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Another Derivatives Dispute Resolved in Favor of Lehman

CHRISTY L. RIVERA

The author suggests that a recent bankruptcy court decision will result in Lehman Brothers having more leverage in its negotiations with derivatives counterparties.

In a decision entirely consistent with its ruling in the “Perpetual” adversary proceeding last year, on May 12, 2011, the U.S. Bankruptcy Court in the Lehman Chapter 11 cases endorsed a strict interpretation of certain Bankruptcy Code provisions to the benefit of Lehman, which will result in Lehman having more leverage in its negotiations with derivatives counterparties.¹ The decision relates to one of the synthetic collateralized debt obligation (“CDO”) transactions to which Lehman Brothers Special Financing Inc. (“LBSF”) was party.

BACKGROUND

In July 2007, LBSF and Ballyrock ABS CDO 2007-1 Limited (“Ballyrock”) entered into a credit default swap agreement, pursuant to which Ballyrock sold credit protection to LBSF. Under the swap agreement, LBSF was required to make periodic payments to Ballyrock and, in exchange, Ballyrock agreed to pay LBSF upon certain defaults with respect

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to an agreed upon pool of residential mortgage-backed securities. Lehman Brothers Holding Inc. ("LBHI") guaranteed LBSF's obligations to make the periodic payments to Ballyrock. Contemporaneously with execution of the swap agreement, Ballyrock entered into an indenture with Wells Fargo Bank, N.A. (the "Trustee"), pursuant to which Ballyrock issued several classes of notes to investors. LBSF is named in the indenture as an express third-party beneficiary. Ballyrock's primary assets were the credit default swap with LBSF and cash.

The credit default swap agreement and the indenture together established the terms governing the transactions between Ballyrock and LBSF. Payments due under the indenture, including termination payments owing to LBSF under the swap agreement, were subject to a "waterfall." The priority of termination payments owing to LBSF depended on the reason for termination. In certain instances, LBSF was entitled to receive the termination payment before any payment was made to the senior noteholders under the indenture. However, if the termination payment owing to LBSF was the result of an event of default by LBSF or LBHI — a "Defaulted Synthetic Termination Payment" — LBSF's payment priority dropped in ranking in the waterfall so that senior noteholders were entitled to be paid first. Under the indenture, the Defaulted Synthetic Termination Payment was capped at \$30,000.

After LBHI filed for bankruptcy on September 15, 2008, Ballyrock notified LBSF that LBHI's bankruptcy filing constituted an event of default under the swap agreement and designated September 16, 2008 as the early termination date in respect of all outstanding transactions thereunder. The Trustee determined that Ballyrock owed LBSF approximately \$404 million, subject, of course, to the waterfall provisions of the indenture. After liquidating its assets, Ballyrock had approximately \$326 million. The Trustee disbursed approximately \$189 million of this to the senior noteholders pursuant to the waterfall, subordinating LBSF's right to the Defaulted Synthetic Termination Payment.

After the Trustee announced its intention to distribute the remaining funds to the senior noteholders, LBSF filed a complaint seeking a judgment declaring that the Trustee's proposed distribution would violate applicable New York and bankruptcy law. LBSF asserted that the indenture

provisions modifying LBSF's right to priority of payment under the waterfall solely as a result of the LBHI bankruptcy filing constituted an unenforceable "*ipso facto*" clause and could not be acted upon by Ballyrock. LBSF also sought a determination that the termination of the credit default swap agreement was improper. Finally, LBSF requested an injunction enjoining the Trustee from disbursing the remaining funds to any party other than LBSF.

Ballyrock moved to dismiss LBSF's complaint for failure to state a claim. After considering arguments by both sides, the court reserved judgment to give the parties time to continue settlement discussions. Ultimately, however, the parties were unable to settle and therefore the court issued its ruling.

THE DECISION

The court denied Ballyrock's motion to dismiss counts I and III of the complaint, holding that LBSF has asserted viable claims that the provisions relating to the Defaulted Synthetic Termination Payment constitute *ipso facto* clauses that may not be enforced and, as a result, LBSF may be entitled to an injunction of the proposed distribution to the noteholders. The bankruptcy court granted Ballyrock's motion to dismiss with respect to count II of the complaint, which alleged Ballyrock's steps to terminate the credit default swap agreement were ineffective. This article discusses the court's rationale for denying Ballyrock's motion to dismiss, but does not address the court's decision to dismiss count II of LBSF's complaint.

In analyzing the complaint, the court highlighted LBSF's assertions that (i) the Defaulted Synthetic Termination Payment provisions were unenforceable because they modified LBSF's right to a high-priority termination payment as a consequence of LBHI's bankruptcy filing and, as a result, that (ii) Ballyrock did not have the contractual authority under the indenture to make the proposed distribution to the senior noteholders. These allegations, the court held, are sufficient to state a claim under the authority of the bankruptcy court's earlier decision in *Lehman Bros. Special Fin. Inc. v. BNY Corporate Tr. Servs. (In re Lehman Bros. Holdings Inc.)* ("Perpetual").²

In refusing to dismiss LBSF's count seeking a declaratory judgment that the Defaulted Synthetic Termination Payment provisions were invalid, the bankruptcy court noted that the Bankruptcy Code invalidates contractual provisions that alter the relationship of the contracting parties solely by virtue of a bankruptcy filing.³ In cases where a debtor attempts to invalidate a contract provision triggered by a bankruptcy filing, the bankruptcy filing at issue is typically that of the debtor — here, LBSF. However, consistent with its ruling in *Perpetual*, the bankruptcy court noted that Bankruptcy Code Sections 365 and 541 “are broadly worded and protect a debtor from the operation of a clause triggered by not only its own bankruptcy filing but also by the bankruptcy of a related entity.” In this case, LBHI.

In *Perpetual*, LBSF filed a complaint against a trustee of a multi-issuer secured obligation program which held collateral for the benefit of a noteholder and LBSF, as counterparty under a swap agreement. LBSF had sought a declaration that LBSF's priority in the collateral did not transfer to the noteholder due to the bankruptcy filing of LBHI. In *Perpetual*, the court held that the provisions of a supplemental trust deed and the notes which modified LBSF's payment priority to the collateral upon an event of default triggered by LBHI's bankruptcy filing constituted unenforceable “*ipso facto*” clauses under Section 365(e). In the *Ballyrock* case, the bankruptcy court concluded that its analysis in *Perpetual* “would render ineffective the changes in the Waterfall that would result from activation of the Defaulted Synthetic Termination Payment Clause.”

The court then held that *Ballyrock* could not rely on the “safe harbor” provisions of Bankruptcy Code Section 560 in order to avoid the possible invalidation of the Synthetic Termination Payment provisions pursuant to Bankruptcy Code Sections 365 and 541. Section 560 permits a non-defaulting swap participant to exercise a contractual right “to cause the liquidation, termination, or acceleration of one or more swap agreements” based on a provision that would otherwise be deemed invalid pursuant to Bankruptcy Code Section 365(e)(1). Also consistent with its ruling in *Perpetual*, the court held that Section 560 should be narrowly construed, only applying to clauses that triggered termination, liquidation or acceleration of the agreement. Accordingly, the provisions regarding the Synthetic Termination Payment were outside the scope of Section 560 — the

provisions proposed to lower LBSF's priority of payment within the Waterfall, depriving LBSF of its pre-existing rights to distribution. According to the court, "[s]uch a mandated elimination of a substantive right to receive funds that existed prior to the bankruptcy of LBHI should not be entitled to any protection under the safe harbor provisions that, by their express terms, are limited exclusively to preserving the right to liquidate, terminate and accelerate a qualifying financial contract." The parties were directed to submit an order consistent with the decision.

CONCLUSION

As is evident from the bankruptcy court's ruling, there is very little case law addressing the issues raised in this lawsuit or in the Perpetual proceeding. It remains to be seen whether another court will follow the Lehman bankruptcy court's lead on these issues. For now, Lehman has two very helpful decisions to refer to in seeking resolutions with its many derivatives counterparties.

NOTES

¹ See *Lehman Brothers Special Financing Inc. v. Ballyrock ABS CDO 2007-1 Limited and Wells Fargo Bank, N.A., Trustee*, Adv. Proc. 09-01032 (Bankr. S.D.N.Y. May 12, 2011).

² 422 B.R. 407 (Bankr. S.D.N.Y. 2010).

³ See 11 U.S.C. § 365(e)(1) (stating that "an executory contract...may not be terminated or modified, and any right or obligation under such contract... may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract...that is conditioned on... the commencement of a case under this title..."); 11 U.S.C. § 541(c)(1)(B) (stating that a debtor's interest in property "becomes property of the estate... notwithstanding any provision in an agreement...that is conditioned on...the commencement of a case under this title...and that effects...modification, or termination of the debtor's interest in property.").