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The Lehman Brothers Court Changes the Rules on Enforceability of *IpsO Facto* Clauses, or for Some Related Entities, *IpsO* for One is *IpsO* for All

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The bankruptcy judge presiding over the *Lehman Brothers* cases expected that these cases would “break new ground as to unsettled subject matter.”¹ He realized his own prediction in his January 25, 2010 decision involving the enforceability of a rights-changing clause in a swap agreement.² The decision is important for several reasons, including the trans-national nature of the controversy, with English courts’ considering the enforceability of the same provision on other grounds and reaching the opposite result. This discussion, however, will focus on only one reason for the importance of the U.S. bankruptcy court’s decision: the unenforceability of an *ipso facto* clause in an executory contract, when the bankruptcy petition that triggered the change in the debtor’s rights under the contract was not the debtor’s own, but the earlier bankruptcy petition of an affiliated entity.

For bankruptcy purposes, an *ipso facto* clause is one that changes the rights of the parties solely on the basis of the occurrence of a bankruptcy, or something similar; namely, the insolvency or financial condition of the debtor, or the appointment or taking possession by a receiver or similar agent to take charge of the debtor’s property.³ The most straightforward example of an *ipso facto* clause is one that terminates a contract or a lease if one of the parties enters bankruptcy. The Bankruptcy Code contains three provisions that render *ipso facto* clauses generally unenforceable, two of which are discussed in the *Lehman Brothers* decision. The first is the provision that defines property of the estate. Property of the debtor prior to bankruptcy becomes property of the estate in bankruptcy, irrespective of any *ipso facto* clause in a governing agreement or instrument.⁴ The second provision prevents the post-bankruptcy-petition termination or modification of an executory contract or unexpired lease of the debtor as a result of an *ipso facto* clause.⁵

Until the *Lehman Brothers* decision of January 25, 2010, it was generally believed that the unenforceable *ipso facto* condition relating to the commencement of a bankruptcy case had to be the debtor’s own bankruptcy case. The bankruptcy court’s decision exploded that belief. The swap agreements were those of Lehman Brothers Special Financing Inc. (“Special Financing”). Another entity, Lehman Brothers Holdings, Inc. (“Holdings”) provided credit support to the swap agreements. Under the swap agreements, Special Financing had rights to certain collateral as did an unrelated party to a separate transaction. The agreements provided that in the event of a bankruptcy by Special Financing, or by a credit support party, Special Financing lost its priority in the collateral. This is an obvious *ipso facto* clause. Holdings filed the first bankruptcy petition in the Lehman corporate family, on September 15, 2008. Special Financing filed its own bankruptcy case 18 days later on October 3, 2008. The earlier bankruptcy of the credit support party, Holdings, triggered the *ipso facto* clause and the loss of collateral priority by Special Financing, which was not yet in bankruptcy. The English courts that considered this provision held this that loss of priority by Special Financing was effective under English law.⁶

Not so, said the U.S. bankruptcy court. The court initially noted that the change in priority rights was not effective immediately on September 15, nor even on October 3, but only when there was a disposition of the collateral, which had not yet occurred.⁷ More significantly as a precedent for other cases, the court focused on the precise wording of the statutes, and observed that the *ipso facto* triggering mechanism of “the commencement of a case” under the Bankruptcy Code did not specifically refer to the debtor’s own case. Earlier proposed, but unenacted, versions of these provisions included specific qualifications of “the

commencement of a case” with either “by or against the debtor” or “concerning the debtor.” The court believed the rejection of these limitations by Congress had significance.⁸

Obviously, the commencement of a bankruptcy case against a stranger should be of no moment. The court was unprepared to say just how close a relationship there must be between the first bankruptcy case and the debtor’s to trigger the unenforceability of an *ipso facto* clause in the debtor’s contracts. For the Lehman Brothers bankruptcy cases, the court had a very close relationship to work with, and in its analysis mentioned the following factors: (1) all the Lehman entities constitute an “integrated enterprise” in which “the financial condition of one affects the others”; (2) the enormous size of the corporate family; (3) the emergency nature in which the first Lehman petition had to be filed; and (4) the resulting inability to plan for a contemporaneous filing of all Lehman entities. As a result, the earlier Holdings filing was the relevant “commencement of a case” to trigger the unenforceability of the *ipso facto* clause in Special Financing’s executory contracts.⁹ The court further held that attempting to enforce the change in priority rights in the collateral would therefore violate the bankruptcy automatic stay.¹⁰

This holding, if followed, has the potential for wide applicability in other cases involving closely-related entities

that provide credit support in an executory contract or unexpired lease of another entity that enters bankruptcy. The first-filed bankruptcy of say, a guarantor, may trigger an *ipso facto* invalidation in a later-filed bankruptcy of a contract counterparty or lessee with valuable rights. The four factors described above were sufficient, but the court did not say that they were all necessary for the result. That is left to case-by-case development. The second factor, in particular, is suspect, for the simple reason that, absent a distinction written by Congress, the same statute should not yield a different result solely in large cases. Excluding this factor leaves a precedent applicable to other integrated businesses that file in emergency situations where there is inadequate time to plan a coordinated filing for all relevant entities. Many cases may satisfy some or all of these criteria. We await the next case in which a debtor seeks to invoke the result reached by the *Lehman Brothers* court.

For more information on how these issues may affect your rights, contact Alec P. Ostrow at apo@stevenslee.com or 212-537-0402. Mr. Ostrow is a Shareholder of Stevens & Lee, P.C., and Co-Chair of the Bankruptcy and Financial Restructuring Group practicing in the New York office.

¹ *Lehman Bros. Special Fin. Inc. v. BNY Corporate Trustee Servs. Ltd. (In re Lehman Bros. Holdings, Inc.)*, 2010 WL 271161 at *13 (Bankr. S.D.N.Y. Jan. 25, 2010).

² *Id.*

³ 11 U.S.C. §§ 365(e)(1), 541(c)(1)(B). These provisions refer to a “custodian,” which is defined in the Bankruptcy Code as a receiver, trustee, or similar agent appointed prior to the bankruptcy case. 11 U.S.C. § 101(11).

⁴ 11 U.S.C. § 541(c)(1).

⁵ 11 U.S.C. § 365(e)(1). This provision has two significant exceptions: when applicable non-bankruptcy law excuses a non-consenting party from accepting performance from or rendering performance to someone other than the debtor (this often arises with respect to so-called “personal services” contracts); and when the contract is to make a loan, extend financing or other financial accommodations to the debtor, or to issue a security of the debtor. Neither exception applied to the Lehman swap agreement at issue.

⁶ *Lehman Bros. Special Fin. Inc. v. BNY Corporate Trustee Servs. Ltd.*, 2010 WL 271161 at *1-5.

⁷ *Id.* at *9.

⁸ *Id.* at *10. The court did not discuss the third Bankruptcy Code provision that renders *ipso facto* clauses generally unenforceable, 11 U.S.C. § 363(l), which treats property used, sold, or leased during the bankruptcy case, and is expressly subject to 11 U.S.C. § 365. Significantly, section 363(l) does contain the limiting phrase, “concerning the debtor,” with respect to “the commencement of a case,” which phrase is absent from the other two sections.

⁹ *Id.* at *10-11. The court had earlier determined that the swap agreement were executory contracts for bankruptcy purposes. *Id.* at *6-7.

¹⁰ 11 U.S.C. § 362(a)(3) statutorily enjoins “any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate.”