until such time as it decides to assume or reject the contract, and that Metavante must pay LBSF default interest on each of the payments it failed to make to LBSF since November 2008. Metavante is appealing the order compelling its performance, and other similarly situated counterparties have challenged Lehman's efforts to use Metavante to force them to perform. *See, e.g., Board of Education of the City of Chicago v. LBSF*, Case No. 09-ap-01455 (Bankr. S.D.N.Y. filed Aug. 27, 2009); *Objection of Capital Automotive L.P. to LBSF's Motion to Compel* (Bankr. S.D.N.Y. filed Nov. 30, 2009).

20 *See* LBSF Mem. Opp'n Ballyrock Mot. to Dismiss 22-24.

21 Noteholders' Mem. in Further Supp. Ballyrock's Mot. to Dismiss 10-12.

22 *Id.* at 8-10; Ballyrock's Reply Mem. 6-12.

23 *See Drexel Burnham Lambert Products Corp. v. Midland Bank PLC*, No. 92 Civ. 3098, 1992 U.S. Dist. LEXIS 21223 (S.D.N.Y. Nov. 9, 1992) (enforcing clause that extinguished termination payment to defaulting swap party).

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