Global financial transactions and jurisdictional fragmentation: Inconsistent Decisions by Leading Trans-Atlantic courts.

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Throughout history, the courts in the common law countries have always been aware that they create law and influence commercial practice and many courts have embraced this task with great responsibility. They see their role as extending beyond the adjudication of the particular dispute between the immediate parties to the guidance of future practice. In this regard, leading courts make in the major financial centres make global law. In litigation concerning recent international financial transactions, national courts have been sensitive to the relevance of other jurisdictions and have expressed a willingness to understand what happens in other jurisdictions. This has been a welcome approach because financial transactions have grown in size and complexity and the largest and most spectacular of them all tend to be cross-border transactions. In times of economic prosperity, contracting parties

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3 See eg The Law Debenture Trust Corporation Plc v Concord Trust, [2007] EWHC 2255 (Ch) involving an anti-suit injunction; and AON Financial Products, Inc v Societe Generale 476 F 3d 90 (2nd Cir. 2007) where the US Second Circuit Court of Appeals reversed a trial decision after ISDA submitted an amicus brief pointing out that “The District Court’s errors in this case are of such fundamental nature that they cast significant doubt on the operation of credit default swap contracts. The rulings are directly contrary to the settlement mechanics set forth in ISDA’s standard documentation that is used in this $17.1 trillion market.” Quotation taken from Joanna Benjamin and David Rouch, “The International Financial Markets as a Source of Global Law: the Privatisation of Rule-making” March 2008 Law and Financial Markets Review 78 at 84 note 27.
are usually ready to re-negotiate and re-structure contracts rather than litigate; such a general
approach changes dramatically when there is the prospect of insolvency of one of the parties
or a general economic downturn.

In equal measure, the courts have for generations endeavoured to learn and apply what the
commercial industry does in practice in an endeavour to facilitate commerce, finance and
economic prosperity.\textsuperscript{4} Frequently the courts and industry work in tandem in this process of
mutual education and feedback, but sometimes clashes do occur – when courts overrule a
widely held perception of industry practice\textsuperscript{5} or when the industry works around court
decisions that are considered erroneous.

This article notes the problem of conflicting court decisions that arise from the fragmentation
of the legal landscape while the financial industry operates on a more or less integrated global
basis. The article focuses on three recent court cases decided in the two leading financial
centres of London and New York in the aftermath of the recent global financial crisis. All
three cases arose from pre-GFC transactions that went sour because of the bankruptcy and
later collapse of the US investment bank of Lehman brothers. One of the cases pitted the
provisions of US Bankruptcy Code against those of the ISDA Master Agreement, which is
one most widely used standard form documents in the world. This case, \textit{Metavante},\textsuperscript{6} is
considered one of the most significant decisions concerning the rights of the parties in over-
the-counter derivatives following a bankruptcy event of default. The significance of this case
is three-fold: first, the decision tested the application the ISDA Master Agreement in the

\textsuperscript{4} The best know judge in this regard might be Lord Mansfield but there are many more judges that have
followed that tradition.

\textsuperscript{5} \textit{Eg Hazell v Hammersmith and Fulham London Borough council} [1990] 2 QB 697, aff’d [1992] AC 1
(HL); and \textit{British Eagle}.

\textsuperscript{6} \textit{In re Lehman Brothers Holdings, Inc.}, Case No. 08-13555 et seq. (JMP) (jointly administered).
commercially-important jurisdiction of New York. Secondly, within the US the decision triggered a number of court cases that are founded on roughly the same facts.\(^7\) Thirdly, in a global setting the decision has opened up a debate on some provisions of the ISDA Master Agreement and one legacy that is certain to remain is the introduction of a sunset clause, of as yet an indeterminate period, to the non-defaulting parties’ right to make a choice as to what to do following the counterparty’s default. The second and third court cases reviewed in this article – actually back-to-back cases – consisted of parallel court actions where the same facts were litigated in London and New York and the courts reached conflicting decisions. The cases graphically illustrate the effect of legal fragmentation because not only do London and New York share the same common law background, but both are keenly aware of the need to avoid conflicting court decisions. The New York decision was handed down later than its London counterpart and the New York judge called for a status conference for resolving the clash between the two decisions. This aspect of dialogue between key jurisdictions is a feature of law-making that has gained momentum and scope in recent years and facilitated global financial transactions. Such dialogue occurs horizontally and involves the courts, industry and regulators. It also takes place vertically, involving domestic, regional and supranational institutions.\(^8\)

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7. The cases include: LBSF and LBHI v AIG CDS; The Board of Education of the City of Chicago v LBSF and LBHI; and Lehman Brothers Commercial Corporation v Norton Gold Fields Ltd. See Andrew Pincus, “The Metavante Ruling – In a Case of First Impression, US Bankruptcy Court Limits ISDA Counterparty Rights Upon a Bankruptcy Event of Default” Energy Trade and Commodities Alert, Alert 09-303 of 3 December 2009.

**Business and Legal Background**

The global financial crisis of 2007-08 was a graphic reminder of the interconnectedness among world economies that has resulted from the steady march of the process of globalisation. It was also a reminder of the ever present threat of financial distress and insolvency. A most visible aspect of globalisation and recent global economic prosperity is the global reach of business conglomerates and none more so than the large banks. Banks and other multi-national businesses operate through complex corporate groups that are interlinked managerially, operationally and financially such that a problem that occurs in one member of the group in one jurisdiction may have global reach. One such bank was Lehman Brothers, reputed to have been the fourth largest US investment bank before its collapse\(^9\) and the largest bankruptcy in history, and whose demise is generally thought to have triggered the most widespread financial crisis since the great depression. Some spectacular litigation has already resulted from the sequential filing for bankruptcy by Lehman Brothers Holdings International, Inc (the parent company) and Lehman Brothers Special Financing (the subsidiary) and on occasion the issue was whether the borrower for bankruptcy purposes was corporate group, the parent company or the individual subsidiary.\(^{10}\) The demise of Lehman Brothers illustrated the breakneck speed that events can take when trouble brews in some quarter and the multi-jurisdictional nature of litigation arising from one large multinational company. It also illustrated that a distressed company or defaulter need not be poor; indeed the company’s overall financial position could be bad while at the same time some of its contracts or subsidiaries are ‘in the money’.

\(^9\) Other recent problematic companies that collapsed or were on the brink of doing so include AIG, Enron, Worldcom and Parmalat.

\(^{10}\) This distinction in part explains the different outcomes in the UK case of *Perpetual* and the US case of *Lehman Brothers*. 
There are a number of business features of cross-border financial transactions that have led to commensurate developments in the law. First, the transactions are huge in size and involve a number of financial institutions. For instance, syndicated loans that are made to corporate borrowers in leveraged finance deals are structured to appeal to different lenders / investors’ appetite for risk in exchange for a higher risk of loss and will thus be structured in tiers that include senior lenders and subordinated debt, which takes the form of a first lien or mezzanine.

Secondly, the large size loans entail large credit risk and the lenders/investors necessarily engage in risk management products such as credit derivatives and swaps to hedge against the risk of loss. At the same time as the lenders are managing risk, the large corporates are also managing the risks facing them such as foreign exchange risk, profit / interest risk, commodity risk, thus creating a large and vibrant market for derivative products.11 Thus, a prevalent feature of modern financing is the use of credit default swaps, which are the commonest financial derivatives used to hedge against the risk of loss by transferring the risk to another party. The legal nature of credit default swaps (CDS) was described in *AON Financial Products, Inc., v Societe Generale*12

‘Simply put, a credit default swap is a bilateral financial contract in which a protection buyer makes periodic payments to the protection seller, in return for a contingent payment if a predefined credit event occurs in the reference credit… Often the reference asset that the protection buyer delivers to the protection seller following a credit event is the instrument that is being hedged.’

The court went on to clarify that credit default swaps are different from insurance contracts:

11 While most derivatives are entered into for speculation and arbitrage, some 10% are used for actual hedging.

‘CDS agreements are thus significantly different from insurance contracts. [T]hey “do not, and are not meant to, indemnify the buyer of protection against loss. Rather, CDS contracts allow parties to ‘hedge’ risk by buying and selling risks at different prices and with varying degrees of correlation.” … The terms of each credit swap agreement independently define the risk being transferred.’13

Credit risk mitigation techniques are part and parcel of modern portfolio management but are also frequently required by the credit rating agencies which have become a significant feature of the larger financial transactions. In a corporate group, one technique is the provision of credit enhancement by another member of the group; say the parent company, which guarantees the obligations of its subsidiary. Such an arrangement gives the creditor two entities to look to for the fulfilment of its obligation – the principal debtor and the credit support provider (guarantor) and by the terms of most financial contracts, the default of the guarantor constitutes the default of the principal debtor as well.

Thirdly, many loans are actually held by institutional investors and other financial institutions rather than commercial banks, as was traditionally the case. The non-bank lenders get involved in the loan either at the outset, i.e. primary syndication level, or at the secondary level where they acquire loan interests by way of purchase from the original lenders. Such providers of funds include sovereign wealth funds, private equity, hedge funds, mutual funds, pension funds, and insurance companies. They have had a tremendous impact on loan markets. First, they see their involvement in a loan as an investment that should produce

13 476 F. 3d 90 at (2nd Cir. 2007) [1]-[2]. Further differences between credit default swaps and insurance contracts include ‘pure loss rather than speculative loss, different common law/legal standards (absence of subrogation, standards on full disclosure or absence thereof, and different markets and methods of contracting (including MTM valuation and regular transfers/novations of CDSs’: Schuyler K Henderson, “Regulation of Credit Derivatives: to What Effect and for Whose Benefit? Part 6” (2009) 8 Journal of International Banking and Financial Law 480.
viable returns on its own merit and compared to other investment instruments and will
dispose of the loan for alternative forms of investment if the outlay on a loan is not profitable.
They are thus unlike commercial banks that are relationship-driven and tend to hold on to the
loan as a market leader on in the hope of ancillary services. To be able to compare the loan
with other assets, such investors demand liquidity of the asset, transparency of pricing and
efficiency of trading procedures.

The desire by institutional investors to acquire loans coupled by the desire for banks to sell
loans has resulted in many loans being sold off to international investors through CDOs.14
The loans therefore end up as part of a different transaction. Case law resulting from the
global financial crisis has provided judicial descriptions of the key features of these complex
transactions that are an established feature of the modern financial landscape.

“Collateralised Debt Obligations

A CDO is a financial structure at the centre of which a special purpose vehicle (“SPV”) issues tranches of debt securities, the performance of which is linked to a portfolio of assets. The SPV may either hold the underlying assets (a “cash CDO”) or take exposure to assets such as corporate bonds or asset-backed securities via a credit default swap with a financial counterparty (a “synthetic CDO”). The performance of CDOs is linked or “referenced” to the pool of underlying bonds or securities, the “Reference Pool”.

In the case of a synthetic CDO the issuer may (as in the present case) invest the proceeds of issue of the CDOs in a portfolio of high quality, typically AAA-rated assets (“collateral”); those collateral assets are used to generate income to make coupon (interest) payments on the CDOs and, in the case of a default of any of the Reference Pool to which the SPV is exposed, to pay the financial counterparty the loss due under the credit default swap. On each occasion on which one of the assets in the Reference Pool defaults or is subject to some other “credit event” (such as a downgrading of its credit rating), then a payment becomes due from the SPV to the financial institution under the credit default swap. At the same time, the principal and interest due from the SPV to the CDO noteholder is correspondingly reduced. The usual practice is for CDO

14 This was the cause of action in UBS AG v HSH Nordbank AG [2009] EWCA Div 585, [2009] 2 Lloyd’s Rep 272.
notes to be issued in different classes, whereby the losses are allocated sequentially commencing with the most “junior” tranche of notes until the original principal amount of such class of notes are written down to zero, and then losses are allocated to the next “higher” tranche of notes, until the entire capital structure is exhausted or the maturity date of the CDO notes occurs. As a consequence junior notes suffer as a result of earlier Reference Pool defaults/other credit events and the less risky “senior” tranches suffer loss only after the underlying classes of CDO notes have been reduced to zero principal value.

A common feature of actively managed CDOs is that one of the parties to the transaction has the right to alter the composition of the Reference Pool. Such a right potentially increases the risk for the holder of the CDO note, particularly if the party with the right to alter the composition of the Reference Pool has an economic interest in the transaction, as in the present case.  

Finally, the larger financial transactions are typically arranged on the basis of standard terms that are recommended by leading industry associations such as ISDA, LMA or LSTA. In the result, any decision that is based on such documents will be watched closely because it has potential for global impact. The clients are sophisticated (sophisticated investors, borrowers or counterparties) and the financial products are sophisticated. The courts’ role in this regard is usually limited to the application of the words of the contract since consumer issues do not intrude in this area.

Financial transactions in the courts
The usual contribution made by the courts to financial law is the interpretation and application of the law in a way where the courts develop the law in the same direction as industry practices. From time to time, though, there are occasional divergences between the courts’ perception and some perceptions in commercial quarters. A court’s decision that is

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out of alignment with commercial perceptions is usually followed by debate and refinement of standard form documentation or corrective legislative action and in that way contributes to the development of the law. One such decision involved the Metavante corporation and Lehman Brothers.

**Metavante**

The Metavante decision concerned straightforward interest rate swap transactions that were entered into in 2007 between Metavante corporation and Lehman Brothers Special Financing, Inc. (LBSF) on the basis of the 1992 ISDA Master Agreement. Lehman Brothers Holdings Inc (LBHI) was the credit support provider and guaranteed the obligations of LBSF. The swap agreement was governed by New York law and both parties were US business entities. Under the swap agreement, Metavante was the fixed rate payer and was required to make quarterly payments based on a fixed interest rate while LBSF, as the floating rate payer, was required to make quarterly payments based on a floating rate. The payments were netted and the net payer was required to pay the difference on a scheduled payment date. “The ISDA Master Agreement included the standard terms for (a) events of default, including section 5(a)(viii) for the bankruptcy of a counterparty or its credit support provider, (b) the right under section 6(a), but not the obligation, of the non-defaulting party to designate early termination upon the occurrence of an event of default, and c) the right under section 2(a)(iii) to withhold performance upon the occurrence of an event of default that is continuing.”

“LBHI filed for bankruptcy protection under Chapter 11 of the US Bankruptcy Code on September 15, 2008, followed three weeks later by LBSF’s bankruptcy filing on October 3,

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*In re Lehman Brothers Holdings, Inc., Case No. 08-13555 et seq. (JMP) (jointly administered). The narrative of facts in the text draws heavily from Andrea Pincus, above,
2008. Under section 5(a)(vii) of the ISDA Master Agreement, each bankruptcy filing was a separate and independent event of default giving rise to (a) Metavante’s right to designate an early termination date, and (b) the trigger of the right to withhold performance under section 2(a)(iii) of the ISDA Master Agreement, as long as an event of default was continuing.” It was common ground that an early termination would have yielded a multi-million dollar payment to LBSF and that the scheduled payments were substantially in favour of LBSF. Metavante did not designate an early termination of the agreement and instead chose to withhold payment under the individual transactions that remained outstanding.

In May 2009 Lehman Brothers (the debtors / defaulting party) moved to compel performance by Metevante (the non-defaulting party) claiming payment of all past due amounts plus default interest. Lehman essentially based its arguments on US bankruptcy law and policy. First, it argued that while the Bankruptcy Code respected the contractual rights of the non-defaulting party to terminate, accelerate or liquidate their positions in derivatives contracts and net payments, such rights inhered only if the contract was terminated. Secondly, it was against the legislative intent of the Bankruptcy Code for Metevante to rely on section 2(a)(iii) and choose to keep the contract on foot rather than promptly terminate it after default. The legislative intention favoured prompt termination so as to permit markets to continue functioning in the direct aftermath of a major player’s collapse. Thirdly, section 2(a)(iii) was an unenforceable *ipso facto* clause in violation of the Bankruptcy Code. It was claimed that “Metavante effectively modified the parties’ contract rights by permitting indefinite suspension of performance obligations only because of the financial condition of the debtors and commencement of the bankruptcy cases.”

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18 Section 365(e) in essence an impermissible bankruptcy penalty – accord, Pincus, above.
Metevante, on the other hand, relied on the provisions of the ISDA Master Agreement and argued that it had the right, but not the obligation, to terminate outstanding transactions and there was no time limit for making the choice. Secondly, it argued that section 2(a)(iii) “expressly permitted the non-defaulting party to suspend its performance while an event of default was continuing, again with no contractual time limit and no exception for a bankruptcy event of default” and thirdly, “the US Bankruptcy Code … expressly excepts from the ipso facto clause prohibition positions under a swap or master netting agreement, and does so without imposing any statutory time limit. The key provisions governing payment and delivery of obligations which the court had to apply were the following.

Section 2(a)(i) of the ISDA Master Agreement states:

“Each party will make each payment or delivery specified in each Confirmation to be made by it, subject to the other provisions of this Agreement.”

Section 2(a)(iii) of the ISDA Master Agreement states:

"Each obligation of each party under Section 2(a)(i) is subject to (1) the condition precedent that no Event of Default or Potential Event of Default with respect to the other party has occurred and is continuing, (2) the condition precedent that no Early Termination Date in respect of the relevant Transaction has occurred or been effectively designated and (3) each other applicable condition precedent specified in this Agreement."

In a bench ruling,\(^\text{19}\) the court held in favour of the defaulting party (Lehman Brothers) and against the non-defaulting party (Metevante). The court expressly limited the “enforceability of section 2(a)(iii) of the ISDA Master Agreement and the scope of the US Bankruptcy Code protections for non-defaulting parties to derivative contracts.” The court ruled that, first, each

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\(^{19}\) There are reports that the court had previously encouraged the litigants to settle their dispute and the judge was “visibly displeased” by the lack of effort on the part of Metevante to settle the dispute: See Andrew Pincus, above.
of the respective bankruptcy filings of LBHI and LBSF constituted a separate event of default that triggered Metavante’s right to terminate the transaction. Secondly, the safe harbor provisions of the US Bankruptcy Code apply only to protect a non-defaulting swap counterparty’s contractual rights solely to liquidate, terminate or accelerate derivative contracts upon the bankruptcy of a counterparty or to ‘offset or net out any termination values or payment amounts or foreclose on collateral. The provisions do not apply where the non-defaulting party fails to terminate, liquidate or accelerate the swap, and they “do not permit the withholding of performance under a swap if the swap is not terminated.” The court explained that “the exceptions to the unenforceability of an *ipso facto* clause – in this case for executory contracts that are swaps – do not extend to the contractual right to withhold performance under section 2(a)(iii) where such indefinite delay of performance is triggered because of the financial condition of the debtors. Suspension of payments, as opposed to termination, thus amounts to a prohibited modification of the parties’ rights and obligations under the contract.” Lastly, despite no contractual or statutory time limit on the right to terminate derivative transactions because of a bankruptcy default, by failing to terminate the transactions more than eleven months after the debtor’s bankruptcy filings Metavante’s ‘window to act promptly under the safe harbor provisions has passed’ and its failure to terminate by that time resulted in a waiver of its rights to do so.” The court therefore ordered Metavante to pay the amounts withheld together with default interest in spite of the ISDA section 2(a)(iii) that permitted such withholding in the face of the continuing default by LBSF and LBHI. In effect, the court decided that under United States law, a non-defaulting party must make a choice to terminate or not to terminate, and the party has a limited time within which to make that choice.
There were a couple of crucial unique facts in the *Metavante* decision that might have swayed the Courts decision against the non-defaulting party; first, Metavante chose to maximise its own benefits from the bankruptcy of Lehman brothers by failing to net payments, which would have resulted in Metavante making substantial payments to Lehman Brothers. Secondly, Metavante chose to ride out the crisis by delaying its decision for some eleven months when the usual commercial expectation was to do it promptly. In this light, the Court’s decision was understandable because the court said, in essence, that there is a limit to extent to which a non-defaulting party can shield behind the literal reading of the ISDA provisions and other transaction documents.

It is possible to pick quite a few areas where the court’s reasoning is not entirely satisfactory. First, for purposes of applying the ipso facto clause the decision did not make a distinction between the default of the credit support provider (LBHI) versus the debtor (LBSF) particularly since there was a time gap between the two. If this distinction is made, one can cogently argue that the trigger for Metavante’s right to modify contractual rights under ISDA section 2(a)(iii) occurred on the earlier bankruptcy and not on the onset of the debtor’s bankruptcy. Secondly, the court did not give clear guidance on how long was too long to wait before a non-defaulting party lost its right to terminate transactions or net payments, or before it will be taken to have waived its right to terminate. Even though a specific time limit would have not been helpful in the light of the variety and complexity of the transactions to which the ISDA Master Agreement is used for, the court would have been

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20 See Andrea Pincus, above.

21 It was only in the Lehman Brothers v BNY case that the court clarified that the Lehman Brothers companies wee to be seen as one corporate family and yet in *Metavante* the court saw them as different.
more helpful by creating a general “reasonable time” standard or holding that there was an implied term in every such contract that the non-defaulting party would act within a reasonable time. While such a standard is fluid, it is helpful enough in common law jurisdictions where the courts and the parties know how to apply it. It would give the parties and the courts to weigh up the relevant factors in each particular transaction such as the volume, complexity and interconnectedness of the transactions covered by the ISDA Master Agreement, the challenges in obtaining replacement trades from qualified counterparties, and the difficult issues involved in restructuring an entire portfolio of an insolvent counterparty.

Arguably, the most noteworthy and controversial aspect of Metavante and one with potentially a global reach was to limit the enforceability of section 2(a)(iii) of the ISDA Master Agreement. A literal reading of the section appears to suggest that it is open-ended and that it entitles the non-defaulting party to do nothing rather than terminate the transactions and crystallise the obligation. The court in the present case ruled that in the circumstances of this case, the section did not mean what it says on its face and the non-defaulting party did not have the choice simply to do nothing indefinitely. It should have fairly promptly elected to terminate the transactions and having failed to do, it was not permitted to terminate or suspend payments until the debtor elected whether to accept or reject the swap in question.


23 Andrea Pincus, above.

24 Mark Daley, above; Wilbur F Forster, Jr., Adrian C Azer and Constance Beverly, “Court Explores Termination Rights Under Bankruptcy Code Section 569” November/December 2009 Pratt’s Journal of Bankruptcy Law 505. The case thus revealed a loophole in the section in that the non-defaulting party can
In refusing to enforce section 2(a)(iii) in its accordance with its terms, the US Bankruptcy Court surprised prevailing orthodoxy and initial reaction in the media was to say that it was unsafe to do business in the United States.

Comparison between *Metavante* and other global authorities

*Metavante* conflicted with *Enron Australia v TXU Electricity*\(^{25}\) on the right to suspend payments re section 2(a)(iii).\(^{26}\) Enron Australia is generally taken to confirm the non-defaulting party’s right to withhold payments and the general enforceability of the section. The Court also upheld the contractual right not to designate an early termination to the contract.\(^{27}\) There are some crucial factual differences between the two cases, though. In *Enron Australia*, the enforceability of section 2(a)(iii) was assumed and not tested. The parties agreed that the section did not operate indefinitely.\(^{28}\) On a general note, however, commentators easily agree that it would not make commercial sense for the non-defaulting party’s right to withhold payment to be available indefinitely,\(^{29}\) but on the other hand it is too drastic to declare it unenforceable. Still, it seems that the Metavante decision is in the minority.\(^{30}\)

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\(^{25}\) [2003] NSWSC 1169, affirmed NSWCA.

\(^{26}\) Pincus at 5.

\(^{27}\) Colin Riegels and Russell Willings, “*Metavante and ISDA Master Agreement: BVI Perspective*” October 28 2009 International Law Office.

\(^{28}\) See also Mark Daley, above.

\(^{29}\) *Schuyler Henderson at [2005]* 1 *Journal of International Banking and Financial Law* 18

\(^{30}\) See also Russell Willings, “Derivatives and Insolvency: a British Virgin Islands Perspective on the *Metavante* Decision and the ISDA Master Agreement” (2010) Vol 3 Issue 1 *Corporate Rescue and Insolvency Journal* 18. *Metavante* is also hard to reconcile with *Marine Trade SA v Pioneer Freight Futures Co Ltd [2009]* EWHC 2656 where the enforceability of section 2(3)(iii) was not in issue and was assumed. *Marine Trade* was relying on the section for purposes of netting payments (and recovery by way of restitution for payments made under protest).
**Lehman Brothers – UK litigation**

The next two cases were based on the same facts and are summarised by the following diagram.

![Diagram showing SPV, LBIE, LBHI, BNY Trustee, Notes, Collateral, Post-default Priority (2), Pre-default Priority (1), Swap, vs, and LBSF relationships]

The Perpetual Trustees/Lehman Brothers Litigation

In *Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd*[^31] an investor sued the collateral trustee to enforce the contract terms that gave the investor priority to the collateral following the default of a competing entity. The Lehman Brothers companies (Lehman Brothers International Europe or “LBIE”) had set up a special purpose vehicle (SPV) which issued notes to investors in the form of synthetic collateralised debt obligations. The subscription money obtained from the investors was used by the SPV to purchase the

collateral for the notes. The SPV in turn entered into a credit default swap with Lehman Brothers Special Financing (LBSF) (the swap counterparty) under which the swap counterparty paid regular amounts to the SPV to service payments to the noteholders in exchange for sums equal to the yield on the collateral. The collateral was charged by the SPV in favour of a trust company to secure the SPV’s obligations to its creditors who included the noteholders and the swap counterparty. The trust deed provided that the rights of the swap counterparty to payments and the collateral would ordinarily have priority over payments to the noteholders but that the priority would change in favour of the noteholders on the occurrence of an insolvency event by the swap counterparty or credit support provider.  

The swap agreement was subject to the ISDA Master Agreement and all the transactions were governed by English law.

On 15 September 2008 LBHI filed for Chapter 11 Bankruptcy protection in the United States. That act constituted an event of default under the swap documentation because LBHI was designated as a credit support provider of LBSF. On 3 October 2008 LBSF also filed for Chapter 11 Bankruptcy protection, which also constituted an event of default and triggered a switch in the priority to collateral from the swap counterparty to the noteholders. The noteholders were not paid and they gave notice to the trustee to terminate their arrangement and required the trustee to enforce the security. The swap counterparty (LBSF) challenged the noteholders claim to priority arguing that it would fall foul of the anti-deprivation rule.

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32 This is the so-called “waterfall flip”.

33 While the scope and preciseness of the anti-deprivation rule is subject to debate, the courts agree that the modern rule is based on public policy and says that one cannot contract out of the insolvency regime: per Perpetual at para 50-57 citing British Eagle International Air Lines v Compagnie Nationale Air France [1975] 1 WLR 758 per Cross LJ (HL); Carreras Rothmans Ltd v Freeman Mathews Treasure Ltd [1985] 1 Ch 207 per Gibson J; and International Air Transport Association v Ansett Australia [2008] BPIR 57 (HC). The rule was stated by Cotton LJ in Ex p Jay: In re Harrison (1880) 14 Ch D 19 at 26 that “there cannot be a valid contract that a man’s property shall remain his until his bankruptcy, and on the happening of that event shall go over to
The trial judge held\(^3\)\(^4\) that the disadvantage suffered by LBSF did not come within the rule and the provisions changing priority to collateral were operated before LBSF filed for bankruptcy protection. The Court of Appeal unanimously dismissed LBSF’s appeal by first asking if there had been a deprivation of property and secondly the timing of the deprivation.

It held that the ‘flip’ of priority from the swap counterparty to the noteholders was not a divesture or transfer of property to the noteholders but merely a change in the order of priorities in which rights were to be exercised in relation to the proceeds of the sale of collateral in the event of default. Furthermore, the court reasoned that it was an agreed feature of the contract documents from inception that the priority right enjoyed by LBSF over collateral was contingent to there being no event of default and was therefore lost in favour of the noteholders on the occurrence of default. In addition, the court noted that the anti-deprivation rule might not apply where, as in the instant case, the person for whose benefit the deprivation took effect could show that the asset, or the insolvent’s interest in the asset, over which the deprivation took effect was obtained by his own money.\(^3\)\(^5\) Lord Justice Patten took the simple view that the ‘flip’ was an original feature of the contract and could not possibly be seen as a deprivation of property on the onset of the counterparty’s bankruptcy.\(^3\)\(^6\) Secondly, the court held that the switch or “flip” from counterparty to noteholder priority did not violate the anti-deprivation rule because it occurred before, not on or after, liquidation since the alteration of priority was triggered when LBHI filed for Chapter 11 bankruptcy, which was some eighteen days earlier than when LBSF (the credit support

\(^{34}\) [2009] EWHC 1912 (Ch).

\(^{35}\) Whitmore v Mason 70 ER 1031 applied.

\(^{36}\) Perpetual Trustee Co Ltd, para 66.
provider) filed for bankruptcy under Chapter 11.37 “If the deprivation occurred before winding up or its equivalent, it did not fall within the scope of the rule”: British Eagle and Carreras Rothmans.

As a matter of policy, the English courts emphasise the principle of party autonomy. In the High Court, the Chancellor observed that the courts should enforce the parties’ agreement rather than enforce the anti-deprivation rule on them. In the Court of Appeal, the Master of the Rolls made it clear that that in “complex and sophisticated contractual arrangements the parties should be expected to know what they were doing, and the courts should be slow to take away their right to freely contract on terms as they see fit.”38 As the Master of Rolls pointed out:

“It is important that, so far as possible, judicial decisions in the insolvency field ensure that the law is clear and consistent. That has always been true, but the need for consistency and clarity is all the greater now that commercial contracts are becoming increasingly complex both in their underlying nature and in their detailed provisions, as is well demonstrated by the contracts in the instant cases… It is also desirable that, if possible, the courts give effect to contractual terms which the parties have agreed. Indeed, there is a particularly strong case for party autonomy in cases of complex financial instruments … and in arrangements involving large corporate groups…; in such cases, the parties are likely to have been commercially sophisticated and expertly advised.”39

37 It was common ground among the court and litigants that the filing of Chapter 11 bankruptcy was equivalent to making a winding-up order under English law.

38 See Christopher Harlowe, “Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd – the anti-deprivation principle – whose rights are they anyway?” (2010 21(3) Entertainment Law Review 114-115. It is important to note that the anti-deprivation principle was only reigned in and not thrown out altogether.

39 Per Lord Neuberger of Abbotsbury MR in Perpetual Trustee Co Ltd v BNY Trustee Services Ltd, at para[58]
Lehman Brothers – US litigation

*In re Lehman Brothers Holdings Inc. v BNY Corporate Trustee Services Ltd*

the facts were exactly the same as those in the English counterpart of this case (*Perpetual Trustee Co Ltd v BNY Trustee Services Ltd*, above). The swap counterparty / the debtor initiated court action in the United States to compel the trustee disregard the contract documents. It argued that the contractual provisions which required the modification of the scheme for payment priority were unenforceable ipso facto clauses under the US Bankruptcy code because they inappropriately modified the debtor’s interest in a contract solely because of a bankruptcy filing. The debtor also argued that any attempt to modify the payment priority violated the automatic stay provisions of the Bankruptcy Code because it improperly sought to exercise control over the property of the debtor’s estate. Finally it argued that so-called safe harbor provisions of the Bankruptcy code did not protect the purported modification of payment priority. BNY defended by arguing that the documents were governed by English law and to be construed in accordance with English law and, under the principles of *res judicata* and comity therefore, the New York Court should defer to the determination of the issues by the English courts. BNY also argued that LBSF could not use its status as a bankruptcy debtor to garner greater rights with respect to the collateral than it possessed before the bankruptcy petition. BNY also argued that the payment modifications at issue were the agreed mechanisms by which the parties’ transactions were to be liquidated and fell within the safe harbor provisions of the Bankruptcy code.

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40 422 B.R 407 (Bankruptcy court S.D.N.Y. 2010)

41 Reliance was put on US Bankruptcy Code 11 U.S.C. sections 365(e)(1) and 541c)(B).

42 Bankruptcy Code section 362(a)(3).
The Bankruptcy Court began by justifying its application of United States law at the expense of English law even though the latter had been explicitly chosen by the parties as the governing law of the contract documents. The court noted that it was not obliged to recognise a judgment rendered by a foreign court but may give *res judicata* effect on the basis of comity. It then observed that the English courts had not taken account of the principles of US bankruptcy law in the earlier proceedings that the trustee wanted enforced. It held that as a general matter, “courts will not extend comity to foreign proceedings when doing so would be contrary to policies or prejudicial to the interests of the United States.”

While recognising that the application of the Bankruptcy Code would yield an outcome directly at odds with the judgment of the English courts, the court articulated the guiding policy:

> “Despite the resulting cross-border conflict, the United States has a strong interest in having a United States bankruptcy court resolve issues of bankruptcy law, particularly in a circumstance such as this where the relevant provisions of the Bankruptcy Code provide greater protections than are available under applicable provisions of foreign law.”

The court therefore decided not to give “preclusive effect” to the English judgments and proceeded to apply the provisions of the Bankruptcy Code. The Bankruptcy court reached different factual and legal conclusions from the English court and applied different law. Key among the differences were these: First, the court held that the priority accorded by the transaction documents to LBSF was a valuable property interest that was entitled to protection as part of the bankruptcy estate. The contract documents that changed priority

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43  At para [5].
44  At para [6].
from LBSF to the noteholders was a modification of that valuable right.\textsuperscript{45} Secondly, the court viewed the Lehman Brothers holding company and the multiple subsidiaries within the corporate group as one integrated enterprise such that the first filing for bankruptcy on 15 September by LBHI was the event that precipitated subsequent related events. The court then noted that an ipso facto clause, which prohibits the modification of a debtor’s right solely because of an agreement conditioned upon the commencement of a \textit{case} under the Bankruptcy Code,\textsuperscript{46} was not limited to the commencement of a \textit{case by or against the debtor}.\textsuperscript{47} In the instant litigation “a case” was commenced by a related entity when LBHI, the corporate parent and credit support provider, filed for bankruptcy. The court therefore held that the transaction documents which sought to modify the right to priority of collateral [the ‘flip’] after the first filing constituted an unenforceable \textit{ipso facto} clause. Similarly, such provisions violated the automatic stay which was triggered on the filing of the bankruptcy petition because they sought to deprive the debtor and its creditors of valuable property.

\textbf{Notes on Lehman Brothers – US litigation.}

The decision has some internal weaknesses but it is the law of the United States. Clearly the disregarded choice of law provisions and based itself exclusively on US policy in a situation when another jurisdiction was clearly relevant – the assets in question were based in England.\textsuperscript{48} The court said:

\begin{quote}
“[T]he English Courts have been most gracious in allowing room for this Court to express itself independently on matters of importance to the administration of the
\end{quote}

\textsuperscript{45} In this regard US law, which requires “modification,” is different from UK law, which requires “deprivation”.

\textsuperscript{46} Sections 356(e)(1) and 541(c)(1)(B).

\textsuperscript{47} Emphasis in original text.

LBHI and LBSF bankruptcy cases. In applying the Bankruptcy Code to these facts the Court recognises that it is interpreting applicable law in a manner that will yield an outcome directly at odds with the judgment of the English Courts.”

There was no attempt to balance domestic policy with the needs of international business / finance. In commercial contracts involving sophisticated businesses, the parties are normally held to their contracts and cannot be seen to contest the documents they signed. The documents create a contractual estoppel whereby the parties are precluded from denying that the obligations they entered into are binding. This is especially so because a leading player, such as Lehman Brothers, was at the forefront of creating and marketing such financial instruments. The court acknowledged the weakness in its approach in a footnote:

“The Court recognizes that there is an element of commercial expectation that underlies the subordination argument. LBSF was instrumental in the development and marketing of the complex financial structures that are now being reviewed from a bankruptcy perspective.”

On a wider stage, the decision declared as unenforceable provisions that common in structured finance transactions where payments to swap counterparty are subordinated if the counterparty has defaulted on its obligations. While this might instinctively be seen as a disadvantage to doing business in the United States generally or where the swap counterparty is subject to the US Bankruptcy Code, and while this might at first blush be seen as detracting from the enforceability of subordination provisions generally, it is thought that the impact of the decision might not be as widespread and the decision might be limited to the facts of this case. Furthermore, English law does not have a principle of substantive consolidation that

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49 Lehman Brothers at para 12 footnote 9.

was relied upon by the Bankruptcy Court to treat LBHI and LBSF as the same. The US decision is therefore unlikely to have impact in the UK for this reason.51

**Conclusion**

The global financial crisis of 2007/08 provided fertile ground for litigation that has expanded and clarified the boundaries of existing financial law. It was not surprising in this plethora of court cases that some conflicting decisions were reached in different jurisdictions or that long-standing perceptions were tested.

Whatever the merits or demerits of the decision in *Metavante*, the decision is the law of the United States and must be taken into account by parties wishing to transact business in that country. The decision potentially has influence beyond the United States because it may influence the views of other courts when they interprete the ISDA Master Agreement section 2(a)(iii). In any event, all parties that enter into transactions that are governed by the ISDA Master Agreement must take the decision into account when they decide whether or not to terminate a transaction following the insolvency of a counterparty.52

English courts have traditionally tried to avoid conflicting decisions with their overseas decisions, particularly in commercial matters. This was exemplified by Coleman J in

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52 Freshfields Bruckhaus Deringer, “US Bankruptcy Court Finds That Payment Conditionality is Unenforceable Under Section 2(a)(iii) of the ISDA Master Agreement” Briefing 2009.
Lordsvale Finance Plc v Bank of Zambia the course of considering a provision concerning default interest rate in a loan agreement:

It would be highly regrettable if the English courts were to refuse to give effect to such prevalent provisions while the courts of New York are prepared to enforce them. For there to be a disparity between the law applicable in London and New York on this point would be of great disservice to international banking.53

It is sometimes inevitable, however, that the law of one country clashes with the principles of another jurisdiction. A case in point is the earlier insolvency case of Bank of Credit and Commerce International54 when English law and practice on set-off brushed against the legal principles of other jurisdictions. In that earlier case, the English authorities were able to cooperate with other jurisdictions to obtain a satisfactory practical result. Similarly in the US Lehman Brothers case the court was keenly aware that its application of United States law was in direct conflict with the earlier English decision based on the same facts. The court called for a status conference to sort out the difficulties that confronted the parties in the face of a fragmented legal world. The court said:

“[T]he Court anticipates that the current ruling may be a controversial one, especially due to the resulting conflict with the decisions of the English Courts. … … This is a situation that calls for the parties, this Court and the English Courts to work in a coordinated and cooperative way to identify means to reconcile the conflicting judgments. The Court directs that the parties attend a status conference to be held on the next available omnibus hearing date in the Debtor’s cases for purposes

53 Lordsvale Finance plc v Bank of Zambia [1996] 3 All ER 156. Similar sentiments have been known to exist in the United States as well: See AON Financial Products, Inc v Societe Generale 476 F 3d 90 (2nd Cir. 2007), above.

54 Citation.
of exploring means to harmonise the decisions of this Court and the English Courts.\textsuperscript{55}

It bears emphasis that the two conflicting UK and US court decisions that left the trustee caught in the middle of a Trans-Atlantic storm were based on different laws. The anti-deprivation principle in English law focuses on the deprivation of property while the US \textit{ipso facto} clause focuses on the modification of contractual relationships. The English insolvency regime is largely pro-creditor and ordinarily upholds commercial contracts while the Bankruptcy court in US applied a statute that is largely pro-debtor. The English decision was consistent with the ISDA Master Agreement and was therefore welcomed by many commercial parties, while the US decision caused consternation in some commercial quarters because it challenged widely held perceptions. It is thought unlikely that US principles would be applied in the UK.

It is not completely unknown that a court decision challenges the wisdom of established law and practice as contained in the documents generated in practice. Examples abound stretching back to the early days of the promissory note and the decisions of Chief Justice Holt.\textsuperscript{56} Legal practitioners know that there is always a risk that a document or provision may be declared as unenforceable by the courts. This is exactly what is known as documentation risk, which is part of legal risk that is the mainstay of a lawyer’s practice.\textsuperscript{57} Practitioners address legal risk in overseas jurisdictions by obtaining legal opinions and routinely advise clients that they cannot be absolutely sure what the courts will do in fact.

\textsuperscript{55} At page 423.

\textsuperscript{56} Footnote Holt CJ and promissory notes. More recent cases include \textit{British Eagle} and \textit{Hazell v Hammersmith}.

\textsuperscript{57} See Roger McCormack’s book on legal risk.
In the history of commercial practice every set back by the courts has provided an opportunity for further debate and led to further development of the law and practice. Standard form contracts are typically updated and new legal opinions issued following significant decisions. It is very clear, therefore, that the courts do influence practice greatly and any decision, however divergent, contributes to the development of the law. It is also clear that industry opinions and commercial practice do influence the law and in that regard there is a healthy symbiosis between the courts and legal practice.

The court decisions mentioned in this essay illustrate an important aspect of the development of commercial law in the present era. Many financial centres are contributing to the law because of the integration of the global financial market. The most complex transactions take place in Europe and particularly in London on the one hand, and the United States and particularly New York on the other hand. There are many nodes in the different geographical regions of the financial market but the current leadership of the law and transactions is a bipolar, trans-Atlantic, affair that is backed by English law and courts on the one hand, and New York law and courts on the other. In this light, the cooperation between the courts, practitioners and regulators in London and New York in important financial matters such as the interpretation of the ISDA Master Agreement is a service to the global financial industry.

58 More recent examples include the two Elliott Associates cases and Aon. Elliott Assocs, LP General Docket No 2000/R/92 (Court of Appeal of Brussels, 8th Chamber, 26 September 2000) reached an unusual interpretation of the pari passu clause and the court action was initiated in Brussels because it was clear that the New York courts would not agree to that interpretation. See also Elliott Assoc, LP v Banco de la Nacion 2000 WL 1449862 (SDNY, 29 September 2000). Following the unusual decision in Brussels, the LMA (industry group in Europe) initiated a discussion group to see the implication of the ‘new’ interpretation. See A Mugasha, The Law of Multi-bank Financing: Syndicated Loans and the Secondary Loan Market (Oxford University Press, 2007) at 234-234.

59 ISDA issued an opinion clarifying the law following Metavante.

60 See eg Enron Australia, above.
This trans-Atlantic cooperation may be one of the more visible legacies\textsuperscript{61} of the Lehman Brothers litigation and may turn out to be the model for future law-making because global transactions and legal fragmentation are here to stay.

**POSTSCRIPT**

There is ongoing vibrant activity inside and outside the courts regarding all the three key cases discussed in this essay. The *Metavante* decision was appealed to the United States District Court for the Southern District of New York and subsequently the Lehman Debtors sought court approval for a settlement deal with Metavante. It has been noted that if the settlement is approved, it would likely forestall a binding precedential judgment by the courts.\textsuperscript{62} An appeal from the English case of *Perpetual Trustee Company Ltd* is expected to be heard in the English Supreme Court during spring 2011. The same litigation in the US is subject to a couple of motions; first, by Lehman Brothers to buy the perpetual notes,\textsuperscript{63} and secondly, by the Trustee seeking declaratory judgment to resolve the impasse between the UK and US litigation. The judge who ordered the status conference recently “asked the parties to agree a date falling after 16 June 2010 on which to hold the hearing.”\textsuperscript{64} If Lehman

\textsuperscript{61} Another important legacy may emerge from the requirements of the rating agencies which are still developing their response to the US decision. Blamed for initial overreaction, they presently distinguish between US and non-US entities when they rate counterparties to swap contracts or securitisation structures. See Clifford Chance, *New Horizons: Legal and Structuring Developments for the new International Structured Debt Products* (London: June 2010) at 66-67.

\textsuperscript{62} Allen & Overy, “Lehman Moves for Bankruptcy Court Approval of Metavante Settlement” 26 March 2010. While the settlement would not be binding on other parties, it would provide guidance to those similarly situated in relation to the Lehman debtors.

\textsuperscript{63} This was the subject of a court order on 22 April 2010.

\textsuperscript{64} Clifford Chance, *New Horizons: Legal and Structuring Developments for the new International Structured Debt Products* (London: June 2010) at 65.
Brothers indeed purchases the Perpetual notes, the basis for the UK and US litigation will be removed and the resolution of the trans-Atlantic conflict in bankruptcy law may not take place.