

# Structured Finance Newsletter

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**Claire J. Mezzanotte**  
Managing Director,  
ABS/RMBS/Covered Bonds  
Structured Finance,  
+1 212 806 3272  
[cmezzanotte@dbrs.com](mailto:cmezzanotte@dbrs.com)

**Jan Buckler**  
Senior Vice President,  
Research and Modeling  
Structured Finance  
+1 212 806 3925  
[jbuckler@dbrs.com](mailto:jbuckler@dbrs.com)

**Rosemary Kelley**  
Senior Vice President, ABS  
Structured Finance  
+1 212 806 3250  
[rkelly@dbrs.com](mailto:rkelly@dbrs.com)

**Chris O'Connell**  
Senior Vice President, ABS  
Structured Finance  
+1 212 806 3253  
[coconnell@dbrs.com](mailto:coconnell@dbrs.com)

**Quincy Tang**  
Senior Vice President, RMBS  
Structured Finance  
+1 212 806 3256  
[qtang@dbrs.com](mailto:qtang@dbrs.com)

**Kathleen Tillwitz**  
Senior Vice President,  
Operational Risk, ABS/RMBS  
Structured Finance  
+1 212 806 3265  
[ktillwitz@dbrs.com](mailto:ktillwitz@dbrs.com)

**Chuck Weillmann**  
Senior Vice President, ABS  
Structured Finance  
+1 212 806 3226  
[cweillmann@dbrs.com](mailto:cweillmann@dbrs.com)

**New York**  
140 Broadway, 35th Floor  
New York, NY 10005  
+1 212 806 3277

**Chicago**  
101 North Wacker Drive  
Suite 100  
Chicago, IL 60606  
+1 312 332 3429

**Toronto**  
DBRS Tower  
181 University Avenue  
Suite 700  
Toronto, ON M5H 3M7  
+1 416 593 5577

## LEHMAN BANKRUPTCY AND SWAP COUNTERPARTY PRIORITY

The bankruptcy of Lehman Brothers was an unprecedented event the effects of which are still being determined. One such matter that has emerged regards the subordination of termination payments under certain structured finance payment waterfalls which could have broad market impact. The payment waterfalls of most structured finance transactions that contain swaps give priority to swap counterparties over noteholders. Depending on the prevailing circumstances at the time of termination, termination payments can be quite significant and even exceed the value of the related collateral. For this reason, in some CDO and ABS transactions the priority of payment is subordinated when there is a swap counterparty default with the noteholders then receiving the return of invested principal before termination payments due to the defaulting swap counterparty.

On January 25, 2010, United States Bankruptcy Court for the Southern District of New York (the "Court") Judge James M. Peck held that waterfall provisions in an indenture subordinating termination payments to a swap provider, Lehman Brothers Special Financing Inc. ("LBSF"), following a swap provider default, were ipso facto clauses and represented modifications that impaired a LBSF property right after the commencement of a bankruptcy case which would be subject to the automatic stay provisions of the Bankruptcy Code. In coming to this determination the Court found that the safe harbor provisions extended to swap agreements under the Section 560 of the Bankruptcy Code did not apply because the waterfall provisions were contained in the transaction documents and not within the swap documentation as defined by the Court.

The ruling included what some have cited as a liberal interpretation of what constitutes "a case" for bankruptcy purposes with the Court concluding that the LBSF bankruptcy case commenced when Lehman Brothers Holding Inc. ("LBHI") filed on September 15, 2008 (not when LBSF filed on October 3, 2008). The Court acknowledges in the ruling that the Lehman bankruptcy is "perhaps the most complex and multi-faceted business ventures ever to seek the protection of chapter 11." However, in formulating the basis for the ruling, the Court has been impugned for its broad interpretation of circumstances and bankruptcy law in an effort to maximize the bankruptcy estate. Observers have also been critical of the Court for liberally construing the elements of future performance to conclude that the contracts were executory, and then rather narrowly construing the interpretation of what constitutes the swap documentation for purposes of applying the safe harbor provisions under the Bankruptcy Code.

The decision represents an important case of first impression providing guidance on how a court would interpret the intention of parties to allocate payments related to secured obligations. If upheld on appeal, the decision will have an impact on existing structured finance transactions, as well as future transactions. The Court's decision in some cases may obviate efforts on the part of transaction parties to structure certain priorities and result in senior positioning of swap termination payments being assumed in all circumstances. The decision is also likely to affect transactions which require posting of collateral to address credit deterioration of the swap provider. DBRS will continue to monitor the developments in this matter and the potential affects of this decision on structured finance credit ratings.

For questions or comments, please contact Claire Mezzanotte at [cmezzanotte@dbrs.com](mailto:cmezzanotte@dbrs.com).