UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Lehman Brothers Special Financing Inc. v. Bank of America N.A.

No. 18-1079, United States Court of Appeals for the Second Circuit (August 11, 2020)

SUMMARY

The Second Circuit affirmed that contractual "Priority Provisions" subordinating Lehman Brothers Special Financing Inc.'s payment priority in synthetic CDO transactions upon its default were enforceable under the safe harbor of Bankruptcy Code § 560. The court held that the Priority Provisions were part of a "swap agreement" and that the distribution of collateral proceeds constituted "liquidation" of the swap agreement under § 560, which protects swap participants from the prohibition on *ipso facto* clauses. This decision broadly interprets the § 560 safe harbor to protect the contractual right to unwind swap transactions and distribute proceeds according to agreed priorities triggered by a counterparty's bankruptcy.

CASE DETAILS

COURT	United States Court of Appeals for the Second Circuit
WRITING FOR THE COURT	Dennis Jacobs; Susan L. Carney; Michael H. Bianco
JURISDICTION	Federal
DECIDED	August 11, 2020
DOCKET	18-1079
DISPOSITION	affirmed
PROCEDURAL POSTURE	Appeal from the District Court's judgment affirming the Bankruptcy Court's grant of defendants' motion to dismiss.
STANDARD OF REVIEW	De novo review of statutory interpretation; plenary review of bankruptcy court's factual findings and legal conclusions.
PRECEDENTIAL VALUE	Published
PARTIES	Lehman Brothers Special Financing Inc. v. Branch Banking and Trust Company, Successor in Interest to Susquehanna Bank and SBSI, Inc., U.S. Bank National Association, Continental Life Insurance Company of Brentwood Tennessee, Country Life Insurance Company, Deutsche Bank Trust Company Americas, as Trustee, Elliott International, L.P., First Northern Bank and Trust Company, Garadex Inc., Gatex Properties Inc., General Security National Insurance, Genworth Life and Annuity Insurance Co., Goldman Sachs International, Goldman

Sachs & Co. LLC, f/k/a, Goldman, Sachs & Co., LGT Bank in Liechtenstein Ltd., The Liverpool Limited Partnership, Magnetar Constellation Fund II Ltd, Magnetar Constellation Master Fund III Ltd, Magnetar Constellation Master Fund Ltd, Mariner LDC, Marsh & McLennan Companies, Inc. Stock Investment Plan, Marsh & McLennan Master Retirement Trust, MBIA, Inc., Modern Woodmen of America, Inc., MoneyGram Securities, LLC and its successors in interest, Morgan Stanley & Co., Incorporated, Morgans Financial Limited, Mulberry Street CDO, Ltd., Natixis Financial Products LLC, PCA Life Assurance Co. Ltd., PHL Variable Insurance Company, Phoenix Life Insurance Company, Putnam Dynamic Asset Allocation Funds – Growth Portfolio, Putnam Intermediate Domestic Investment Grade Trust, Putnam Stable Value Fund, RGA Reinsurance Co., SBSI, Inc., SCOR Reinsurance Company, Security Benefit Life Insurance Co., Shenandoah Life Insurance Company, State Street Bank and Trust Company, as Trustee, State Street Global Advisors, State Street International Ireland Limited, Structured Credit Opportunities Fund II, L.P., Susquehanna Bank, Tricadia Credit Strategies Master Fund, Ltd., f/k/a, Mariner-Tricadia Credit Strategies Master Fund, Ltd., Trustee U.S. Bank Trust National Association, UniCredit Bank AG, London Branch, ZAIS Investment Grade Limited X

TOPICS

bankruptcy | chapter 11 | contracts | statutory interpretation | commercial litigation

PRACTICE AREAS

Bankruptcy | Commercial Litigation

QUESTIONS PRESENTED

1. Whether the priority provisions are unenforceable ipso facto clauses under the Bankruptcy Code.
2. Whether the priority provisions are nevertheless enforceable under the section 560 safe harbor for swap agreements.

HOLDINGS

1. The priority provisions are enforceable under section 560 safe harbor even if they are ipso facto clauses.

KEY QUOTATIONS

> *"The Bankruptcy Code generally prohibits enforcement of ipso facto clauses— contract clauses that modify or terminate an executory contract due to a debtor's filing of a bankruptcy petition."* (at 15)

> *"We hold that, even if the Priority Provisions were ipso facto clauses, their enforcement was nevertheless permissible under the section 560 safe harbor."* (at 16)

FACTUAL BACKGROUND

The case involves synthetic collateralized debt obligations (CDOs) structured by Lehman affiliates. A special purpose vehicle (Issuer) issued notes to noteholders and used proceeds to acquire collateral. The Issuer entered into a swap agreement with LBSF. The indenture included priority provisions that subordinated LBSF's payment priority if LBSF defaulted. Upon LBHI's bankruptcy, LBSF defaulted, triggering early termination of swaps and liquidation of collateral. The proceeds were distributed to noteholders according to the priority provisions, leaving LBSF with nothing. LBSF sought to recover the distributions.

PROCEDURAL HISTORY

LBSF commenced an adversary proceeding in the Bankruptcy Court against defendants. The Bankruptcy Court granted defendants' motion to dismiss, holding that the priority provisions were enforceable under section 560 safe harbor. LBSF appealed to the District Court, which affirmed. LBSF then appealed to the Second Circuit.

DISPOSITION

affirmed

CASES CITED

- Nicosia v. Amazon.com, Inc., 834 F.3d 220 (2d Cir. 2016)
- Lehman Bros. Holdings Inc. v. BNY Corp. Tr. Servs. Ltd., 422 B.R. 407 (Bankr. S.D.N.Y. 2010)
- Merit Management Grp. v. FTI Consulting, Inc., 138 S. Ct. 883 (2018)
- Mission Product Holdings, Inc. v. Tempnology, LLC, 139 S. Ct. 1652 (2019)
- Sandifer v. U.S. Steel Corp., 571 U.S. 220 (2014)
- Thrifty Oil Co. v. Bank of Am. Nat'l Tr. & Sav. Ass'n, 322 F.3d 1039 (9th Cir. 2003)
- In re Dow Corning Corp., 215 B.R. 346 (Bankr. E.D. Mich. 1997)
- PaineWebber Inc. v. Bybyk, 81 F.3d 1193 (2d Cir. 1996)
- Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V., 651 F.3d 329 (2d Cir. 2011)
- 172 Van Duzer Realty Corp. v. Globe Alumni Student Assistance Ass'n, 25 N.E.3d 952 (N.Y. 2014)
- Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007-1 Ltd., 452 B.R. 31 (Bankr. S.D.N.Y. 2011)
- United States ex rel. Wood v. Allergan, Inc., 899 F.3d 163 (2d Cir. 2018)
- Lehman II, 2018 WL 1322225 (S.D.N.Y. Mar. 14, 2018)
- Lehman I, 553 B.R. 476 (Bankr. S.D.N.Y. 2016)

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