



LEARNING CURVE®

Flip Flop On Flip Clauses Continues

Introduction

Lehman Brothers Special Financing Inc.'s pending appeal against the judgments of the U.K. High Court and the Court of Appeal in the so-called "flip clause cases," concerning the enforceability of flip clauses, is scheduled to be begin with **Belmont Park Investments Pty Limited** (*Belmont Park Investments Pty Limited v BNY Corporate Trustee Services Limited and Lehman Brothers Special Financing Inc (UKSC 2009/0222)*) on March 1, 2011. The case is being closely watched by market participants interested to know whether the U.K. Supreme Court will resolve or confirm the apparent disparity between English and U.S. law regarding the enforceability of such clauses.

Flip clauses provide that payment obligations owed to different creditors "flip" in priority following an event of default. They have been routinely used in securitisation and structured finance transactions to mitigate the practical effect on cash-flows of a default by a swap counterparty and are an accepted commercial term underlying the cash-flow modeling and rating of securities.

These cases have created a great deal of uncertainty in relation to priority of claims involving asset-backed and credit-linked securities using derivatives and could have potentially wide-ranging implications on existing and future transactions worth trillions of dollars.

This Learning Curve will look at the practical impact of the cases and the options available to mitigate their effect.

Conflicting rulings

On January 25, 2010, Judge **James Peck** of the US Bankruptcy Court ruled that a flip clause was an unenforceable *ipso facto* provision on the grounds that it was triggered by the bankruptcy of LBSF and did not fall within the safe harbour protections of the US Bankruptcy Code.

Judge Peck's decision directly contradicted the decisions of

the English courts in parallel proceedings which held that the flip clause did not violate the anti-deprivation principle and was therefore enforceable under English law.

In the ordinary course, any amounts payable to the swap counterparty under the swap will generally be paid in priority to any amounts payable to securities-holders.

An early termination of the swap may be triggered if the swap counterparty is in default (including bankruptcy) and, if the swap is in-the-money from the swap counterparty's perspective, a termination payment may be payable by the securities issuer to the swap counterparty. To the extent that such payment is material, the issuer may have insufficient funds to service the securities causing an event of default.

The flip clause is intended to mitigate the impact of the counterparty default by reversing the priority of payments so that any termination payment due to the swap counterparty is only payable after the securities-holders have been paid.

Market impact

The potential unenforceability and apparent disparity between English and U.S. law has created considerable uncertainty. The leading rating agencies have threatened to cap the ratings of securities at the rating of the swap counterparty if it may be subject to U.S. bankruptcy proceedings.

According to **Fitch Ratings**¹, the impact of Judge Peck's decision on existing structured finance ratings could be "wide ranging" globally and European structured finance transactions may be most impacted "given the prevalence of derivatives to hedge interest rate and foreign exchange risk."

Implications for legacy and future transactions

A significant segment of market participants had expected Judge Peck's decision to be overturned on appeal but a settlement between the parties to the U.S. proceedings was approved by the U.S. Bankruptcy Court on December 15, 2010 which

resolved the U.S. and English litigation between those parties.

The apparent disparity between U.S. and English law therefore persists for the time being and may not be resolved until further cases are heard on this matter, including the *Belmont Park* case on March 1.

It is also possible that the question will be revisited before the US courts because there remain a large number of unresolved claims in relation to the flip clause in respect of other notes issued under the Dante Programme.

Arrangers of securities need to consider the flip clause uncertainty now. Set out below are some structuring options:

1. Location of swap counterparty

For so long as the apparent disparity between U.S. and English law continues, securitisation arrangers may prefer English law as the governing law and, where possible, may prefer to avoid direct contracts with swap counterparties that may be subject to U.S. bankruptcy law. For legacy securities, arrangers may seek to novate swaps to non-U.S. swap counterparties. However, it may be difficult to achieve this and there are some legal uncertainties for international financial institutions with links to the U.S.

More broadly, Judge Peck's judgment has highlighted that mandatory bankruptcy law provisions of any counterparty jurisdiction may need to be considered for any securities issuance (whether U.S. or non-U.S.).

2. Legal opinions

For future transactions involving non-English swap counterparties, securitisation arrangers and the rating agencies rating the securities may require a legal analysis or even a formal legal opinion regarding the enforceability of flip clauses under the laws of the swap counterparty jurisdiction (traditionally, the English law enforceability opinions delivered for securities issuances are qualified by the local law of the transaction parties and by provisions of bankruptcy and insolvency laws). This may have timing and costs implications when arranging transactions and should be discussed with counsel at the outset.

3. Replacement of swap counterparty following default

For future transactions, rather than including a flip clause, it may be possible to mitigate the effect of a swap counterparty default on securities-holders' cash-flows by including a mechanism whereby an "early warning" trigger (such as a ratings downgrade) or event of default in relation to the swap counterparty automatically triggers an obligation on the swap counterparty to novate the swap to a swap counterparty with the requisite rating and/or which may not be subject to U.S. bankruptcy law.

Such a mechanism is already suggested by **Standard &**

Poor's new "Criteria for Swap Counterparties in Structured Finance Transactions" which states that the downgrade of a swap counterparty's S&P credit rating below a certain threshold should trigger remedies including its replacement by another swap counterparty meeting certain specifications and with a credit rating above the requisite threshold. If such a provision is not included in the securities documents, then the rating of the relevant securities will generally be limited by the rating of the swap counterparty.

In designating a replacement mechanic, parties structuring a new securities transaction will have to consider the practicalities in relation to appointing a replacement swap counterparty (e.g., time frame and cost).

4. Safe harbours

Judge Peck concluded that since the relevant flip clause was not part of the swap agreement itself, it did not fall within the safe harbours to the *ipso facto* prohibition relating to swap agreements.

Arrangers should consider consulting with their lawyers as to whether it is possible to structure and draft the securities documents in order to fall within such safe harbours by including a flip clause or an equivalent mechanism in the swap agreement itself.

5. Elimination or reversal of flip clauses

Market participants may consider other alternative methods to protect cash-flows following the bankruptcy of a swap counterparty. One possibility would be for securities-holders to be paid ahead of the swap counterparty in the ordinary course priority of payments with no flip clause, or with the priority being reversed only if the swap is terminated as a result of an event of default which is not bankruptcy and has not been caused by the swap counterparty. However, these commercial terms and cash-flows would need to be considered and agreed on a case-by-case basis.

Conclusion

The decision of the U.K. Supreme Court in relation to LBSF's pending appeal will be informative. However, given the new rating agency criteria and pending ratings actions and the legal uncertainty due to the appeals process, market participants are and should be considering with their lawyers how to deal with flip clauses and counterparty risk now.

This Learning Curve was written by Elana Hahn, partner at Morrison & Foerster in London.

¹ Quoted in Reuters article "Lehman rulings may impact global structured finance", 29 January 2010.



Elana Hahn