The process whereby U.S. courts recognize and enforce the judicial determinations and proceedings of courts abroad (commonly referred to as “comity”) has been an integral part of U.S. jurisprudence for hundreds of years. Comity plays an important role in cross-border bankruptcy cases involving debtors that are subject to bankruptcy or insolvency proceedings outside the U.S. but have creditors or assets in the U.S. Comity is among the fundamental principles underpinning chapter 15 of the Bankruptcy Code, as well as provisions in U.S. bankruptcy law governing cross-border cases that preceded chapter 15’s enactment in 2005.

The extent to which U.S. and foreign bankruptcy laws are inconsistent is an important component in a U.S. court’s determination of whether a foreign court’s decrees should be enforced in the U.S. under principles of comity. Conflicts of law in the realm of cross-border bankruptcy cases were the subject of two rulings handed down by New York bankruptcy courts in early 2010. In In re Metcalfe & Mansfield Alternative Investments, bankruptcy judge Martin Glenn, by way of “additional assistance” in a chapter 15 case involving a Canadian debtor, enforced a Canadian court’s order confirming a restructuring plan that contained nondebtor releases and injunctions, even though it was uncertain whether a U.S. court would have approved the releases and injunctions in a case under chapter 7 or 11 of the Bankruptcy Code. In In re Lehman Brothers Holdings, Inc., bankruptcy judge James M. Peck refused to recognize rulings by U.K. courts that validated a “flip clause” in a swap agreement that shifted the priority of claims between a noteholder and its swap counterparty, a Lehman Brothers affiliate, due to the U.S. bankruptcy filing of the parent company. Even though the priority shift was valid under
U.K. law, the court declined to recognize the rulings notwithstanding principles of comity, because it concluded that the flip clause, a common risk-mitigation technique in swap transactions, was an ipso facto clause unenforceable under U.S. law. These rulings indicate that comity continues to be a significant consideration in cross-border bankruptcy cases involving the conflicting laws of different nations, both within and outside chapter 15. In Part I of this article, which appeared in the March/April 2010 edition of the Business Restructuring Review (Vol. 9, No. 2), we addressed the court’s ruling in Metcalfe & Mansfield. Part II discusses the bankruptcy court’s decision in Lehman Brothers.

Comity

As noted, U.S. courts apply general principles of comity in determining whether to recognize and enforce foreign judgments. In its 1895 ruling in Hilton v. Guyot, the U.S. Supreme Court held that a U.S. court should enforce the judgment and that the issue should not be “tried afresh” if a foreign forum provides

a full and fair trial abroad before a court of competent jurisdiction, conducting the trial upon regular proceedings, after due citation or voluntary appearance of the defendant, and under a system of jurisprudence likely to secure an impartial administration of justice between the citizens of its own country and those of other countries, and there is nothing to show either prejudice in the court, or in the system of laws under which it was sitting.

Comity has long been an important consideration in cross-border bankruptcy and insolvency cases. Prior to the enactment of chapter 15 in 2005, section 304 of the Bankruptcy Code governed proceedings commenced by the accredited representatives of foreign debtors in the U.S. that were “ancillary” to bankruptcy or insolvency cases filed abroad. Ancillary proceedings were typically commenced under section 304 for the limited purpose of protecting a foreign debtor’s U.S. assets from creditor collection efforts by means of injunctive relief granted by a U.S.
bankruptcy court and, in some cases, for the purpose of repatriating such assets or their proceeds abroad for administration in the debtor’s foreign bankruptcy case. In deciding whether to grant injunctive, turnover, or other appropriate relief under former section 304, a U.S. bankruptcy court was obliged to consider “what will best assure an economical and expeditious administration” of the foreign debtor’s estate, consistent with a number of factors, including comity.

Comity continues to play a prominent role in chapter 15, which is patterned on the Model Law on Cross-Border Insolvency. The Model Law is a framework of legal principles formulated by the United Nations Commission on International Trade Law in 1997 to deal with the rapidly expanding volume of international insolvency cases. To date, it has been adopted in 18 nations or territories. The stated purpose of chapter 15 is “to incorporate the Model Law on Cross-Border Insolvency so as to provide effective mechanisms for dealing with cases of cross-border insolvency” consistent with objectives that include cooperation between U.S. and non-U.S. courts and related functionaries.

To effectuate that goal, if a U.S. court “recognizes” a foreign “main” or “nonmain” proceeding under chapter 15, it is authorized under section 1507 to provide “additional assistance” to a foreign representative. This can include injunctive relief or authority to distribute the proceeds of all or part of the debtor’s U.S. assets, provided the court concludes, “consistent with the principles of comity,” that such assistance will reasonably ensure, among other things, the just treatment of creditors and other stakeholders, the protection of U.S. creditors against prejudice in pursuing their claims in the foreign proceeding, and the prevention of fraudulent or preferential
disposition of property. In addition, if the bankruptcy court enters an order of recognition under chapter 15, section 1509 provides that any other U.S. court “shall grant comity or cooperation to the foreign representative.”

Applying principles of comity to strike a fair balance between the competing interests of creditors under conflicting laws is a difficult undertaking. The bankruptcy court in Lehman Brothers was recently called upon to do so.

**Lehman Brothers**

In one of the myriad legal disputes arising from the mammoth bankruptcy of investment bank holding company Lehman Brothers Holdings, Inc. (“LBHI”), a New York bankruptcy court refused to grant comity to the English courts concerning the interpretation of a contract that contained an English choice-of-law provision. One of LBHI’s subsidiaries, Lehman Brothers Special Financing, Inc. (“LBSF”), had entered into certain swap agreements with various special-purpose entities (the “SPEs”), which had in turn issued credit-linked notes to various noteholders. After LBHI filed for chapter 11 protection in September 2009, two English courts ruled that a provision in related transaction documents that altered the priority of payments from the SPEs to favor noteholders over LBSF, effective upon LBHI’s bankruptcy filing, was valid and enforceable under English law. The English courts did not address whether the “flip clauses” were valid and enforceable under U.S. law. U.S. bankruptcy judge James M. Peck refused to enforce the rulings notwithstanding principles of comity, concluding, among other things, that the priority shift triggered by parent company LBHI’s chapter 11 filing was an unenforceable *ipso facto* clause under U.S. law.
The Transactions

The relevant transactions, known as the “Dante Program,” provided for the creation of synthetic interests in certain reference entities through the creation of credit-linked notes. All of the relevant agreements contained choice-of-law provisions that they were to be governed by English law. The SPEs issued the notes, using the proceeds to buy certain highly rated collateral (the “Collateral”). The Collateral was then transferred to a trustee, the Bank of New York (“BNY”). On the other side of the transaction, LBSF entered into swap agreements with the SPEs, such that LBSF was obligated to remit to BNY periodic payments that would be used, along with the returns from the Collateral, to fund distributions on the notes.

Both LBSF’s payment obligations under the swap agreements and noteholder distributions were affected by the occurrence or nonoccurrence of certain credit events with respect to the reference entities, with the purpose that a default by any of the reference entities would decrease the amount owed by LBSF and the amount distributed on account of the notes. Thus, the risk of default by the reference entities was borne by the noteholders, not LBSF. In addition, defaults by reference entities entitled LBSF to certain payments to be funded by liquidation of the Collateral.

Rights to proceeds from the Collateral were specified in detail in the Principal Trust Deed and the Supplemental Trust Deed (collectively, the “Trust Deeds”), which initially conferred the highest priority of payment for obligations owed to LBSF, so that LBSF would recover proceeds due to defaults by reference entities before the noteholders would receive the proceeds from any excess Collateral. However, under certain circumstances, including a bankruptcy filing by LBSF or LBHI, or nonpayment by LBSF of any amounts due under the swap agreements, the Trust
Deeds provided for a change in payment priority, such that the noteholders would receive payment from the proceeds of the Collateral prior to LBSF.

The Lehman Bankruptcy Filings

LBHI filed for chapter 11 protection in New York on September 15, 2008. Shortly thereafter, LBSF ceased making payments under any of the relevant swap agreements. On October 3, 2008, LBSF filed for bankruptcy protection in the same court. At the time, due to defaults by various reference entities, LBSF was owed substantial sums under the relevant swap agreements.

The U.K. Litigation

Two noteholders filed litigation in English court against BNY seeking a judgment that, due to the bankruptcy filing by LBHI and nonpayment under the swap agreements by LBSF, the noteholders had priority of distribution of the Collateral proceeds pursuant to the Trust Deeds. LBSF intervened in the English proceeding and counterclaimed for a stay of the litigation. As a defense to the noteholders’ claim that they had priority of distribution under the Trust Deeds, LBSF raised the “anti-deprivation principle,” a doctrine of English insolvency law akin to the prohibition on enforcement of ipso facto clauses under U.S. bankruptcy law.

The High Court of Justice, Chancery Division, ruled in favor of the noteholders. It found that LBHI was a “credit support provider” under the agreements and that the bankruptcy filing of such an entity constituted an event of default under the Trust Deeds. The court concluded that the anti-deprivation principle did not apply in the case before it, ruling that the priority of payment shifted from LBSF to the noteholders as of September 15, 2008, when LBHI filed for bankruptcy protection. In addition, the English court held, an “early termination payment” provided for in
the notes calculated in favor of LBSF would be subordinated to noteholder distributions. The court then adjourned further proceedings on the matter to allow the parties time to confer and to allow cooperation between the U.S. bankruptcy court and the English courts with respect to the matter. LBSF appealed the ruling to the English Court of Appeal, which affirmed the decision below on November 6, 2009.

The U.S. Bankruptcy Court’s Decision

LBSF commenced an adversary proceeding in the U.S. bankruptcy court seeking a declaratory judgment that the change in payment priority under the Trust Deeds in favor of the noteholders was an unenforceable *ipso facto* clause under sections 365(e)(1) and 541(c)(1)(B) of the Bankruptcy Code. LBSF also sought a declaratory judgment that any action undertaken to alter payment priority under the Trust Deeds violated the automatic stay. LBSF sought summary judgment on both claims.

After determining that all of the agreements in question were executory contracts, the court considered whether the point at which the payment priorities shifted in favor of the noteholders was the date LBHI filed for bankruptcy or some time afterward. The court acknowledged that the English courts had construed the relevant documents to effectuate the shift as of LBHI’s petition date. However, the bankruptcy court declined to defer to this determination, explaining that it is “not obliged to recognize a judgment rendered by a foreign court, but instead may choose to give *res judicata* effect on the basis of comity.”

Comity is generally not extended to foreign proceedings, the court emphasized, “when doing so would be contrary to the policies or prejudicial to the interests of the United States.”
Judge Peck wrote, “has a strong interest in having a United States bankruptcy court resolve
issues of bankruptcy law, particularly . . . where the relevant provisions of the Bankruptcy Code
provide far greater protections than are available under applicable provisions of foreign law.”

The bankruptcy court construed the relevant agreements to require “certain affirmative acts to be
taken prior to the effectiveness of any modification of payment priority or method of calculation
of the Early Termination Payment.” Among other things, these acts included payment of
amounts due under the Trust Deeds “in connection with the realisation or enforcement of the
[Collateral],” as a condition precedent to the priority shift. In fact, the court noted, many of the
actions required to effectuate the priority shift either occurred after LBSF filed for bankruptcy
protection or had not yet occurred. As such, the court concluded that there was no automatic
shifting of payment priorities under the agreements and, further, that “the relevant date for
purposes of testing whether any shifting of priorities occurred under the Transaction Documents
is the LBSF Petition Date.” According to the court, “LBSF held a valuable property interest in
the Transaction Documents as of the LBSF Petition Date and, therefore, such interest is entitled
to protection as part of the bankruptcy estate.”

However, the court further held that if the “relevant date” was instead the LBHI petition date, the
prohibition on enforcement of ipso facto clauses in sections 365(e)(1) and 541(c)(1)(B) would
nonetheless invalidate any shifting in payment priorities. According to the court, in prohibiting
modification of a debtor’s rights solely because of a provision in an agreement conditioned upon
“the commencement of a case under this title,” the language of sections 365(e)(1) and
541(c)(1)(B) “is not limited to the commencement of a case by or against the debtor” (emphasis
added. Such limiting language, the court explained, was considered but rejected by lawmakers when they enacted the provisions. The absence of “precise limiting language,” the court reasoned, leaves open the possibility that the provisions can be read to invalidate ipso facto clauses that are triggered by a bankruptcy filing by or against an entity other than the debtor that is party to the contract. The court recognized that attempting to define the kinds of relationships that would qualify for extended ipso facto protection is akin to opening the proverbial can of worms:

The Court recognizes the potential for future disputes over the interpretation of this language but declines here to make any broad pronouncements, interpret the language in the abstract or to expand on the various relationships between or among debtor entities that would make it appropriate for one debtor to invoke ipso facto protection due to the filing of another affiliated member of a corporate family. The description of the kind of relationship that is sufficient to trigger such protections affecting the rights of contracting parties is best left to a case-by-case determination. With this principle of restraint in mind, the Court will apply the language of these sections of the Bankruptcy Code to the situation presented by the sequential filings of the LBHI and LBSF bankruptcy cases and confine its conclusions to the Debtors’ business structure and circumstances.

Explaining that LBHI, LBSF, and their debtor affiliates “are perhaps the most complex and multi-faceted business ventures ever to seek the protection of chapter 11,” the bankruptcy court emphasized that their various corporate entities comprise an “integrated enterprise” and, as a general matter, “the financial condition of one affiliate affects the others.” The closeness of these relationships, the court emphasized, warranted extending the ipso facto protections triggered by the parent company’s bankruptcy filing to its affiliates, even though they did not seek chapter 11 protection until some time later:

Under these circumstances, the first filing at the holding company level of the corporate structure has significance, especially in the context of the ipso facto provisions that speak in terms of the commencement of “a” case under this title. Regardless of how this language may be interpreted in other settings, the Court is convinced that the chapter 11 cases of LBHI and its affiliates is a
singular event for purposes of interpreting this *ipso facto* language. Nothing in this decision is intended to impact issues of substantive consolidation, the importance of each of the separate petition dates for purposes of allowing claims against each of the debtors or any other legal determination that may relate to the date of commencement of a case. However, for purposes of applying the *ipso facto* provisions of 365(e)(1) and 541(c)(1)(B), what happened on September 15, 2008 was a bankruptcy filing that precipitated subsequent related events. LBHI commenced a case that entitled LBSF, consistent with the statutory language, fairly read, to claim the protections of the *ipso facto* provisions of the Bankruptcy Code because its ultimate corporate parent and credit support provider, at a time of extraordinary panic in the global markets, had filed a case under the Bankruptcy Code.

The bankruptcy court also ruled that the priority-shift provision was not saved by the “safe harbor” in section 560 of the Bankruptcy Code for swap agreements, because the provisions were clearly not part of (or even referred to in) the swap agreements between LBSF and the SPEs, and the provisions did not relate to “the liquidation, termination, or acceleration” of a swap agreement. Finally, the court rejected BNY’s argument that the priority-shift provision was nothing more than a subordination agreement that would be enforceable under applicable nonbankruptcy law, observing that “BNY cannot overcome the shifting nature of the subordination that is being activated by reason of a bankruptcy filing.”

**Outlook**

*Metcalf & Mansfield* and *Lehman Brothers* are interesting case studies on comity in cross-border bankruptcy cases involving significant differences in law among nations that are otherwise generally perceived as having a common legal heritage. Where such conflicts of law are manifest, the U.S. bankruptcy court is obligated to balance the strong interests in applying local law to a given dispute against the important international principle of deference to the duly sanctioned resolutions of foreign states and their judicial institutions.
The fact that the bankruptcy courts in *Metcalfe & Mansfield* and *Lehman Brothers* reached different conclusions is a testament to the difficulty of striking the proper balance under the circumstances of any given case. In *Lehman Brothers*, Judge Peck respectfully declined to defer to the English courts because deference would have had ramifications that were diametrically opposed to important provisions in U.S. bankruptcy law designed to prevent forfeiture of a debtor’s rights. Judge Glenn reached a different conclusion in *Metcalfe & Mansfield*. Given the present state of uncertainty in U.S. law concerning the circumstances under which third-party releases and injunctions are valid and enforceable on jurisdictional grounds, Judge Glenn’s decision to enforce the Canadian courts’ orders is not surprising.

Finally, the U.S. bankruptcy-law implications of *Lehman Brothers* beyond the ruling’s application of principles of comity will doubtless be fodder for discussion and dispute for some time.

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