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BRIEFING

SUMMARY JANUARY 2010

A Perpetual headache: 'flip' clause declared unenforceable by US Bankruptcy Court

The US Bankruptcy Court has issued a declaratory judgment that the relevant clause flipping priority from the swap counterparty to the noteholders constituted an *ipso facto* provision and was therefore unenforceable – a judgment that produces a different result under US law to that established by the Court of Appeal in the Perpetual Trustee case from November 2009 (*Perpetual Trustee Company Limited & another v BNY Corporate Trustee Services Limited & another* and *Butters & others v BBC Worldwide & others* [2009] EWCA Civ 1160). The court also held that any attempt to enforce noteholder priority would constitute a violation of the automatic stay under the US Bankruptcy Code.

Ipso facto clauses are provisions in executory contracts (and affecting property of the company) that modify or terminate a contractual right or interest in property due to the bankruptcy or financial condition of a company. In contrast to the English law position, US law does not allow the termination of executory contracts or leases because the company has become insolvent. The US Bankruptcy Code (Bankruptcy Code) also prevents the company being deprived of property following the commencement of bankruptcy. This limitation on the removal of property from the insolvent estate has much in common with the so called 'anti-deprivation' principle under English law albeit that the US doctrine is wider than the English principle.

Facts

The US Bankruptcy Court case[1] (as with the Court of Appeal) concerned the priority of payment to beneficiaries holding competing interests in collateral securing certain note issues. The documentation governing the issues in question had one particularly significant clause. This clause stated that the order of priority of distribution of the proceeds of realisation of collateral changed following an event of default under the swap agreement if the defaulting party was the swap counterparty. Prior to an event of default the swap counterparty would rank first in order of priority, and after the event of default, it would be the noteholders.

The Court of Appeal had previously held that the 'flip' from swap counterparty priority to noteholder priority did not constitute a deprivation that was precluded by the anti-deprivation rule. The flip merely changed the order of priorities in which the rights were to be exercised in relation to the proceeds of sale of the collateral in the event of a default. Even if the flip had constituted a deprivation, the rule would not in any event have been applicable, as the triggering event was a Chapter 11 filing of Lehman Brothers Holding Inc (LBHI), which occurred prior to the Chapter 11 filing of Lehman Brothers Special Financing (LBSF) (the swap counterparty).

For further details on the Court of Appeal decision, please see our recent client briefing entitled *Court of Appeal rules on the scope of the 'anti-deprivation' rule.*

The US Bankruptcy Court decision

In the US Bankruptcy Court decision, Judge Peck held that the clause flipping priority from the swap counterparty to the noteholders constituted an *ipso facto* clause and was therefore unenforceable. He confirmed that the transaction documents constituted executory contracts (because each party had unsatisfied contractual payment obligations) and were therefore subject to the protections of section 365 of the Bankruptcy Code, which states 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

[1] *In re: Lehman Brothers Special Financing Inc. v BNY Corporate Trustee Services Limited* (Case No: 09 – 01242)

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of a provision in such contract... that is conditioned on... the commencement of a case under this title...'

The court also held that any attempt to enforce noteholder priority would constitute a violation of the automatic stay under the Bankruptcy Code and that the 'safe harbor' provisions of the Bankruptcy Code did not apply.

Judge Peck took the view that the earlier bankruptcy filing of LBHI was sufficient for LBSF to claim the protections of the *ipso facto* provisions of the Bankruptcy Code. The Lehman entities were an 'integrated enterprise' and 'the financial condition of one affiliate affected the others' to such an extent that the first filing at the holding company level, ie the LBHI bankruptcy, was sufficient to trigger the protections for LBSF. The Chapter 11 filings of the Lehman entities were for these purposes a single event. This is in contrast to the decision of the Court of Appeal that held that there was no breach of the anti-deprivation rule as the trigger date was prior to the insolvency of LBSF.

While respecting the Court of Appeal decision as valid and binding between the parties, the US Bankruptcy Court took the view that the Court of Appeal – in coming to its decision – did not consider the applicability and impact of section 365 of the Bankruptcy Code. Judge Peck confirmed that, as a general matter, '[US] courts will not extend comity to foreign proceedings when doing so would be contrary to the policies or prejudicial to the interests of the United States'.

Commentary

Judge Peck recognised that the US court would be 'interpreting applicable law in a manner that will yield an outcome directly at odds with the judgment of the English Courts'. Despite the disadvantages of conflicting judgments, he concluded that the US had a sufficiently strong interest in the circumstances to justify and require the application of US bankruptcy law, noting in particular where the relevant provisions of the Bankruptcy Code would provide the debtor with greater protection than that available under English law.

It is interesting to note that Judge Peck did not refer to the decisions in *In Re Maxwell Communications Corporation*[2] and the jurisprudence based thereon, which suggests that US courts can and will refrain from enforcing the rules of US bankruptcy law (in *In Re Maxwell Communications Corporation* it was the fraudulent conveyance rules) in cases where the affected transaction had only a limited connection with the US. In *In Re Maxwell Communications Corporation* the Court of Appeals for the Second Circuit concluded that in '… cooperative parallel bankruptcy proceedings seeking to harmonise two nations' insolvency laws for the common benefit of creditors, the doctrine of international comity precludes application of the American… laws to transfers in which England's interest had primacy'. *In Re Maxwell Communications Corporation* was a case of two parallel insolvency proceedings, but it is not clear that the absence of insolvency proceedings in England should prevent the application of this approach.

In any event, Judge Peck confirmed that the situation called for the parties to 'work in a coordinated and cooperative way to identify means to reconcile the conflicting judgments' and required the parties to arrange a further hearing for '…the purposes of exploring means to harmonise the decisions…'. While harmonising the two different approaches might be a real problem, there could be room for an accommodation by, for example, limiting the territorial reach of each ruling – so, for example, with the approval of both courts, the US ruling could govern the distribution of certain assets and the English ruling could govern the distribution of other assets. However, it is unclear whether such an approach would be acceptable and workable and whether there will be an attempt to go back to the English court to have the US order recognised here. It remains to be seen what the next steps in the saga will be.

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[2] 93 F.3d 1036 Court of Appeals, 2nd Circuit 1996

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