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## DUELLING DECISIONS: AN OCEAN APART

In order for a rating agency to provide timely advice and analysis to the marketplace, it must cast its gaze on both the forest and the trees. At a micro level, analysts become intimately familiar with the financial information and business profiles of companies and credits that they rate. However, in order to provide useful insight, rating agencies must be able to step back from the nuances of particular credits and companies to take in the entire environment. It is important for rating agencies to be in tune with economic developments and to understand the ever-changing nature of the global economy. Legal developments must also be monitored for their potential impact on DBRS-rated securities and their issuers. One recent legal development has the potential to seriously and negatively impact certain DBRS ratings.

The bankruptcy of Lehman Brothers Holdings Inc. (Lehman Brothers) in September 2008 shook the financial world, and in the minds of many commentators marked the beginning of the financial crisis and the global economic downturn. Described as the biggest bankruptcy in U.S. history, the tentacles are long, multiple and will play out over a number of years, sometimes with unforeseen consequences. A recent decision of the United States Bankruptcy Court for the Southern District of New York (the New York Court) in one of the many Lehman Brothers-related bankruptcy proceedings illustrates how unexpected legal developments can challenge prior assumptions and the understandings upon which ratings are based.

At issue was a contractual provision commonly found in the complex and esoteric world of credit default swaps. In certain structured finance transactions known as collateralized debt obligations (CDOs), obligations under a credit default swap agreement are an essential asset supporting the issued securities. The matter before the court concerned rights to collateral posted under a credit default swap entered into by an issuer of credit-linked notes in a CDO structure, with a Lehman Brothers entity serving as swap counterparty.

As the use of credit default swaps has grown over the last decade, the legal documentation under which they are entered has become standardized. In the normal course, the swap counterparty ranks equal to noteholders when it comes to priority to the collateral. However, if the swap counterparty causes a default under the swap agreement, the counterparty's entitlement to the collateral is subordinated to that of the noteholders. There are a number of events that can cause the counterparty to default under the agreement, including its bankruptcy. This feature is particularly important in CDO transactions as otherwise, if the swap counterparty ranks equal to noteholders in all circumstances, noteholders would be exposed to the risk of the counterparty going bankrupt, which is precisely what happened with Lehman Brothers.

The New York Court ruled that the subordination of Lehman Brothers' rights to the collateral upon its bankruptcy violates the *ipso facto* rule of U.S. bankruptcy law. Under the *ipso facto* rule, changes or modifications cannot be made in a contract to which a debtor is a party solely due to the fact of the debtor having made a bankruptcy filing. As a result of this decision, noteholders and Lehman Brothers are to rank equally with regard to the collateral, with noteholders likely suffering a loss as a consequence.

The case is further complicated by a decision of the Court of Appeal of England and Wales (the English Court), which, in the same matter and on the same facts, came to the opposite conclusion, upholding the subordination of the counterparty's rights to the collateral. As of this date, it is unclear how the competing and contradictory decisions will be applied to the distribution of the collateral.

There are a number of grounds to appeal the decision of the New York Court, both on the basis of jurisdiction and on the merits. The agreements are governed by English law and the assets in question, the collateral, are located in the United Kingdom. Despite these facts, the New York Court determined that it had jurisdiction as one of the parties to the contract, Lehman Brothers, was a U.S. entity. This implies that notwithstanding the clearly stated intentions of sophisticated parties, any agreement anywhere in the world will be subject to U.S. law if one of the parties is a U.S. entity. On the merits of the case, the New York Court repeatedly refers to the change or modification made to the agreements upon Lehman Brothers' bankruptcy filing. However, as the English Court points out, there was no change or modification to any agreement. The agreement, entered into years before the bankruptcy, provided for differing baskets of rights in differing circumstances. In upholding the subordination of priority, the English Court was simply giving effect to what sophisticated parties had freely bargained for long before the eve of bankruptcy.

DRBS understands that an appeal will be filed and will be watching the outcome closely. A confirmation of the decision by the appellate court would mean that a basic legal and structural element upon which the ratings of CDO obligations are based would no longer be valid in any transaction involving a counterparty that could fall under the jurisdiction of the U.S. Bankruptcy Court. It is very likely that such an outcome would have serious and negative ratings consequences for certain CDO structures. The upholding of the New York Court's judgment would also necessitate a reconsideration of the suitability of U.S. counterparties for these transactions.

This decision could also impact Canadian corporate issuers or issuers of traditional asset-backed securities that access the swap market to hedge interest rate or exchange rate exposures. While the cash flows associated with these swaps are not as integral to the ratings of these securities as is the case with CDOs, if the decision of the New York Court is not overturned on appeal, any Canadian corporation or issuer involved in a swap with a U.S. financial institution may find itself unexpectedly liable for termination payments if the counterparty files for bankruptcy protection.

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