UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

LEHMAN BROTHERS HOLDINGS INC., *et al.*	::	S.D.N.Y. Bankr.
Debtors.	::	Chapter 11 No. 08-13555 (JMP)
LEHMAN BROTHERS SPECIAL FINANCING INC.,	::	
Plaintiff,	::	M 47 (CM)
v.	::	S.D.N.Y. Bankr.
BNY CORPORATE TRUSTEE SERVICES LIMITED,	::	Adv. Pro. No. 09-01242 (JMP)
Defendant.	::	

BRIEF OF AMICUS CURIAE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION IN SUPPORT OF APPELLANT AND IN FAVOR OF REVERSAL

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rules of Appellate Procedure 26.1 and 29(c), amicus curiae the Securities Industry and Financial Markets Association hereby certifies that it is a non-profit corporation. It has no parent corporation and no publicly held corporation owns 10% or more of its stock.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

CASES

STATUTES

STATEMENT OF INTEREST[1]

The Securities Industry and Financial Markets Association ("SIFMA") brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association ("GFMA"). For more information, visit www.sifma.org.

This appeal presents questions of significance to SIFMA's members concerning the functioning of the derivatives markets. The validity and enforceability of priority of payment provisions governing swap termination payments are at issue in this appeal in the context of structured finance products that incorporate credit default swaps as part of the structure. These include synthetic collateralized debt obligations ("CDOs") and credit-linked note programs. The face amount of interests in synthetic CDOs alone issued in 2005-2007 was in the tens of billions of dollars annually.[2] As discussed below, moreover, the impact of the Bankruptcy Court's rulings are not limited to synthetic CDO and credit-linked note programs. To the contrary, those

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[1] While Second Circuit Rule 29.1(b) does not apply to proceedings in this Court, SIFMA states, consistent with that Rule, that no party's counsel authored this brief in whole or in part; that no party or party's counsel contributed money that was intended to fund preparing or submitting the brief; and that no person other than SIFMA, its members, and its counsel contributed money that was intended to fund preparing or submitting this brief.

[2] SIFMA, Global CDO Issuance, Oct. 1, 2010, www.sifma.org/uploadedFiles/Research/Statistics/SIFMA_GlobalCDOData.xls (last visited Oct. 29, 2010); *see also* Karen Brettell, *Lehman Win in CDO Case Could Spark Downgrades – Fitch*, Reuters, Aug. 14, 2009, www.reuters.com/article/idUSN1430383420090814 (last visited Oct. 29, 2010) ("[V]olumes of synthetic CDOs, pools of assets sliced into varying layers of risk, are estimated to be hundreds of billions of dollars globally.") (hereinafter, *Lehman Win Could Spark Downgrades*).

rulings also have implications for other derivatives transactions including currency swaps and interest rate swaps that are widely used as hedges for commercial and financial transactions.

Many of SIFMA's members – which included Lehman Brothers Holdings Inc. prior to its bankruptcy filing – are active participants in the derivatives and structured finance markets. SIFMA's members play a variety of roles in structured finance transactions. Some have sponsored and structured synthetic CDOs, credit-linked note programs and other structures impacted by the issues on this appeal, while others have invested in notes and other instruments issued by such vehicles. Thus, SIFMA's members do not have a uniform financial interest in the outcome of this appeal. Indeed, should they one day find themselves in bankruptcy proceedings, certain of SIFMA's members might well benefit from the rulings of the Bankruptcy Court that are the subject of this appeal. SIFMA nonetheless submits this brief as amicus curiae supporting the position of Appellant BNY Corporate Trustee Services Limited ("BNY") because the Bankruptcy Court's rulings are flatly inconsistent with how the market was expected to operate, and have created substantial uncertainty, all without any evident legal basis.

The Court granted SIFMA leave to file a brief as amicus curiae by "Memo Endorsed" Order dated October 20, 1010.

SUMMARY OF ARGUMENT

Both this Court and the Bankruptcy Court have recognized that the Bankruptcy Court's rulings upset market expectations. Not only were the priority of payment provisions at issue marketed by Lehman Brothers Special Financing Inc. ("LBSF") and its affiliates as an important feature of transactions such as those at issue here, but the credit ratings of the transactions depended upon this feature. The Bankruptcy Court turned market expectations on their head by refusing to enforce these provisions that LBSF and its affiliates included in the structure of these transactions – as they had to because the transactions could not have been marketed without these safeguards for investors. In so doing, the Bankruptcy Court deprived investors of the benefit of the protections against LBSF credit risk that they bargained for, and which the credit rating agencies relied upon in rating the notes. *See* Part I, *infra*.

The applicable Bankruptcy Code provisions do not provide any basis to upset these market expectations. To the contrary, Congress added Section 560 to the Bankruptcy Code for the very purpose of ensuring the smooth functioning of the derivatives markets in the event of the bankruptcy of a swap market participant. Not only do the Bankruptcy Court's rulings fly in the face of the statutory language and this clearly expressed legislative intent, but the Bankruptcy Court's "I know it when I see it" approach to determining which entities' bankruptcy filings may trigger the Bankruptcy Code's *ipso facto* prohibitions has created market uncertainty that goes far beyond the particular transactions at issue here – the very result that Congress sought to avoid.

ARGUMENT

I.

THE BANKRUPTCY COURT'S RULINGS UPSET MARKET EXPECTATIONS

LBSF and other Lehman entities were active participants in the synthetic CDO market. Business Wire, *Fitch Monitoring Potential Implications of Lehman Bankruptcy on Global Synthetic CDOs*, Sept. 16, 2008 (hereinafter, *Fitch Monitoring*).[3] For example:

> Lehman acted as swap counterparty in 69 Fitch-rated synthetic CDOs; 31 in Europe; 35 in Asia; three in the U.S. In many of these transactions, Lehman Brothers Special Financing Inc. acted

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[3] http://www.smartbrief.com/news/aaaa/industryBW-detail.jsp?id=493B9493-E3FB-4B69-BFB3-9AB1956F6C7D (last visited Oct. 29, 2010).

> as the buyer of credit protection from the CDO as CDS swap counterparty, and Lehman Brothers Holdings Inc. acted as a guarantor or credit support provider.

Id. As LBSF's counsel has confirmed, "[t]hese transactions . . . were . . . largely structured by [LBSF] and its affiliates…." Transcript of Hearing of Motion of Harrier Finance Limited, a.k.a Rathgar Capital Corporation, to Dismiss Adversary Proceeding at 22-23, *Lehman Bros. Special Fin., Inc. v. Harrier Fin. Ltd.* (Bankr. S.D.N.Y. Sept. 17, 2009) (Adv. Pro. No. 09-01241).

The contract term providing that noteholders would be paid before LBSF in the event that LBSF was the defaulting party was a feature that LBSF and its affiliates built into many – possibly all – of these transactions to meet the requirements of both investors and credit rating agencies. *See, e.g.*, *Fitch Monitoring* ("If an early termination is triggered where the swap counterparty is the defaulting party, the eligible securities are typically liquidated and used to repay the CDO notes before any swap termination payment is potentially due to [Lehman]."); *see also* Izabella Kaminska, *Europe's ABS Currency-Swap Exposure*, Financial Times, Feb. 15, 2010 ("[S]aid swap termination payment is commonly subordinated to note payments if the termination payment results from the bankruptcy of the swap counterparty.") (hereinafter, *Europe's ABS Currency-Swap Exposure*)[4]; Kingsley T.W. Ong, *The ISDA Master Agreement: Insolvency Stalemate and Endgame Solutions for Hong Kong Liquidators,* 40 Hong Kong L.J. 337, 351 n.60 (2010) (requirement to pay noteholders before paying a defaulting swap counterparty is "market-standard in the securitization and structured finance industry;" its "primary objective . . . is to disincentivise default by a swap counterparty and ensure that the

[4] http://ftalphaville.ft. com/blog/2010/02/15/149331/europes-abs-currency-swap-exposure (last visited Oct. 31, 2010).

defaulting swap counterparty does not benefit from its own default by continuing to be paid at a senior position in the waterfall.").

In the particular transactions at issue on this appeal, a bankruptcy-remote vehicle – Saphir Finance Public Limited Co. ("Saphir") – entered into credit default swaps ("CDS") with LBSF. Pursuant to the CDS, LBSF was required to make periodic payments (commonly referred to as "premiums") to Saphir. LBSF's promise to make periodic premium payments was guaranteed by a "credit support provider" – its corporate parent, Lehman Brothers Holdings Inc. ("LBHI"). Saphir, in exchange, agreed to make loss protection payments to LBSF upon the occurrence of certain events (and satisfaction of certain conditions) with respect to an underlying pool of "reference obligations." (Because these were "synthetic" transactions, Saphir was not required to actually hold the reference obligations.) A bankruptcy filing by either LBSF or LBHI constituted an event of default under the agreements governing the CDS.

Saphir sold notes to investors, and used the proceeds, among other things, to acquire a pool of collateral. The noteholders had a security interest in this collateral to secure the payment of principal and interest. LBSF, as swap counterparty, also had a security interest in this same pool of collateral to secure payments due it under the CDS. BNY held (and continues to hold) the collateral as secured party and trustee for the benefit of the noteholders and LBSF. BNY was to make payments from the collateral on behalf of Saphir, which pledged the collateral. LBSF asserts that it is entitled to priority payment from the collateral notwithstanding the provisions to the contrary of the security agreement that it and its affiliates drafted, while the noteholders, through BNY as trustee, seek payment in accordance with the provisions of the security agreement.

The agreed upon contractual term providing that noteholders would be paid first in the event of an LBSF default was an important feature of the transactions, and was highlighted in the offering documents prepared by LBSF and its affiliates. Series Prospectus, Saphir Finance Public Limited Company, Series No. 2006-5, at 20-21 (describing payment priorities in the event of an early redemption of the respective notes, with payments to noteholders to be net of "Unwind Costs" – including any swap termination payments due LBSF – *except* in the event of an LBSF default); Offering Circular Supplement, Saphir Finance Public Limited Company, Series No. 2004-11, at 15-16 (same). This provision is memorialized in a "Supplemental Trust Deed" in each of the transactions at issue. It was of particular significance to the ratings agencies assigning credit ratings to the notes.

Both Moody's Investors Service and Fitch Ratings specifically described priority of payment provisions like those at issue as an important element that they considered in rating structured finance transactions such as these that are exposed to "hedge counterparty risk." *See* Bill Harrington, Nicholas Lindstrom, & Edward Manchester, *Framework for De-Linking Hedge Counterparty Risks from Global Structured Finance Cashflow Transactions*, Moody's Investors Service, May 25, 2006, at 8 ("To ensure sufficient Counterparty risk de-linkage, [a termination payment to the swap counterparty] should only be made . . . once all amounts senior thereto in the respective priority of payments have been made, particularly when the Counterparty is the Defaulting Party . . . . See *Table 2B* for the priority in which termination payments to the Counterparty should be made."); *id.* at 16 (Table 2B, providing for swap counterparty to be paid after noteholders where the swap counterparty is the defaulting party) (copy attached as Exhibit A to the Compendium of Rating Agency Criteria submitted herewith); *see also* Dr. Stefan Bund, Alessandro Cipolla, Andre Dahlkamp, Euan Gatfield, Alex Kung, & Jennifer San Cartier, *Counterparty Risk in Structured Finance Transactions: Hedge Criteria*, Fitch Ratings, Aug. 1, 2007, at 12 ("One way to provide additional protection to the noteholders in the event of a default by the counterparty is to make any termination payments owed by the SPV to the counterparty subordinate to any payments of interest and/or principal and the topping up of any reserve fund in the Structured Finance transaction's priority of payments.") (copy attached as Exhibit B to the Compendium of Rating Agency Criteria submitted herewith); *see also* Michael Drexler & Katrien van Acoleyen, *CDO Spotlight: Counterparty Risk In Structured Finance Transactions*, Standard & Poor's, Mar. 7, 2005, at 1 ("[M]itigated credit risk" can be achieved "by structuring the transaction in such a way that it would terminate with no loss to investors if the counterparty did not comply with certain downgrade provisions.") (copy attached as Exhibit C to the Compendium of Rating Agency Criteria submitted herewith).

The reason for this credit ratings impact is straightforward. Absent a default by either party, the CDS typically would remain in existence for the term of the notes. Although limited loss protection payments may have become payable to LBSF depending on the performance of the "reference obligations" and certain other conditions, the mark-to-market amount of the entire CDS would become payable only upon the early termination of the CDS. *See, e.g., Europe's ABS Currency – Swap Exposure* ("Even though the swaps undergo mark-to-market gains and losses over the life of an ABS transaction, the fact that the notes are supposed to be hedged over the life of the transaction means gains and losses have no discernible 'real-world consequence' for noteholders."). If, however, the CDS counterparty or its credit support provider were to default, and the CDS were terminated earlier than anticipated as a result, then the termination payment amount would be valued as of the early termination date. If the swap happened to be "in the money" to the swap counterparty (here, LBSF) on that date, then the vehicle (here, Saphir) would be left with the Hobson's choice of leaving in place a swap with a bankrupt counterparty that presumably would be unable to meet its contractual obligation to make premium payments, or terminating and owing potentially very large sums to a counterparty that was not otherwise entitled to any payment at that time, and might never be.

The solution that the parties to these transactions agreed upon, and that the ratings agencies relied on, was that if LBSF defaulted, it would be paid after the noteholders. This was the way that LBSF and other sponsors structured and marketed these transactions, this was the way the market – including SIFMA's members – expected them to operate, and this was the way the rating agencies rated the notes.

As the Bankruptcy Court acknowledged, its rulings upset the expectations of those who had invested hundreds of billions of dollars in this market by invalidating the agreed upon priority of payment provisions, and thus literally upending the way these transactions were meant to operate in the event of an LBSF default:

> 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. The Court assumes that a bankruptcy affecting any of the Lehman entities was viewed as a highly remote contingency at the time that the Transaction Documents were being prepared. At that time, LBSF agreed to a subordination of its Swap Counterparty Priority in the hard-to-imagine event that it should be in default at some time in the future. Capital was committed with this concept embedded in the transaction.

In re Lehman Bros. Holdings Inc., 422 B.R. 407, 422 n. 9 (Bankr. S.D.N.Y. 2010) (hereinafter, *BNY I)*. As this Court observed in granting leave to appeal: "Judge Peck's interpretation of the Bankruptcy Code's *ipso facto* provisions has potentially far-reaching ramifications for the international securities markets, and has triggered significant uncertainty in the financial community." Decision and Order Granting BNY Corporate Trustee Services Limited's Motion for Leave to Appeal, dated September 20, 2010, at 16.

The result of this "Shot Heard Around the CDO World" is a massive redistribution of wealth from investors who bargained for payments in accordance with contractual priorities to the creditors of LBSF's bankruptcy estate:

> [U]nless the decision is overturned, Lehman Brothers Special Financing will likely receive a windfall of billions of dollars from various structured finance transactions contrary to the terms of the transactions and the intentions of the parties. Investors in highly rated structured notes who had not intended to take Lehman risk will suffer massive losses, and creditors of Lehman who did agree to take Lehman bankruptcy risk will instead be repaid.

James G. Rumball & Alana Hunt, *A New Threat for Structured Finance*: *Are Flip Clauses Enforceable?*, Passport for Business, Spring 2010, at 18; *see also* David B. Stratton & Michael J. Custer, *Shot Heard Around the CDO World: Flip Clauses Found To Be Unenforceable Ipso Facto Provisions*, 29 Am. Bankr. Inst. J. 30, 31 (2010) (observing that the Bankruptcy Court's rulings have created "significant uncertainty with respect to the enforceability in bankruptcy of flip clauses or similar market-standard subordination provisions in CDO transactions.").

Not surprisingly, "[t]he outcomes of the court cases in favor of Lehman will have clear rating implications for synthetic CDOs and other similar securitizations." *Lehman Win Could Spark Downgrades* (quoting Fitch press release); *see also id.* ("If Lehman ultimately succeeds in its claim, Fitch will cap its ratings of notes sold from CDOs backed by CDSs to the rating of the CDS counterparty, when the counterparty could be subject to U.S. bankruptcy proceedings, Fitch said."). This ratings impact is not limited, moreover, to synthetic CDOs, but "could have implications . . . for global structured finance transactions generally due to the widespread use of the subordination provisions within securitization structures . . . ." *Id.* This may include, for instance, transactions involving currency swaps and interest rate swaps that are widely used to hedge commercial and financial transactions. *Europe's ABS Currency-Swap Exposure*.

SIFMA is concerned about this disruption of the market and the concomitant losses to investors who will not receive what they bargained for if the Bankruptcy Court's rulings are permitted to stand. This result is particularly inappropriate because the Bankruptcy Court's rulings were legally unfounded, as discussed in Part II, *infra*.

II.

THE BANKRUPTCY COURT'S RULINGS HAD NO BASIS IN LAW

When it granted LBSF summary judgment, the Bankruptcy Court disregarded the plain meaning of the applicable Bankruptcy Code provisions and disregarded Congress' intent to facilitate the stable functioning of derivatives markets when a swap participant files for bankruptcy protection – *i.e.*, in precisely this situation. SIFMA believes that reversal is appropriate not only to remedy the Bankruptcy Court's incorrect legal rulings as they apply to this case, but to put an end to the market disruption and uncertainty occasioned by those rulings.

A. Congress Amended The Bankruptcy Code To Avoid Precisely The Type Of Market Disruption That The Bankruptcy Court Has Caused

Congress has added a number of provisions to the Bankruptcy Code over the past two decades to ensure that the derivatives markets continue functioning even in the event of the bankruptcy of a major market participant. It did so to avoid systemic risk to our nation's economy. The Bankruptcy Court's rulings fly in the face of both these statutory provisions and Congress's intent in enacting them.

Congress made its intent clear when it originally enacted Bankruptcy Code Section 560 in 1990:

> The effect of the swap provisions will be to provide certainty for swap transactions and thereby stabilize domestic markets by allowing the terms of the swap agreement to apply notwithstanding the bankruptcy filing. Parties to the swap agreement can close out all their transaction [sic] immediately and do not have to keep transactions open and unhedged during the bankruptcy proceedings.

136 Cong. Rec. S 7535 (daily ed. June 6, 1990) (Statement of Sen. DeConcini).

The House of Representatives Committee Report relating to the 1990 legislation further elaborated on these goals:

> U.S. bankruptcy law has long accorded special treatment to transactions involving financial markets, to minimize volatility. Because financial markets can change significantly in a matter of days, or even hours, a non-bankrupt party to ongoing securities and other financial transactions could face heavy losses unless *the transactions are resololved* [sic] *promptly and with finality.*

H.R. Rep. No. 101-484 at 2 (1990), *reprinted in* 1990 U.S.C.C.A.N. 223, 224 (emphasis supplied).

Then, in 1998, the President's Working Group on Financial Markets published recommendations to further the Congressional policies, which were explained in a statement by the United States Department of the Treasury as follows:

> The efficient operation of financial markets is extremely important to this country and our economy. It is the government's responsibility to make rules affecting these markets which serve to minimize systemic risk. Therefore, there is an overriding public policy interest in making limited exemptions to the normal treatment of creditors in bankruptcy proceedings in order to protect markets important to the operation of the economy as a whole.

Treasury Deputy Assistant Secretary for Federal Finance Roger L. Anderson Delivers Testimony to the Senate Judiciary Subcommittee on Administrative Oversight and the Courts, May 19, 1998, RR-2458.[5]

Congress amended Section 560 and other provisions of the Bankruptcy Code relating to derivatives transactions in 2005. In doing so, it reaffirmed its commitment to establishing safeguards against bankruptcy-driven disruptions of the derivatives markets to enhance economic stability:

> These provisions are intended to reduce "systemic risk" in the banking system and financial marketplace. To minimize the risk of disruption when parties to these transaction become bankrupt or insolvent, the bill amends provisions of the banking and investment laws, as well as the Bankruptcy Code, to allow the expeditious termination or netting of certain types of financial transactions. Many of these provisions are derived from recommendations issued by the President's Working Group on Financial Markets and revisions espoused by the financial industry.

H.R. Rep. No. 109-31, pt. 1, at 20 (2005), *reprinted in* 2005 U.S.C.C.A.N. at 105-06 (footnotes omitted.).

The result of the 1990 and 2005 Bankruptcy Code Amendments is a statutory scheme that: (1) permits swap participants to terminate and liquidate swap agreements according to their terms, notwithstanding the bankruptcy of a counterparty and notwithstanding any other provision of the Bankruptcy Code (Section 560); (2) permits swap participants to exercise their contractual rights under security agreements relating to swap agreements notwithstanding any "automatic stay" resulting from a bankruptcy of a counterparty (Section 362(b)(17)); and (3) prohibits the avoidance of transfers made in connection with a swap agreement (Section 546(g)).

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[5] http://www.treas.gov/press/releases/rr2458.htm (last visited Oct. 30, 2010).

Congress has also recognized the importance of keeping these provisions current with developments in the derivatives markets. For instance, the definition of "swap agreement" set forth in Section 101(53B) of the Bankruptcy Code includes agreements that are "similar to any other agreement or transaction referred to in this [definition] and that . . . is of a type that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap markets or other derivatives markets . . . ." Congress thus recognized that reducing systemic risk requires that new types of transactions used in financial markets, as well as more traditional transactions, be enforceable in accordance with their terms, notwithstanding bankruptcy.

Congress focused its attention not only on swaps, moreover, but also on other complex transactions that would pose risks to financial markets and the economy if bankruptcy laws were allowed to interfere with them. These include repurchase agreements (Sections 559, 101(47), 362(b)(7), 546(f)), securities contracts (Sections 555, 741(7), 362(b)(6), 546(e)), forward contracts (Sections 556, 101(25), 362(b)(6), 546(e)), commodities contracts (Sections 556, 761(4), 362(b)(6), 546(e)), and master netting agreements (Sections 561,101(38A), 362(b)(27), 546(j)). All of these provisions reflect a common theme: parties to financial transactions that, if disrupted, would pose systemic risk to the economy are permitted to enforce the terms of their contracts notwithstanding the bankruptcy of a counterparty.

The Bankruptcy Court's decision cannot be squared with the plain meaning of the statutory provisions enacted by Congress, and directly undermines Congress's intent that swap transactions be "resolved promptly and with finality" notwithstanding the bankruptcy of a counterparty. The Bankruptcy Court ruled that under some undefined circumstances, but not under other circumstances, the provisions drafted by LBSF and its affiliates that they used to market billions upon billions of dollars in notes are not enforceable. As a result, parties now have no way of knowing whether a swap termination is final, or if instead the termination will be undone by a court months or years later. Thus, terminations are no longer either prompt or final.

Both the words of Section 560 and the Congressional policy underlying it compel the conclusion that the noteholders are permitted to enforce the agreed upon priority of payment provisions. If, instead, the Bankruptcy Court's rulings are permitted to stand, they will create significant uncertainty for the financial markets by rewriting the terms of swap agreements contrary to the statutory language, Congressional intent and the intentions of the contracting parties.

B. The Parties' Agreement Regarding The Priority Of Payments Is Enforceable Pursuant To The Plain Meaning Of The Bankruptcy Code

Section 560 of the Bankruptcy Code provides that the contractual right to liquidate a swap agreement "shall not be stayed, avoided, or otherwise limited by operation of any provision" of the Bankruptcy Code. The plain meaning of this provision is that the terms of the Supplemental Trust Deeds relating to the priority and sources of termination payments under the swap agreements with LBSF are enforceable, even if they could otherwise be construed as prohibited *ipso facto* clauses (which they cannot for the reasons set forth in BNY's brief).

1. The Bankruptcy Code Defines "Swap Agreement" To Include Related Security Agreements Such As The Supplemental Trust Deeds

In rejecting BNY's argument that the "safe harbor" provisions of Section 560 apply here, the Bankruptcy Court recited that "the provisions of section 560 . . . refer specifically to 'swap agreements . . . ,'" which according to the Bankruptcy Court do not include the provisions of the Supplemental Trust Deeds. *BNY 1*, 422 B.R. at 421. BNY demonstrates that this analysis is based on an incorrect reading of the documents because the terms of the Supplemental Trust Deeds were in fact incorporated into the CDS documentation. (Appellant's Brief at 31-33.)

Even if this were not the case, the Bankruptcy Court's conclusion would nonetheless be incorrect because it disregards the Bankruptcy Code's definition of a "swap agreement."

Section 101(53B)(A)(vi) of the Bankruptcy Code defines "swap agreement" broadly to include "any security agreement or arrangement or other credit enhancement *related to* any agreements or transactions referred to" in the preceding provisions of the definition of "swap agreement." (emphasis added.) Thus, under the plain meaning of Section 101(53B), the Supplemental Trust Deeds – which are by definition security agreements that secured payment to LBSF under the swap agreements – constitute part of a "swap agreement."

The Supreme Court has repeatedly stated that the Bankruptcy Code is to be interpreted according to its plain meaning: "It is well established that 'when the statute's language is plain, the sole function of the courts – at least where the disposition required by the text is not absurd – is to enforce it according to its terms.'" *Lamie v. U.S. Trustee*, 540 U.S. 526, 534 (2004) (quoting *Hartford Underwriters Ins. Co. v. Union Planters Bank, N. A.*, 530 U.S. 1, 6 (2000)). The provisions of Section 101(53B) could hardly be clearer that security agreements *related to* swap agreements are included in the term "swap agreements." As the leading bankruptcy commentator has observed: "The *Lehman* decision [the decision that is the subject of this appeal] is questionable because the priority-shifting provisions were contained in the security arrangement for the subject swap agreement and, thus, were a swap agreement under Bankruptcy Code section 101(53B)(A)(vi)." 5 *Collier on Bankruptcy* ¶ 560.02 at 560-6 n. 2 (16th ed. 2010).

The inclusion of security agreements in the definition of "swap agreement" is not an accident. When Congress in 1990 added the provisions to the Bankruptcy Code that deal with the treatment of swap agreements, the definition of "swap agreement" did not expressly include security agreements. Pub. L. No. 101-311, § 101(2), 104 Stat. 267 (1990). Congress modified

Section 101(53B) as part of the 2005 amendments, however, to add a separate clause to the definition of "swap agreement" that expressly includes security agreements. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 907(a)(1)(E), 119 Stat. 23, 172-73 (2005). The legislative history confirms the obvious conclusion that Congress intentionally broadened the scope of this provision:

> The definition [of swap agreement] also includes any security agreement or arrangement, or other credit enhancement, related to a swap agreement, including any guarantee or reimbursement obligation related to a swap agreement. This ensures that any such agreement, arrangement or enhancement is itself deemed to be a swap agreement, and therefore eligible for treatment as such for purposes of termination, liquidation, acceleration, offset and netting under the Bankruptcy Code . . . .

H.R. Rep. No. 109-31, pt. 1, at 129 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 190.

The CDS and the Supplemental Trust Deeds together constitute a "swap agreement" under the Bankruptcy Code. The Bankruptcy Court's holding to the contrary ignores the plain meaning of the Bankruptcy Code and negates Congress's specific goal of ensuring the smooth functioning of derivatives markets in precisely this situation.

2. The Noteholders' Rights To Settlement And Payment Of Termination Amounts In Accordance With The Terms Of The Contract Are Expressly Preserved By Section 560 Of The Bankruptcy Code

Section 560 of the Bankruptcy Code provides in pertinent part:

> The exercise of any contractual right of any swap participant or financial participant to cause the liquidation, termination, or acceleration of one or more swap agreements because of a condition of the kind specified in section 365(e)(1) of this title . . . shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title.

This provision expressly permitted Saphir to terminate the swap agreement, and BNY as trustee, at the direction of the noteholders, to liquidate the parties' positions according to the terms of their agreement.

LBSF asserted in the Bankruptcy Court that Section 560 does not preserve the contractually agreed upon priority of payment provisions on the theory that "liquidation" means no more than "termination;" *i.e.*, that upon termination BNY could not make payments in accordance with the contractual priority of payments provisions. That is incorrect as a matter of both legislative history and plain English.

As originally enacted, Section 560 addressed only the "termination" of swap agreements. Pub. L. No. 101-311, § 106(a), 104 Stat. 267, 268 (1990). As part of the 2005 amendments, however, Congress revised Section 560 to also permit "liquidation" of swap agreements. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 907(j)(1), 907(o)(10), 119 Stat. 23, 178, 182 (2005). If "liquidation" means no more than "termination," this amendment was pointless. The Court should not, however, adopt a construction of a statute that renders meaningless words chosen by Congress. *TRW Inc. v. Andrews*, 534 U.S. 19, 31 (2001) ("It is a cardinal principle of statutory construction that a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant.") (internal quotation marks omitted). Indeed, Congress stated its intent for this amendment to "clarify that the provisions of the Bankruptcy Code that protect . . . rights to terminate under swap agreements also protect rights of liquidation and acceleration." H.R. Rep. No. 109-31 at 132, *reprinted in* 2005 U.S.C.C.A.N. at 193. Clearly, Congress intended "liquidation" to mean something more than "termination."

There is a plain meaning of "liquidate" that is consistent across legal dictionaries, financial dictionaries and general dictionaries. Black's Law Dictionary defines "liquidate" to mean "[t]o settle (an obligation) by payment or other adjustment; to extinguish (a debt)." *Black's Law Dictionary* 1014 (9th ed. 2009). As used in the financial community, "liquidate" means "[t]o discharge, to pay off, to convert into cash by selling." L. Davids, *Dictionary of Banking and Finance* 129 (1978). In general usage, "liquidate" means "to settle or pay (a debt): to liquidate a claim." *The Random House Dictionary of the English Language* 1121 (2d ed. unabridged 1987); *accord Merriam-Webster's Collegiate Dictionary* 726 (11th ed. 2004) ("to settle (a debt) by payment or other settlement").

The CDS and the Supplemental Trust Deeds set forth the agreements of Saphir, LBSF, the noteholders and BNY as trustee regarding the amount, priority, and source of the payments to be made to LBSF upon a termination of the CDS resulting from LBHI's bankruptcy. Specifying the amount, priority, and source of payments of a debt are part of the process of settling a debt and thus of "liquidating" the related agreement. Accordingly, the plain meaning of Section 560 is that the parties are entitled to enforce the contractual provisions regarding liquidation following termination of the CDS. LBSF is not entitled to rewrite or ignore these provisions.

3. The "*Ipso Facto*" Provisions Of Sections 365(e)(1) And 541(c)(1) Have No Applicability To Transactions Protected By Section 560

Section 560 of the Bankruptcy Code provides that the contractual right to liquidate a swap agreement "shall not be stayed, avoided, or otherwise limited by operation of any provision" of the Bankruptcy Code. The plain meaning of this provision is that the "*ipso facto*" provisions of Section 365(e)(1) and 541(c)(1) of the Bankruptcy Code do not trump the contractual rights of BNY to liquidate the swap agreement with LBSF pursuant to the terms of the parties' agreement.

Furthermore, Section 362(b)(17) of the Bankruptcy Code – which, as noted above, is part of a package of statutory provisions designed to ensure the stability of financial markets – provides that the automatic stay of Section 362(a) does not prohibit "the exercise by a swap participant or financial participant of *any contractual right* (as defined in section 560) *under any security agreement* or arrangement or other credit enhancement forming a part of or related to any swap agreement. . . ." (emphasis added) The Supplemental Trust Deeds are security agreements that form a part of, and relate to, swap agreements. Congress expressly stated in Section 362(b)(17) that bankruptcy would not limit the ability of swap participants to enforce *any* contractual right under a security agreement relating to a swap agreement. Similarly, Section 362(o) provides that "[t]he exercise of rights not subject to the stay . . . pursuant to paragraph . . . (17) . . . shall not be stayed by any order of a court . . . ." The Bankruptcy Court's order holding that Sections 365(e)(1)(B) and 541(c)(1)(B) prohibit BNY from enforcing the provisions of the Supplemental Trust Deeds relating to termination payments under swap agreements cannot be harmonized with Sections 560, 362(b)(17) and 362(o).

C. Contract Rights Triggered By LBHI's Bankruptcy Filing Could Not Violate The Bankruptcy Code's *Ipso Facto* Prohibitions

Even if Sections 560 and 362(b)(17) did not expressly authorize the enforcement of the parties' agreement regarding swap termination payments, the Bankruptcy Court's ruling would nonetheless be incorrect. To reach its conclusion, the Bankruptcy Court determined that the *ipso facto* prohibitions of Sections 365(e)(1)(B) and 541(c)(1)(B) were triggered by the bankruptcy filing of LBSF's corporate parent LBHI – and potentially could also be triggered by those of an undefined, and by the Bankruptcy Court's own reasoning, indefinable class of additional third parties. The Bankruptcy Court's "unprecedented," "I know it when I see it" approach to the Bankruptcy Code leaves market participants with no way of determining when the *ipso facto* prohibitions may again be brought into play in connection with the termination of derivatives or other financial markets contracts at a cost of tens or hundreds of billions of dollars.

The Bankruptcy Court explained its conclusion that LBSF was entitled to invoke Sections 365(e)(1)(B) and 541(c)(1)(B) to invalidate the swap termination provisions in the Supplemental Trust Deeds even if the priority of payment provisions were triggered by the bankruptcy of LBHI – which occurred weeks before LBSF itself sought bankruptcy relief – by stating that Sections 365(e)(1)(B) and 541(c)(1)(B) "prohibit[] modification of a debtor's right solely because of a provision in an agreement conditioned upon 'the commencement of a *case* under this title.' . . . Notably, the language used is not limited to the commencement of a case *by or against the debtor*." *BNY I*, 422 B.R. at 419. It also acknowledged, however, that no other court has ever held that Sections 365(e)(1)(B) and 541(c)(1)(B) prohibit the enforceability of contract provisions that refer to the bankruptcy of a non-party to the contract. 422 B.R. at 422.

In its Decision and Order Granting BNY Corporate Trustee Services Limited's Motion for Leave to Appeal, this Court noted certain decisions of other courts that reflect that the *ipso facto* prohibitions apply only to contract termination or modifications resulting from a bankruptcy filing by a party to the contract. A number of additional court decisions are based on the same premise. *E.g.*, *Lyons Savings & Loan Ass*ociation *v. Westside Bancorporation, Inc.*, 828 F.2d 387, 393 n.6 (7th Cir. 1987) ("Section 365(e) of the Bankruptcy Code invalidates *ipso facto* or bankruptcy termination clauses which permit one contracting party to terminate or even modify an executory contract or unexpired lease in the event of the bankruptcy *of the other contracting party*.") (emphasis added); *In re Cole*, 226 B.R. 647, 652 (9th Cir. BAP 1998) ("An ipso facto clause is a provision in an executory contract . . . that results in a breach solely due to the financial condition or the bankruptcy filing *of a party*") (emphasis added); *In re IT Group,* *Inc., Co.*, 302 B.R. 483, 488 (D. Del. 2003) (right of first refusal is not an *ipso facto* clause because "the right of first refusal is triggered by any transfer . . . and not by a member filing for bankruptcy"); *I.T.T. Small Business Finance Corp. v. Frederique*, 82 B.R. 4, 6 (E.D.N.Y. 1987) ("An 'ipso facto' or 'bankruptcy clause' is a contractual provision which expressly states that *upon a borrower's filing of a bankruptcy petition*, the creditor may accelerate payment....") (emphasis added); *In re Sapolin Paints, Inc.*, 5 B.R. 412, 417 (Bkrtcy. E.D.N.Y. 1980) (addressing enforceability of "bankruptcy clauses, i.e., a clause in a lease which permits its termination on resort *by the lessee* to the protection of the bankruptcy laws") (emphasis added). *See also* 1 D. Epstein, S. Nickles, & J. White, *Bankruptcy* § 5-12 at 467-68 (1992) ("The term '*ipso facto*' was used to refer to those clauses that provided that the contract or lease terminated instantly, or '*ipso facto*' upon the filing of a bankruptcy petition *by one of the parties*.") (emphasis added). There is, in contrast, no policy, rationale or logical justification for the Bankruptcy Court's unprecedented expansion of the *ipso facto* provisions.

1. The Policy Behind Sections 365(e)(1)(B) And 541(c)(1)(B) Supports The Conclusion That The Statutes Are Limited To The Bankruptcy Of A Contracting Party

Limiting Sections 365(e)(1)(B) and 541(c)(1)(B) to contract clauses that relate to the bankruptcy of a contracting party is consistent with the purposes of the statute. One commentator has expressed the policy behind Section 365(e)(1) as follows: "If those types of provisions were enforceable, then a debtor-in-possession would forfeit valuable contract rights by applying for reorganization under the Bankruptcy Code." M. Bienenstock, *Bankruptcy Reorganization* 460 (1987) (footnote omitted). Here, LBSF did not forfeit contract rights by applying for reorganization. While there may be an adverse effect on LBSF as a result of the termination of the swap agreements, that effect – even if it could be characterized as a forfeiture of contract rights, which it is not – did not occur as a result of LBSF filing for bankruptcy. Rather, it occurred because a third party – LBHI – filed for bankruptcy. The payment provisions at issue do not discourage LBSF from filing for bankruptcy: the treatment of LBSF under the payment provisions is identical whether or not LBSF files for bankruptcy. Refusing to enforce these payment provisions under these circumstances thus will not further the goals of the Bankruptcy Code.

2. **The Bankruptcy Court's Decision Yet Again Creates Uncertainty**

As the Bankruptcy Court acknowledged: "Opening up the subject to cases filed by debtors other than the counterparty itself has the potential of opening up a proverbial 'can of worms' . . . ." *BNY I*, 422 B.R. at 419. While the Bankruptcy Court theorized that not every third-party bankruptcy filing would trigger the *ipso facto* prohibitions, it offered no meaningful guidance as to where the line should be drawn. This reasoning provides cold comfort to market participants attempting to evaluate their exposure to swap counterparties and their guarantors. Indeed, this is no more than Justice Potter Stewart's famous test: "I know it when I see it." (*Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964) (Stewart, J. concurring)).

CONCLUSION

The Bankruptcy Court's rulings not only upset market expectations, but they did so in a way that provides market participants with no way to gauge their exposure. The Court should not permit these rulings, which lack any legal basis, to stand.

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