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Good news for CDO trustees in the Lehman flip clause litigation

By Amanda Darwin

After a decade of litigation, the so-called “flip clause” litigation by Lehman Brothers Special Financing (“LBSF”) against scores of CDO trustees, issuers, and noteholders with respect to billions of dollars in noteholder funds has come closer to a happy ending for the trustees. On August 11, 2020, the U.S. Court of Appeals for the Second Circuit ruled in favor of CDO trustees, issuers, and noteholders who exercised their rights to liquidate swaps associated with Lehman-created CDOs upon the filing of bankruptcy by Lehman Brothers Holdings Inc. and its affiliates. The Second Circuit’s ruling affirms the U.S. District Court’s March 2018 decision and the U.S. Bankruptcy Court’s July 2016 order, all ruling in favor of the CDO trustees, issuers, and noteholders. While LBSF may appeal to the U.S. Supreme Court, it seems unlikely that the Supreme Court will hear the case, given the lack of split opinions on the topic among the U.S. Circuit Courts.

The so-called “flip clause” litigation was brought by LBSF in 2010 against CDO trustees, issuers, and noteholders because the trustees declared events of default under the indentures and related swap agreements following Lehman’s bankruptcy filing. Upon the occurrence of the event of default in the swaps and indentures, the swaps were terminated and the collateral pools owned by the CDOs were liquidated in accordance with the terms of the applicable indentures. In some instances, the trustees held the liquidation proceeds in escrow pending a determination by the court of LBSF’s rights to the funds, and in other cases, the trustees distributed the funds to the noteholders, bypassing LBSF in the waterfall, the terms of which “flipped” the distribution priorities after an event of default.

LBSF claimed that the termination of the swaps and liquidation of the collateral pools and failure to pay LBSF the funds due it in accordance with the pre-default waterfall under the indentures were violations of the Bankruptcy Code’s prohibition against *ipso facto* clauses. *Ipso facto* clauses are clauses in contracts that trigger a default by a party merely because of that party’s bankruptcy filing. Generally, the Bankruptcy Code states that such clauses are unenforceable. Section 560 of the Bankruptcy Code, however, provides a safe harbor for swap contracts and other derivatives. The trustees, issuers, and noteholders argued that the trustees’ actions to terminate the swap contracts and indentures were protected by the safe harbor in Section 560 and that the safe harbor allowed the trustees to liquidate the collateral and distribute the proceeds of the collateral to the noteholders, bypassing LBSF, all as provided by the plain language of the swaps and the indentures.

LBSF enjoyed some early successes in the Bankruptcy Court, as Judge Peck rendered some preliminary rulings in 2011 that cast doubt on the availability of the safe harbor to trustees of structured financings. However, upon full briefing and argument of the case before Judge Chapman commencing in 2015, the Bankruptcy Court's order confirmed the rights of parties to swap documents under Section 560. The recent ruling by the Second Circuit further confirms the protections afforded by Section 560, stating that the purpose of Section 560 was to ensure that the markets are "not destabilized by uncertainties regarding the treatment of the financial instruments under the Bankruptcy Code."

The Second Circuit's decision can be found at *Lehman Brothers Special Financing Inc. v. Bank of America National Association*, No. 18-1079 (2d Cir. Aug. 11, 2020).

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