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Investor Alert

Dante: A boost for Noteholders' hopes for repayment

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The Supreme Court of England and Wales on Wednesday 27 July handed down a landmark judgment in the English arm of the long running 'Dante litigation[1]'.

As many readers will be aware, this litigation concerns the rights of holders of structured Notes issued under the Lehman Brothers' Dante Programme (named after the first of many Issuer entities in the programme, Dante Finance plc[2]). For Noteholders, the issue considered in the judgment is critical. In essence, it is whether the proceeds of liquidating the collateral provided to support the Notes are (at least in large part) to be returned to the Noteholders because of the Early Termination Event constituted by the Lehman bankruptcy, or whether instead the proceeds of liquidating the collateral are property of the relevant Lehman entity, to be included in the general distribution to its creditors.

The litigation concerns the validity of so-called "flip" clauses. These are common clauses in structured note documentation and are designed to give investors protection against counterparty risk. In normal circumstances, these clauses provide that "Swap Counterparty Priority" applies, by which the underlying swap counterparty (i.e. in this case a Lehman entity) has first priority over the collateral. However, in the event of an Early Termination Event triggered by a bankruptcy or other Event of Default by the underlying swap counterparty, the flip clause provides that "Noteholder Priority" applies, such that instead the Noteholders have first priority over the collateral.

The legal issue with which the courts in both England and the United States have been wrestling is the extent to which flip clauses contravene public policy provisions in insolvency law, which seek to preserve the rights of creditors by precluding parties from removing property from the ambit of a bankrupt debtor's estate simply by virtue of the event of bankruptcy. In the English context, the principle is known as the "anti-deprivation rule". The aim is to prevent an unsecured creditor from seeking to elevate himself over the other unsecured creditors, and thus to preserve the general principle that unsecured creditors share equally in the proceeds of bankruptcy. Lehman's trustees in bankruptcy argue that flip clauses are unlawful and void, because they have the effect of putting the collateral (over which Lehman would otherwise have first priority) outside of the bankrupt estate on the event of bankruptcy.

The Supreme Court upheld the first instance and Court of Appeal Judgments in favour of the respondent Noteholders ("Belmont") and dismissed the Lehman trustee's contentions. It held that the provisions of the flip clauses were lawful and effective, and did not contravene the anti-deprivation rule[3]. Lord Collins delivering the majority speech held that this was because the anti-deprivation rule was not intended to bite on contractual provisions which had been incorporated as part of a delicate risk balancing exercise in the furtherance of such a complex financial transaction. The primary purpose of the flip clause was not intentionally to seek to deprive other creditors of a share of the assets (and indeed its provisions were triggered by a wide variety of Events of Default and not just bankruptcy). Instead, the flip clause was viewed as part of the intricate risk allocation arrangements which surrounded what amounted in substance to the provision of security by the Noteholders to Lehman for the performance of the Noteholder's own obligations.

The judgment is rooted in a pragmatic and commercial approach to the issues, and the unanimous decision is hugely encouraging for Noteholders. Of course the implications of the judgment flow beyond the Dante Programme, and the opposite result would have been hugely disruptive to the structured credit markets by undermining the basis on which every transaction incorporating a flip clause was entered into.

However, while the appellate procedure in England has now been exhausted (and at every stage the English courts have supported the Noteholders), Lehman can be expected to raise additional hurdles to seek to prevent disbursement of the proceeds of collateral to Dante Noteholders. Noteholders will have to consider with their legal advisers how to approach the practical issue of obtaining substantive relief.

One hurdle which arises stems from the fact that the US Bankruptcy Court has determined in a similar application (made in respect of different transactions by the Perpetual Trustee Co representing different Noteholders) that the flip clauses do contravene the US equivalent of the anti-deprivation rule (the *"ipso facto"* rule). Perpetual were also involved in the English proceedings at earlier stages, but had settled their claims prior to the Supreme Court hearing. Accordingly, there are conflicting decisions in the UK and US courts.

That conflict has (deliberately) yet to be tackled, let alone resolved. The English lower court had limited its decision to a declaration which could be appealed in order to reach a binding and final resolution of the English insolvency law issue. As the Supreme Court judgment acknowledges:

"Following communications between the High Court in England and the Bankruptcy Court in New York, it was agreed that, in order to limit potential conflict between decisions in the two jurisdictions, relief would be limited to declaratory relief":

In the High Court hearing which gave rise to the appellate proceedings, it was made clear that the Lehman trustee in bankruptcy would be seeking to make the UK courts apply US law either through the Cross Border Insolvency Regulations 2006 (which implement the UNCITRAL Model Law on Cross-Border Insolvency in the UK), or alternatively through a common law request for aid from the US Bankruptcy Court. Those aspects do not appear to have been progressed while the English point of law on the anti-deprivation rule was being resolved through the appellate process. Battle will no doubt now recommence on those elements of the case, unless a decision is taken to settle Belmont's claims for strategic reasons.

Notwithstanding the complications arising from the parallel proceedings in the US, investors holding outstanding Series of Notes under the Dante Programme will also need to satisfy the Trustee in relation to the indemnity that the Trustee is entitled to require from Noteholders before enforcing security over any Collateral and distributing the proceeds thereof. Those holders of Notes under the Dante Programme who have not yet made contact with the Trustee (Bank of New York Mellon) are strongly advised now to do so.

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1 *Belmont Park Investments PTY Limited -v- BNY Corporate Trustee Services Limited and Lehman Brothers Special Financing, [2011] UKSC 38*

2 Other SPV Issuers under the Dante Programme include: Angiolieri Finance plc, Aquamarine Finance plc, Beryl Finance Ltd, Boccaccio Finance plc, Citrine Finance Plc, Diadem City CDO Limited, Diamond Finance plc, GMG Finance Limited, Jupiter Quartz Finance plc, Lion City CDO Limited, Merlin Finance S.A., Onyx Funding Limited, Pearl Finance plc, Petrarca Finance plc, Quartz Finance plc, Ruby Finance plc, Saphir Finance plc, Topaz Finance Limited and Zircon Finance Limited.

3 The full text of the judgment can be found at http://www.supremecourt.gov.uk/docs/UKSC_2009_0222_Judgment.pdf and a press release summarising the findings is at http://www.supremecourt.gov.uk/docs/UKSC_2009_0222_ps.pdf

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