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Second Circuit Affirms Enforceability of Flip Provisions in Swap Agreements Under Bankruptcy Code Safe Harbor

Daniel A. Rubens and Douglas S. Mintz*

The authors of this article discuss a decision by a panel of the U.S. Court of Appeals for the Second Circuit addressing the enforceability of "flip clauses" in connection with the post-bankruptcy liquidation of swap agreements.

For over a decade, Lehman Brothers Special Financing ("LBSF") has been litigating the enforceability of so-called "flip clauses" in connection with the post-bankruptcy liquidation of swap agreements. These clauses, which are common in structured financing transactions, specify the priority of payments when a swap provider (like LBSF) is in default. In particular, these clauses purport to subordinate the swap provider's payment priority below that of noteholders when termination payments are owed due to the provider's default.

BACKGROUND

When LBSF's holding company (Lehman Brothers Holdings Inc.) filed a Chapter 11 petition in September 2008, that filing placed LBSF in default under various swap agreements to which LBSF was a party. In a 2010 complaint involving 44 synthetic collateralized debt obligations ("CDOs") that LBSF created, LBSF sought to claw back over $1 billion that had been distributed to noteholders in connection with the early termination of swap transactions, arguing that the flip clauses in those transactions were *ipso facto* provisions and therefore unenforceable.[1] The noteholders defended the distributions on various grounds, including by invoking the safe harbor codified in Section 560 of the Bankruptcy Code, which exempts "swap agreements" from the Bankruptcy Code's prohibition of *ipso facto* clauses.[2] In two earlier cases involving

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[1] *Ipso facto* clauses are contractual provisions that modify a debtor's contractual rights solely because it petitioned for bankruptcy; the Bankruptcy Code generally treats such provisions as unenforceable.

[2] In relevant part, Section 560 provides:

similar CDOs, the judge originally presiding over Lehman's bankruptcy, Bankruptcy Judge James M. Peck, had treated the flip provisions as unenforceable *ipso facto* clauses and deemed them to fall outside of the Section 560 safe harbor.[3]

BANKRUPTCY AND DISTRICT COURT DECISIONS

In this case, however, Bankruptcy Judge Shelley C. Chapman disagreed, concluding, *inter alia*, that even assuming the flip provisions should be treated as *ipso facto* clauses, they were nonetheless enforceable under the Section 560 safe harbor.[4] On appeal, District Judge Lorna G. Schofield affirmed that ruling.[5] LBSF again appealed, and on August 11, 2020, a panel of the U.S. Court of Appeals for the Second Circuit affirmed in a *per curiam* opinion.[6]

SECOND CIRCUIT PANEL AFFIRMS

The Second Circuit began its analysis by noting the safe harbor's purpose when enacted in 1990—"to protect the stability of swap markets and to ensure that swap markets are not destabilized by uncertainties regarding the treatment of their financial instruments under the Bankruptcy Code,"[7]—as well as a 2005 amendment that broadened the definition of "swap agreement" to include virtually all derivatives. Against that background, the court of appeals readily rejected LBSF's arguments against the safe harbor's application.

First, even though the flip clauses were set forth in indentures (as opposed to the swap agreements themselves), the court held the provisions were sufficiently incorporated into the swap agreements by reference. Second, the court held that

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> The exercise of any contractual right of any swap participant or financial participant to cause the liquidation, termination, or acceleration of one or more swap agreements because of a condition of the kind in section 365(e)(1) of this title [the prohibition on *ipso facto* clauses] or to 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 shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title.

[3] *See Lehman Bros. Holdings Inc. v. BNY Corp. Tr. Servs. Ltd.*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010)*; Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007-1 Ltd.*, 452 B.R. 31 (Bankr. S.D.N.Y. 2011).

[4] *Lehman Bros. Special Fin. Inc. v. Bank of Am. Nat'l Ass'n* (553 B.R. 476 (Bankr. S.D.N.Y. 2016)).

[5] S.D.N.Y. Mar. 14, 2018.

[6] 2d Cir. Aug. 11, 2020.

[7] *Id.* (internal quotation marks omitted).

Section 560's reference to "liquidation" was broad enough to encompass the distribution of collateral under the flip clauses. Third, the court deemed it irrelevant for purposes of the safe harbor that indenture trustees (as opposed to the noteholders themselves) were the parties that exercised the right to liquidate.

For these reasons, the court held that the safe harbor protected the distributions pursuant to the flip clauses. Although the court grounded its holding primarily on the statutory text and features of the synthetic CDO transactions at issue, it noted that its conclusion was consistent with Section 560's legislative history, which reflects Congress's intent "to protect a swap participant's ability to unwind the swap transaction" and concerns about protecting market stability.[8] In that regard, this holding is consistent with Second Circuit decisions interpreting other bankruptcy safe harbor provisions broadly in order to minimize the risk of market disruption.[9]

CONCLUSION

This ruling may bring to an end a 12-year saga that has played out before numerous judges in the U.S. and England. Unless LBSF obtains further review from the Second Circuit *en banc* or the U.S. Supreme Court, all courts within the Second Circuit must treat flip clauses in CDO transactions like these as enforceable under the Section 560 safe harbor. More broadly, this ruling reinforces the deference courts provide to safe-harbored agreements and the provisions of those agreements. Parties should generally expect courts to continue granting wide protections to non-debtor counterparties in safe-harbored transactions.

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[8] *Id.*

[9] *See, e.g.*, *In re Tribune Co. Fraudulent Conveyance Litig*, 946 F.3d 66, 92 (2d Cir. 2019).