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Feature

By Pierre J. Riou

The Flap over Flip Clauses

Should They Flop against Debtors' Nondebtor Subsidiaries?

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Synthetic collateralized-debt obligations (CDOs), rather than investing in fixed-income securities as collateral for their debts to noteholders, invest in credit-default swap agreements (CDSAs) indexed to reference portfolios of fixed-income securities. To mitigate counterparty risk, the CDSA counterparty is typically required to have a guarantor, who is commonly a corporate affiliate of the counterparty.

As expressly permitted by § 560 of the Bankruptcy Code, the CDSA in such a transaction typically includes an *ipso facto* clause pursuant to which, in the event of the bankruptcy of either the counterparty or its guarantor, the CDO's issuer may specify an early termination of the CDSA. In that circumstance, a so-called "flip clause" in the CDO's indenture, to which the CDSA counterparty but not its guarantor is a party, shifts from senior to junior the counterparty's priority for distributions of moneys received by the indenture trustee.

Origin of the Controversy

In re Lehman Brothers Special Financing Inc.

The continued viability of synthetic CDO indenture flip clauses has been called into question by two opinions of Hon. **James M. Peck** of the influential U.S. Bankruptcy Court for the Southern District of New York, who presides over the bankruptcies of Lehman Brothers Holdings Inc. (LBHI) and Lehman Brothers Special Financing Inc. (LBSF), the debtors in possession.

LBSF, a wholly-owned subsidiary of LBHI, was the counterparty under CDSAs for a number of synthetic CDOs for which LBHI was LBSF's guarantor. Based on LBHI's bankruptcy in 2008, the issuers of some of those CDOs specified early terminations of the related CDSAs. A few weeks later, LBSF itself filed for bankruptcy, and based on this, the issuers of other CDOs specified early CDSA terminations. Subsequently, LBSF filed adversary proceedings seeking to avoid the priority-shifting consequences of the CDO indenture flip clauses.

In an opinion granting summary judgment to LBSF in one of those adversary proceedings, the *Lehman* bankruptcy court framed the issue as follows: "The intriguing question presented is whether it is the bankruptcy filing of LBHI or the later filing of LBSF that is the relevant commencement of a case for purposes of invalidating the shifting of priorities [as to LBSF] under the Transaction Documents."[1] In answering that question, the *Lehman* bankruptcy court acknowledged:

> No case has ever declared that the operative bankruptcy filing is not limited to the commencement of a bankruptcy case by the debtor-counterparty itself but may be a case filed by a related entity—in this instance the counterparty's parent corporation as credit support provider. Because this is the first such interpretation of [§ 365(e)(1)(B)'s and § 541(c)(1)(B)'s] *ipso facto* language, the Court anticipates that the current ruling may be a controversial one, especially due to the resulting conflict with the decisions of the English Courts.[2]

The following year, in a similar adversary proceeding, the *Lehman* bankruptcy court held that "[§§ 365(e)(1)(B) and 541(c)(1)(B)] are broadly worded and protect a debtor from the operation of [an *ipso facto*] clause triggered by not only its own bankruptcy filing but also by the [earlier] bankruptcy of a related entity."[3] The *Lehman* bankruptcy court reached this conclusion based on (1) the plain language in §§ 365(e)(1)(B) and 541(c)(1)(B) referring to "the commencement of a case under

1 *Lehman Bros. Special Fin. Inc. v. BNY Corporate Tr. Servs. Ltd. (In re Lehman Bros. Holdings Inc.)*, 422 B.R. 407, 415 (Bankr. S.D.N.Y. 2010) (*BNY*).

2 *Id.* at 422.

3 *Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007-1 Ltd. (In re Lehman Bros. Holdings Inc.)*, 452 B.R. 31, 39 (Bankr. S.D.N.Y. 2011) (*Ballyrock*).

this title"; (2) the fact that the quoted phrase is not immediately followed by a phrase such as "by, against or concerning the debtor"; and (3) the legislative history establishing that Congress considered—but ultimately rejected—alternate language referring to "the commencement of a case under this Act by or against the debtor" or "the commencement of a case under this title concerning the debtor."[4] The *Lehman* bankruptcy court acknowledged "the potential of opening up a proverbial 'can of worms'" by rejecting a previous bright-line rule.[5]

A Flip Clause Should Not Flop if Triggered before the CDSA Counterparty's Bankruptcy

The U.S. Supreme Court has cautioned against giving too much weight to one's interpretation of a single phrase of the Code in isolation.[6] Statutory analysis begins with the plain meaning of the text: Only if the statute is ambiguous may a court resort to canons of construction, and only if canons of construction fail to clarify the ambiguity may legislative history be examined to determine congressional intent.[7] One such canon of construction is that where two sections of a statute have related origins and language, they are generally construed *in pari materia*.[8] Thus, in construing the Code, the "plain meaning" of an isolated phrase in a subsection or two is not necessarily the correct meaning.[9] This article posits that an *in pari materia* reading of the Code leads to the conclusion that, for purposes of §§ 365(e)(1)(B) and 541(c)(1)(B), the operative bankruptcy filing is limited to the commencement of a bankruptcy case by, against or concerning *the* debtor on whose behalf protection is sought from the operation of a flip clause in a synthetic CDO indenture.

The § 362 Automatic Stay

The Code's intent is to protect the debtor and the debtor's estate, not to protect nondebtors or their property.[10] Accordingly, the automatic stay, by its express terms, applies only to actions against the debtor or property of the debtor's estate.[11] Thus, it is a "well-settled" proposition that the automatic stay does not extend to the assets of a debtor's subsidiary, even if the debtor owns 100 percent of the subsidiary's corporate stock.[12] A Second Circuit panel stated this well-settled proposition in *Feldman v. Trustees of Beck Indus. Inc. (In re Beck Indus. Inc.)*, a case predating the Bankruptcy Reform Act of 1978:

> [The debtor's] [o]wnership of all of the outstanding stock of a [nondebtor] corporation...is not the equivalent of ownership of the subsidiary's property or assets.... If it is desirable for the Bankruptcy Court to have jurisdiction of all litigation involving subsidiaries, solvent or not, of the debtor, the answer lies with Congress.[13]

Perhaps because of that well-settled proposition, the *Lehman* bankruptcy court did not suggest that LBSF was protected from the flip clauses by § 362 upon LBHI's filing for bankruptcy.[14]

> **[T]he *Lehman* bankruptcy court's opinions might not withstand a well-crafted appeal and/or might not be followed by sister courts.**

Although the *Lehman* bankruptcy court does not cite or rely on the case, it bears noting that in *Queenie Ltd. v. Gardner*, a post-*Beck*, post-Bankruptcy Reform Act a panel of the Second Circuit appears to have held that the automatic stay extended to a debtor's wholly owned nondebtor subsidiary because adjudication of a claim against the subsidiary *per se* would have "an immediate adverse economic impact" on the parent.[15] That holding seems incompatible with the plain language of § 362, which says nothing of imposing an *automatic* stay against any action that, although neither against the debtor nor against the property of the debtor's estate, would have "an immediate adverse economic impact" on the debtor.[16] *Queenie*'s holding also does violence to the above-quoted fundamental precept of corporate law stated in the well-reasoned *Beck* opinion. For these reasons, *Queenie* is of doubtful precedential value, even if that panel was not bound by *Beck*.[17]

Apart from its questionable legal basis, the *Queenie* exception would swallow § 362. If an action against a nondebtor's wholly owned subsidiary is subject to the automatic stay because it *per se* would have an immediate adverse impact on the parent or its estate, it is difficult to see where to draw the line. For example, would the debtor's ownership of 50 percent or 5 percent of the issued and outstanding stock of a nondebtor corporation result in an automatic stay of actions against the latter?

In leading to its above-discussed holding, the *Queenie* panel stated a broader proposition that one might be tempted to assert applies to LBSF: "The automatic stay can apply to nondebtors, but normally does so only when a claim against the nondebtor will have an immediate adverse economic consequence for the debtor's estate. Examples [include] a claim to establish an obligation of which the debtor is a guarantor."[18] In the LBSF adversary proceedings, however, the triggering of the flip clauses did not implicate LBHI's

4 *See id.*; *BNY*, 422 B.R. at 418-19.
5 *BNY*, 422 B.R. at 419.
6 *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 371 (1988) (noting that construction of Code "is a holistic endeavor").
7 *Gottlieb v. Carnival Corp.*, 436 F.3d 335, 337-38 (2d Cir. 2006).
8 *Choudhury v. Polytechnic Inst. of N.Y.*, 735 F.2d 38, 43 n. 5 (2d Cir. 1984).
9 *See Buchwald v. Williams Energy Mktg. & Trading Co. (In re Magnesium Corp. of Am.)*, 460 B.R. 360, 367 (Bankr. S.D.N.Y. 2011) ("Statutory provisions (including, and perhaps especially, those in the Bankruptcy Code) must be construed *in pari materia*, and one statutory provision in the Bankruptcy Code cannot be considered without reference to other relevant provisions of the same statute, and its object and policy.").
10 *LTV Corp. v. Aetna Cas. & Sur. Co. (In re Chateaugay Corp.)*, 167 B.R. 776, 780 (S.D.N.Y. 1994).
11 *See* 11 U.S.C. § 362 (imposing automatic stay of actions against debtor or against property of estate).
12 *Donarumo v. Furlong (In re Furlong)*, 660 F.3d 81, 89-90, 90 and n. 9 (1st Cir. 2011) (citing opinions of Third and Fourth Circuits).
13 479 F.2d 410, 415, 419 (2d Cir. 1973); *see also In re Stein & Day Inc.*, 113 B.R. 157, 162 (Bankr. S.D.N.Y. 1990) ("A bankruptcy court's jurisdiction does not extend to a wholly-owned subsidiary of the debtor, unless the subsidiary is 'a mere sham or conduit rather than a viable entity.'") (citing *In re Beck Indus.*, 479 F.2d 410, 416 (2d Cir. 1973)); *Anvil P'ship v. Clifford/Sooner Drilling Program (In re Clifford Res. Inc.)*, 24 B.R. 778, 780 (Bankr. S.D.N.Y. 1982) ("*Beck*...remains good law although [it was] decided under the former Bankruptcy Act.").
14 As discussed below, the *Lehman* bankruptcy court relied instead on §§ 365(e)(1)(B) and 541(c)(1)(B).
15 *See Queenie*, 321 F.3d 282, 288 (2d Cir. 2003) ("[T]he stay applies to Queenie because it is wholly owned by Gardner, and adjudication of a claim against the corporation will have an immediate adverse economic impact on Gardner.").
16 The Bankruptcy Reform Act of 1978 did not express Congress's desire that bankruptcy courts should have jurisdiction of all litigation involving subsidiaries, solvent or not, of the debtor.
17 *See United States v. Rybicki*, 354 F.3d 124, 145 (2d Cir. 2003) (noting that court may look to cases decided under prior statute to determine what current statute meant to Congress when enacted, even if earlier case law, after intervening statute, is not "precedent" in sense that it sets forth rules of law that later courts are bound to follow).
18 *Queenie*, 321 F.3d at 287.

guarantee—it only shifted LBSF's priority with respect to distributions of moneys received by the CDO indenture trustee. Thus, any adverse economic impact was to LBSF, not LBHI.[19]

Sections 365(e)(1)(B) and 541(c)(1)(B)

The phrase "the commencement of a case under this title" in §§ 365(e)(1)(B) and 541(c)(1)(B), fairly read *in pari materia* with other relevant subsections and sections, can only refer to a person who is a debtor at the time of the triggering of the *ipso facto* clause from which protection is sought. The very sentence of § 541(c)(1)(B), which includes the quoted phrase, makes this point clear in that it protects from the operation of an *ipso facto* clause triggered by the commencement of a bankruptcy case the property of the estate of "the debtor." Similarly, § 541(a) provides that the commencement of a case creates an estate consisting of property and interests of "the debtor." Subsections (a) and (b)(1) of § 365, by qualifying references to executory contracts with "of the debtor," also make it clear that the "case" referred to in § 365(e)(1)(B) can only be the case commenced by "the debtor" who seeks protection from the *ipso facto* clause, not a case commenced previously by some other debtor, however closely related. As noted above, § 362 also imposes an automatic stay of certain actions against "the debtor" or property of its estate.

Neither § 365(e)(1)(B) nor § 541(c)(1)(B), fairly read *in pari materia* with other relevant provisions and with the Code's intent of protecting debtors and the property of their estates, suggests that commencement of a case affords the Code's protection to wholly owned nondebtor subsidiaries or other nondebtor affiliates of the debtor, even if those nondebtors subsequently become debtors by commencing their own bankruptcy cases. At such subsequent time that an affiliated nondebtor commences a bankruptcy case and itself becomes a debtor, it too is afforded protection under the automatic stay and §§ 365(e)(1)(B) and 541(c)(1)(B) as "the debtor" in its own right, but if a flip clause subordinates a nondebtor's priority of distribution under a CDO indenture and that entity subsequently files for bankruptcy, neither the automatic stay, § 365(e)(1)(B) nor § 541(c)(1)(B) can *retroactively* avoid the flip clause's effect based on an earlier bankruptcy commenced by the entity's parent.[20]

Conclusion

The *Lehman* bankruptcy court would invalidate, as to LBSF, synthetic CDO indenture flip clauses triggered by LBHF's bankruptcy *or by LBHI's earlier bankruptcy*. With respect to the latter, the *Lehman* bankruptcy court's rulings may be viewed as relying entirely on an unprecedented broad interpretation of "the commencement of a case under this title" for purposes of §§ 365(e)(1)(B) and 541(c)(1)(B). Insofar as they extend the Code's protections to nondebtor subsidiaries of debtors, the *Lehman* bankruptcy court's opinions might not withstand a well-crafted appeal and/or might not be followed by sister courts.[21] abi

19 *See Ballyrock*, 452 B.R. at 34 ("[T]he contractual provision at issue...deprives LBSF of the benefit of its in-the-money position as a direct consequence of the commencement of a bankruptcy case by LBHI.").

20 Nor should a debtor be able to avoid, under §§ 547(b) or 548(a), distributions made to others of higher priority under a synthetic CDO indenture's flip clause triggered prior to the debtor having filed for bankruptcy. *Cf. Sullivan v. Willock (In re Wey)*, 854 F.2d 196, 199 (7th Cir. 1988) (holding that pre-petition termination of contract pursuant to its terms and consequent cessation of debtor's rights under contract does not constitute transfer within meaning of either § 547(b) or § 548(a)); *accord Edwards v. Fed. Home Loan Mortg. Corp. (In re LiTenda Mortg. Corp.)*, 246 B.R. 185, 191-92 (Bankr. D.N.J. 2000).

21 This aspect of the *Lehman* bankruptcy court's opinions, and the holding that flip clauses in synthetic CDO indentures are unenforceable *against a debtor counterparty* under the automatic stay and §§ 365(e)(1)(B) and 541(c)(1)(B), and are not saved by the § 560 safe harbor, remain the subjects of litigation.