

Client Alert

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New York Bankruptcy Court Dismisses Lehman Bros. Special Financing Inc.'s Lawsuit to Recover Over \$1 Billion of Swap Agreement Distributions

In a highly anticipated decision, the Bankruptcy Court for the Southern District of New York (the "Court") on June 28, 2016, dismissed Counts I through XIX of Lehman Brothers Special Financing Inc.'s ("LBSF") fourth amended complaint (the "Complaint") in *Lehman Bros. Special Fin. Inc. v. Bank of America, N.A., et al.*¹ In doing so, the Court removed the majority of the approximately 250 noteholder, issuer and indenture trustee defendants from the LBSF lawsuit to recover over \$1 billion distributed in connection with 44 swap transactions. Notably, the Court rejected the "singular event" theory articulated in an earlier decision in *Lehman Bros. Special Fin. Inc. v. BNY Corp. Trustee Servs. Ltd.*,² adopted a broad reading of Bankruptcy Code Section 560 derivative safe harbor protections and dismissed LBSF's various state law claims.

Although LBSF asserted 25 separate counts in its Complaint, LBSF's core argument contended that the payment priority provisions in the various swap transactions were unenforceable *ipso facto* clauses under Section 365(e) of Title 11 of the United States Code (the "Bankruptcy Code") because they modified LBSF's payment priority upon either an LBSF or Lehman Brothers Holding Inc. ("LBHI") (LBSF's parent) bankruptcy filing.³ Addressing this claim, the Court considered several underlying questions: (i) whether the alleged *ipso facto* provision modified LBSF's payment priority rights; (ii) whether a modification of LBSF's rights, if any, was effective upon LBSF's receipt of a valid termination notice or not until the noteholders received their distributions; (iii) whether it is LBSF's or LBHI's petition date that is the relevant point in time to determine the enforceability of the alleged *ipso facto* provisions; and (iv) whether the safe harbor provisions of Section 560 of the Bankruptcy Code protect some or all of the distributions from avoidance.⁴

The Court held that the priority provisions in "Type 1 Transactions,"⁵ or those transactions where LBSF held a right to payment priority that was subordinated to that of the noteholders' upon the occurrence of LBHI's bankruptcy filing, were *ipso facto* clauses because LBSF held a right to payment ahead of the Type 1 Transaction noteholders and such right was modified by LBHI's bankruptcy filing. Nevertheless,

¹ See *Lehman Bros. Special Fin. Inc. v. Bank of America, N.A., et al. (In re Lehman Bros. Holdings Inc.)*, No. 08-13555, AP No. 10-05437, 2016 Bankr. LEXIS 2405 (Bankr. S.D.N.Y. 2016) (SCC) ("BANA"). Claims I through XIX of the Complaint encompass all of the claims LBSF asserted against the majority of the named defendants. Claims XX through XXV remain, but those counts relate solely to specific defendants with separate and unique facts.

² See *Lehman Bros. Special Fin. Inc. v. BNY Corp. Trustee Servs. Ltd. (In re Lehman Bros. Holdings Inc.)*, 422 B.R. 407, 420 (Bankr. S.D.N.Y. 2010) (JMP) ("BNY").

³ BANA, 2016 Bankr. LEXIS 2405 at *4.

⁴ *Id.* at *4-5.

⁵ The Type 1 Transactions contained the same type of payment priority modification provisions as those at issue in the Court's earlier decisions in *BNY* and *Lehman Bros. Special Financing Inc. v. Ballyrock ABS CDO 2007-1 Ltd. (In re Lehman Bros. Holdings Inc.)*, 452 B.R. 31 (Bankr. S.D.N.Y. 2011) ("Ballyrock"). BANA, 2016 Bankr. LEXIS 2405 at *34.

the Court adopted a broad and literal interpretation of the safe harbor of Section 560 to encompass the payment priority provisions in the Type 1 Transactions and deemed them enforceable.⁶ Specifically, the Court found that the enforcement of the payment priority provisions constituted the exercise of a contractual right of a swap participant to cause the liquidation or termination of a swap agreement, rendering them protected from unenforceability under Section 560.⁷ Thus, the Court dismissed Counts I through XII against the swap participants in the Type 1 Transactions.

By contrast, the Court held that the relevant priority provisions in the “Type 2 Transactions,” or those transactions where LBSF held a contingent right to payment priority conditioned upon the transaction’s early termination’s not being the result of LBSF’s default, were not unenforceable *ipso facto* clauses because they did not modify any of LBSF’s rights as a result of LBHI’s bankruptcy filing. Rather, the Court determined that the condition precedent to LBSF’s contingent right to payment priority never occurred.⁸ For Type 2 Transactions, LBSF’s own default, LBHI’s bankruptcy filing, caused the early termination; thus, LBSF never held a right to payment ahead of the Type 2 noteholders that could have been modified by its default. Accordingly, the Court held that LBSF did not state a claim against the swap participants in the Type 2 Transactions in Counts I through XII of the Complaint.⁹

With respect to the Type 2 Transactions, the Court declined to adopt the “singular event theory” discussed in *dicta* in *BNY*, which would have allowed LBSF to look to LBHI’s petition date (18 days earlier than LBSF’s) to determine the enforceability of the alleged *ipso facto* provisions.¹⁰ Instead of adopting the reasoning in *BNY*, the Court held that any modification of LBSF’s rights that occurred prior to the LBSF petition date cannot be the basis of a violation of the anti-*ipso facto* provisions.¹¹ As a result, even if the Type 2 Transactions *ipso facto* modified LBSF’s rights, any such modification in the “Pre-Pre Transactions”¹² and “Pre-Post Transactions”¹³ occurred upon the early termination of the swap agreements, which happened before LBSF’s petition date in both the Pre-Pre and Pre-Post Transactions. Thus, the payment priority provisions could not be rendered unenforceable by Section 365(e)(1).

As a result of its determination that the payment priority provisions were not unenforceable *ipso facto* clauses, the Court dismissed LBSF’s various state law claims. LBSF’s unjust enrichment, constructive trust, money had and received, replevin, and breach of contract claims were premised upon the existence of some improper conduct or breach by the swap participants, but the Court held there was nothing improper about the enforcement of valid payment priority provisions.¹⁴ The Court also dismissed LBSF’s state law constructive fraud claim because LBSF received “fair consideration” under the swap

⁶ *Id.* at *57. Section 560 provides, in pertinent part, that the exercise of a contractual right of any swap participant “to cause the liquidation, termination, or acceleration of a swap agreement because of a condition of the kind specified in section 365(e)(1) of this title shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court” 11 U.S.C. § 560.

⁷ *BANA*, 2016 Bankr. LEXIS 2405 at *57-58.

⁸ *Id.* at *36.

⁹ *Id.* at *43-46.

¹⁰ *Id.* at *47-48.

¹¹ *Id.* at *51-57.

¹² The term “Pre-Pre Transactions” refers to those swap transactions where, after LBHI’s petition date, but before LBSF’s petition date, LBSF received an early termination notice and the noteholders received their distribution, thus rendering the entire swap transaction complete before LBSF’s petition date. *Id.* at *20.

¹³ The term “Pre-Post Transactions” refers to those swap transactions where, after LBHI’s petition date, but before LBSF’s petition date, LBSF received an early termination notice, but the noteholders did not receive their distribution until after LBSF’s petition date. *Id.*

¹⁴ *Id.* at *74-77.

agreements.¹⁵ Finally, the Court dismissed LBSF's request for a declaratory judgment that the enforcement of the payment priority provision constituted an impermissible penalty because the provision did not fix damages but only eliminated LBSF's right to receive funds upon a default by LBSF.¹⁶

The *BANA* decision resolves much of the uncertainty created by the Court's earlier decisions in *BNY* and *Ballyrock*. The structured finance industry now has a clear answer that the early termination date is the operative date for when the modification of a party's payment priority rights occurs under a swap agreement. Additionally, the Court's rejection of the "singular event theory" reinforces the significance of the petition date and confirms that even among affiliates, each debtor may look only to its own petition date when triggering Bankruptcy Code protections, including determining whether a contract provision is an unenforceable *ipso facto* clause.

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¹⁵ *Id.* at *77-79.

¹⁶ *Id.* at *80-81.