Enforceability of priority 'flip clause' upheld by High Court

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Perpetual Trustee v BNY Corporate Trustee Services & Lehman Brothers Special Financing Inc; Belmont Park Investments v BNY Corporate Trustee Services & Lehman Brothers Special Financing Inc [2009] EWHC 1912 (Ch)

The High Court has handed down judgment in the above case which considered the enforceability of a priority 'flip clause' contained in several series of repackaged notes. The priority flip clause is a provision which provides for payments due to the swap counterparty to be paid in priority to payments due to the noteholders, unless a swap counterparty Event of Default occurs, following which, the priority 'flips' and payments are then made to noteholders in priority to the swap counterparty.

"A flip clause is a provision which provides for payments due to the swap counterparty to be paid in priority to payments due to the noteholders, unless a swap counterparty Event of Default occurs, in which case payments are then made to the noteholders in priority to the swap counterparty."

The case is of interest firstly, due to the prevalence of priority of payment waterfalls in repackagings and securitisations which contain similar 'flip clauses', and secondly due to its consideration of the state of the law on 'flawed asset' provisions which are also currently topical following the reliance by Lehman counterparties on the flawed asset provision in section 2(a)(iii) of the ISDA Master Agreement.

Snapshot summary

The High Court ruled that the switch in priority does not breach the principle in *British Eagle* that a contractual provision that purports to remove from an insolvent company an asset that would otherwise be available to creditors is unenforceable as contrary to the mandatory provisions of insolvency law. However, the proceedings have been stayed pending resolution of the proceedings between BNY Corporate Trustee Services Ltd (the "**Trustee**") and Lehman Brothers Special Financing Inc ("**LBSF**") in the US Bankruptcy Court and to allow time to the US Bankruptcy Court or the foreign representative of LBSF to make a request for assistance from the High Court under article 9 or article 25 of the UNCITRAL Model Law.

The facts

Perpetual and Belmont (the "**Claimants**") are (or represent) noteholders of various credit-linked notes issued by SPVs (each an "**Issuer**") under a multi-issuer secured note issuance programme. The first defendant, the Trustee, is the trustee for these notes. The

second defendant, LBSF, is the swap counterparty for the programme. In respect of each series of notes in question, LBSF has entered into an ISDA Master Agreement and confirmation (the "**Swap Agreement**") with the Issuer under which LBSF pays the Issuer the amounts due under the notes and the Issuer, in return pays LBSF amounts equal to the yield on the collateral held by the Issuer and, on maturity, also pays an amount calculated by reference to any credit events occurring during the term of the notes in respect of one or more reference entities. Under each series of notes, the note proceeds were used to purchase securities which were held as collateral by the Trustee on the terms of the Principal Trust Deed, as supplemented by a Supplemental Trust Deed, to secure the obligations of the relevant Issuer to the noteholders and the swap counterparty (LBSF). All relevant documentation was governed by English law.

Lehman Brothers Holdings Inc, the Credit Support Provider of LBSF, entered into insolvency proceedings in the US on 15 September 2008 and LBSF entered into insolvency proceedings in October 2008, each of which constituted an Event of Default under the Swap Agreement with LBSF as Defaulting Party. There was no dispute as to the occurrence of an Event of Default.

The main provision under scrutiny was Clause 5.5 of the Supplemental Trust Deed. This provides that on an enforcement of the security the Trustee shall apply all moneys in accordance with:

> "Swap Counterparty Priority unless an Event of Default (as defined in the Swap Agreement) occurs under the Swap Agreement and the Swap Counterparty is the Defaulting Party (as defined in the Swap Agreement) or […] in which case Noteholder Priority shall apply."

"Swap Counterparty Priority" provides for payment of any termination payment due to LBSF under the Swap Agreement to be paid in priority to the redemption amount payable to noteholders and "Noteholder Priority" provides for noteholders to be paid in priority to the claims of LBSF under the Swap Agreement.

Due to the credit-linked nature of the notes and the amounts payable under the Swap Agreement on the occurrence of certain credit events, amounts are due to LBSF under the Swap Agreement. Consequently, the change in priority of payments, if upheld, would result in LBSF receiving less on an enforcement of the security than it would otherwise have received.

The proceedings

The Claimants issued claims in the High Court against the Trustee to procure realisation of the collateral held by the Trustee pursuant to the Trust Deed and its application in accordance with Clause 5.5, i.e. payment to the noteholders in priority to paying the claims of LBSF.

"The provision under scrutiny was Clause 5.5 of the Supplemental Trust Deed which provides that on an enforcement of the security the Trustee shall apply all moneys in accordance with Swap Counterparty Priority unless an Event of Default occurs under the Swap Agreement and the Swap Counterparty is the Defaulting Party, in which case Noteholder Priority shall apply."

LBSF issued proceedings in the US Bankruptcy Court contending that Clause 5.5 and related clauses were in breach of provisions of the US Bankruptcy Code which render unenforceable contractual provisions which modify the interest of a debtor in a contract as a result of a bankruptcy filing. LBSF then intervened in the English proceedings commenced by the Claimants and applied for a temporary stay of proceedings pending resolution of the proceedings in the US Bankruptcy Court. In order to consider the application for a stay of proceedings, the court first had to consider the enforceability of Clause 5.5 as the question of a stay would not arise were LBSF's submission that Clause 5.5 is unenforceable successful.

LBSF's submission: Clause 5.5 void for breach of pari passu principle

LBSF claimed that Clause 5.5 of the Supplemental Trust Deed is void under English law relying on the *pari passu* principle and the rule that a contractual provision that applies on insolvency to divest the insolvent company of an asset is contrary to this principle and, therefore, void. LBSF relied on the House of Lords ruling in ***British Eagle International Airlines v Compagnie National Air France*** *[1975] 1 WLR 758* ("**British Eagle**"), which is authority for the proposition that it is not possible to contract out of the *pari passu* principle, even where the contract is entered into pre-insolvency for legitimate business purposes and without any intention to avoid the insolvency rules. *British Eagle* concerned a clearing arrangement between airlines under which debts owed by and to members were set off against each other and only the net balance was payable. On a liquidation of one of the members, and application by its liquidator to recover a balance due without regard to the set-off under the clearing arrangement, the House of Lords held that the clearing arrangement, by agreeing that simple contract debts were to be satisfied in a particular way, was a "contracting out" of the provisions for the payment of unsecured debts *pari passu* and that such a contracting out was contrary to public policy. By analogy, LBSF's assertion was that Clause 5.5, by providing for a different priority of payments on an insolvency of LBSF than would otherwise apply, constituted a contracting out of the *pari passu* principle and was, therefore, contrary to public policy.

Claimants submission: a determinable interest

The Claimants contended that Clause 5.5 is valid and relied on the distinction drawn by the courts between a contract which by reason of the insolvency seeks to remove assets from the estate of the bankrupt and a contract providing for an asset in which the insolvent's interest is limited and determines on insolvency (also referred to as a "flawed asset" or a determinable interest). The Claimants contended that LBSF had a determinable interest because, under the terms of the Supplemental Trust Deed, LBSF only ever had an interest, in respect of its payment in priority, that determines on an Event of Default if LBSF is the Defaulting Party.

"LBSF claimed that Clause 5.5 of the Supplemental Trust Deed is void under English law relying on the *pari passu* principle and the rule that a contractual provision which applies on insolvency to divest the insolvent company of an asset is contrary to this principle and therefore void"

"A simple stipulation that, upon a man's becoming bankrupt that which was his property up to the date of the bankruptcy should go over to someone else and be taken away from his creditors, is void as being a violation of the policy of the bankruptcy law." Per James LJ ***Ex parte Jay*** *(1880) 14 Ch D*

Furthermore, the Claimants also argued that even if LBSF's submission (that the *British Eagle* principle applied) were correct, Clause 5.5 would still be enforceable because (1) the clause was not triggered by any insolvency of LBSF, and (2) as there was no insolvency process concerning LBSF in England, the principle did not apply.

The judge (Chancellor, Morritt J) considered the following three contentions:

(i) the application of the *British Eagle* principle;
(ii) whether it applies if there is no insolvency process in relation to the insolvent company in England; and
(iii) whether it applies if the clause operates on an event other than the insolvency of LBSF.

First issue: The scope of the *British Eagle* principle

The Chancellor considered the extent and application of the principle as formulated in the line of cases starting with **Ex Parte Mackay** (*1873) LR 7 Ch App 643* and the principle as explained by the Court of Appeal in that case that "*a man is not allowed…to provide for a different distribution of his effects in the event of a bankruptcy from that which the law provides*". In particular, the Chancellor considered the judgment of Neuberger J in **Money Markets International Stockbrokers Ltd v London Stock Exchange** [2002] 1 WLR 1150 ("**MMI**") which provided a comprehensive review of the case law in this area and in which Neuberger J recognised flawed asset arrangements as an exception to the principle and described them as "*an interest granted on the basis that it is inherently limited on insolvency […] in other words a determinable interest*."

"An interest granted on the basis that it is inherently limited on insolvency is recognised by the court. In other words, a determinable interest, that is an interest with a limitation until insolvency, is valid." *Per Neuberger J,* ***Money Markets International Stockbrokers Ltd v London Stock Exchange*** *[2002] 1 WLR 1150*

That a contractual provision that excludes mandatory provisions of insolvency law is contrary to public policy and therefore void is, in the judgment of the Chancellor, clear, as is the exception to that principle for the grant of an interest in property which is determinable on insolvency. However, in between these two extremes, there is a grey area.

"That it is contrary to public policy and therefore void, by contract to exclude the mandatory provisions of the Insolvency Act 1986 is clear enough. It is also clear that there exists an exception to that principle for the grant of an interest in property which is determinable on the insolvency of the grantee. Between these two extremes there exists an uncertain area." *Per Morritt J, para 43,* ***Perpetual Trustee v BNY***

Following the case law, and particularly approving the judgment of Neuberger J in *MMI*, the Chancellor held that Clause 5.5 is not contrary to public policy on the grounds raised by LBSF. In reaching this conclusion the Chancellor considered the structure of the transaction as a whole and not just the terms of Clause 5.5 in isolation. The Trust Deed creates security over collateral bought by the Issuer with the note proceeds; in no sense was that an asset derived directly or indirectly from LBSF. In coming to his conclusion the Chancellor also took a commercial approach and was clearly conscious of the potential ramifications of his judgment for a multitude of financial transactions when he stated that the court should not be quick to interpret commercial transactions so as to invalidate them, particularly when such interpretation would cast doubt on long-standing commercial arrangements. The Chancellor was no doubt aware that many finance contracts contain a flawed asset provision and rely on the enforceability of these provisions under common law, which

would be called into question if the Chancellor had adjudged the approach in Clause 5.5 to be an invalid forfeiture clause.

The judgment also considers the commercial sense of Clause 5.5: in the Chancellor's opinion, while LBSF was performing under the Swap Agreement it was appropriate for LBSF to have security for its obligations in priority to the security of the noteholders, but a condition of this priority was LBSF's continuing to perform under the Swap Agreement. However, although this reasoning applies on the facts of this particular case (as LBSF had, in fact, ceased to make payments under the Swap Agreement) it is not actually a requirement of the 'flip clause' that LBSF is 'continuing to perform' but simply that no Event of Default has occurred. The occurrence of an Event of Default (such as a party becoming insolvent) does not necessarily mean that there has been a failure to make payment. It would seem odd, and without basis in the authorities, for the enforceability of the 'flip clause' to be dependent on precisely which Event of Default has been triggered. The key consideration remains whether the interest of LBSF was, as granted, a limited interest. As such, it is suggested that the Chancellor's reference to LBSF's failure to perform was just one of several factors that led to his conclusion and that a payment default is not a necessary condition for a 'flip clause' to be enforceable.

"The court should not be astute to interpret commercial transactions so as to invalidate them, particularly when consequential doubt might be case on other long-standing commercial arrangements." *Per Morritt J, para 45,* ***Perpetual Trustee v BNY***

The Chancellor goes on to conclude that the interest of LBSF in the security was, as to its priority, always limited and conditional, the condition in this case being the non-occurrence of an Event of Default. As such, it could never have passed to a liquidator free from those limitations. In other words, the right of LBSF to be paid in priority was a determinable interest, and not a divestiture clause which operated on insolvency.

"Such beneficial interest by way of security as LBSF had in the collateral was, as to its priority, always limited and conditional. As such, it could never have passed to a liquidator free from those limitations and conditions as to its priority." *Per Morritt J, para 45,* ***Perpetual Trustee v BNY***

As the first point had been decided against LBSF it was not necessary to consider the other two points. However the Chancellor went on to consider these two points as, in the Chancellor's opinion, his views on these issues might be helpful considering the likelihood of the case going further.

Second issue: LBSF not subject to English insolvency proceedings

The Chancellor accepted the prima facie logic of the submission that the principle of *British Eagle* is based on insolvency law in England and therefore requires some insolvency process in England, but thought that this was to ignore the fact that both the common law and the UNCITRAL Model Law of Insolvency, implemented in the UK by the Insolvency Act 2000 and Cross-Border Insolvency Regulations 2006 permit the court to cooperate with insolvency regimes for foreign states. In such co-operation, the court is free to assume that the insolvency proceedings in the foreign jurisdiction are insolvency proceedings in England. In addition, as a practical matter LBSF could procure that it is wound up in England by submitting a petition, either by itself or by its foreign representative appointed by the US Bankruptcy Court. Given this, the Chancellor thought

that it would be absurd to hold that *British Eagle* is not applicable when LBSF, by their own actions, could take steps to ensure that it is. Therefore, the Chancellor did not agree that the *British Eagle* principle could only be applied where LBSF is subject to English insolvency proceedings.

Third issue: switch to noteholder priority not triggered by insolvency

The third issue the Chancellor considered was whether, if the principle in *British Eagle* applied, would it still apply where the event which caused the switch to noteholder priority was not the occurrence of insolvency proceedings but another Event of Default. The judge referred to the decision of the Court of Appeal in **Ex Parte Jay** (1880) 14 Ch D 19 in which a forfeiture clause provided for forfeiture of building materials in the event of either a breach of stipulation or the bankruptcy of the builder. The builder filed for bankruptcy but was not in breach of any stipulations on his part. The Court of Appeal found that the forfeiture clause was void on an insolvency however it accepted that had the other party sought to enforce the clause following a breach of stipulation in the absence of any insolvency, then this would have been valid and enforceable. The Chancellor found that this was binding authority for the proposition that if a provision is exercisable on one of a number of events, including bankruptcy, its invalidity in relation to an insolvency does not invalidate it in relation to the other events.

"[Ex parte Jay] seems to me to be direct and binding authority for the proposition that if a particular provision is exercisable on one of a number of events, including bankruptcy, its invalidity in relation to bankruptcy does not invalidate it in relation to the other events." *Per Morritt J, paras 33 & 50,* ***Perpetual Trustee v BNY***

Although an Event of Default had occurred on the insolvency proceedings of LBSF, there had also been an Event of Default under the ISDA Master Agreement as a result of the Chapter 11 filing of Lehman Brothers Holdings Inc, the Credit Support Provider of LBSF. There was some debate as to which of the Events of Default triggered the change of priority under Clause 5.5, however the Chancellor saw no reason why the Claimants should not rely on the insolvency of the Credit Support Provider of LBSFas the Event of Default which triggered the switch in priority. In such circumstances, even if, hypothetically, the principle in *British Eagle* applied, the court would still have found that Clause 5.5 was valid and enforceable as its operation was triggered not by an insolvency but by another Event of Default.

"It would be premature and academic for this court to decide on the extent of its powers under the UNCITRAL Model Law or the common law in the absence of a specific request." *Per Morritt J, para 63,* ***Perpetual Trustee v BNY***

Stay of proceedings

Having decided the question of the enforceability of Clause 5.5, the Chancellor considered the application of LBSF to stay the proceedings. The purpose of the stay sought by LBSF was the giving of time for the US Bankruptcy Court to formulate and transmit to the High Court any request for assistance it might think fit either under the common law or the UNCITRAL Model Law. LBSF argued that the UNCITRAL Model Law, which gives the English courts the power to grant any appropriate relief necessary to protect the interests of creditors and to co-operate to the maximum extent possible with foreign courts or foreign representatives, entitles the court to apply the provisions of the US Bankruptcy Code, including the provisions which might render clauses such as Clause 5.5 unenforceable.

As to the submission that the US Bankruptcy court might ask for assistance of the English courts under common law, the Chancellor referred to the judgment in **Cambridge Gas Transportation Corporation v Unsecured Creditors of Navigator Holdings plc** [2007] 1 AC 508, in which the Privy Council expressed doubt that under common law the court would be entitled to give effect to foreign law. However he did not discuss the point further.

Nor did the Chancellor comment on whether or not the UNICTRAL Model Law would entitle the court to apply provisions of the US Bankruptcy Code.

The Chancellor concluded that until such time as any request for assistance was made, it would be premature for the court to decide on the extent of its powers under common law or the UNCITRAL Model Law and consequently granted the temporary stay of proceedings until a date not earlier than 1 October 2009 to give the foreign representative of LBSF and the US Bankruptcy Court time to formulate any request for assistance

Conclusion

The decision on the enforceability of Clause 5.5 of the Supplemental Trust Deed is consistent with the authorities and upholds the somewhat fine distinction between a divestiture clause and a flawed asset provision. The Chancellor's consideration of the operation of such a provision on a non-insolvency Event of Default, while *obiter,* is also a helpful clarification on the breadth of principle in *British Eagle*. However, the suggestion that under the UNICTRAL Model Law the High Court could apply provisions of US Bankruptcy law to invalidate a clause in an English law agreement which is enforceable under English law has caused some disquiet among market participants. Ultimately, the Chancellor did not attempt to address this point but has stayed the proceedings to allow the US Bankruptcy Court time to determine its next steps in light of the decision to uphold the validity of Clause 5.5.

As the Chancellor himself recognised in the judgment, it is likely that this judgment will be appealed so this will not be not the last word on this point.

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