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LEGAL ALERT

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U.S. District Court Affirms Lehman Ruling Raising Concern on Cross-Affiliate Netting

A recent opinion by the U.S. District Court for the Southern District of New York affirms a 2010 ruling by the Lehman Brothers bankruptcy court, which rendered certain netting and setoff provisions unenforceable in bankruptcy. The core holding – that a counterparty cannot offset pre-petition and post-petition amounts – should come as no surprise to market participants. In reaching that result, however, both courts opined that parties seeking to exercise setoff rights under the Bankruptcy Code's safe harbor statutes remain subject to the more restrictive mutuality requirements of section 553 of the Bankruptcy Code. That ruling likely will continue to cause some significant changes in the risk management practices of traders.

Swedbank was one of Lehman's depository banks. As such, Lehman deposited money with Swedbank, both before and after filing its bankruptcy petition. In the latter category, Lehman deposited approximately $11.7 million after September 15, 2008, when Lehman Brothers Holdings Inc. (LBHI) filed its voluntary petition. After the bankruptcy filing, Swedbank notified Lehman that it was placing an administrative freeze on the relevant accounts for purposes of exercising setoff rights.

Swedbank's receivables arose out of the termination amounts owed under a series of ISDA Master Agreements. Swedbank entered into five ISDA Master Agreements (the Agreements) with Lehman entities, one of which was LBHI. LBHI's bankruptcy filing triggered an Automatic Early Termination in three of the Agreements. Because LBHI guaranteed the payment obligations of the other Lehman entities, Swedbank asserted that it was owed a net termination payment of approximately SEK 119 million. (Using a present-day conversion rate, Swedbank asserted that it was owed approximately $17.9 million in termination payments.) Swedbank also held a promissory note from LBHI in the amount of approximately $18 million.

Lehman responded to the administrative freeze by asking the court to enforce the automatic stay and by demanding payment of its post-petition deposits. Lehman disputed Swedbank's setoff rights – initially, with respect to the purported right to offset post-petition amounts due Lehman against pre-petition amounts due Swedbank. As a result, Lehman alleged that the administrative freeze constituted a violation of the automatic stay.

In its objection, Swedbank argued that it was entitled to offset post-petition deposits against pre-petition claims as a result of the safe harbor provisions of the Bankruptcy Code. Section 553 of the Bankruptcy Code governs setoff rights in bankruptcy in the typical scenario, and it imposes a requirement of mutuality. Swedbank, however, argued that section 553 is rendered inapplicable by the safe harbor provisions of the Bankruptcy Code, which defer to contractual rights. Swedbank therefore contended that the traditional requirement of mutuality did not apply to instances of setoff governed by the safe harbor statutes.

Swedbank's objection prompted Lehman to file a reply, which significantly broadened the scope of Lehman's arguments. First, Lehman argued that the setoff provisions of the safe harbor statutes apply only to safe harbor contracts – not to Lehman's bank deposits. More significantly, Lehman argued that any setoff rights conferred in the safe harbor statutes remain subject to the more restrictive requirements in section 553 of the Bankruptcy Code, including the requirement of mutuality.

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On May 5, 2010, the bankruptcy court issued an opinion siding with Lehman. First the court found that with regard to the prospective setoff, there was no mutuality present. The court reasoned that the deposits at issue were post-petition, and mutuality has historically required pre-petition amounts owed between the parties.

Next, the bankruptcy court held that any attempted setoff under the safe harbor protections of the Bankruptcy Code is nevertheless subject to the mutuality requirement. Because Swedbank could not establish mutuality with respect to the post-petition deposits, the court ruled that it could not exercise its purported setoff rights.

On appeal, Swedbank argued that the language of the safe harbor provisions allowed it to exercise any contractual right of setoff found in its swap agreement, notwithstanding the language in section 553. Swedbank emphasized the language of section 560 of the Bankruptcy Code, which states: "The exercise of any contractual right of any swap participant … to offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of one or more swap agreements shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court."

The district court, however, placed little emphasis on the statutory language. Instead, it focused primarily on the legislative history related to sections 553 and 560. It stressed that at one time, the safe harbor provisions did not provide for setoff rights, and all parties were subject to section 553 requirements, including mutuality. Taking that into account, the court noted, "if Congress had intended to eliminate the fundamental principle of mutuality, we would expect some discussion of this change in the legislative history." The court found great meaning in the fact that no such legislative history existed: "There is not a single passage in the legislative history that specifically addresses whether the Safe Harbor Provisions were intended to be an exception to section 553. Likewise, there is no mention in the legislative history that the Safe Harbor Provisions were intended to eliminate the mutuality requirement. We think this silence is significant."

Beyond the plain meaning of the safe harbor provisions, many in the industry argue that legislative history does support Swedbank's case. For example, they point to Congress's deletion of the term "mutual" from numerous subsections to section 362(b) – provisions that once exempted only mutual setoff from the automatic stay. The district court, however, limited its analysis of legislative history to only sections 553 and 560.

As a result, the district court refused to allow Swedbank's efforts to exercise its contractual rights of netting. It also refused to enforce cross-contract netting, to the extent that it extended to general commercial transactions (i.e., contracts that did not qualify for safe harbor protections).

Swedbank has not indicated whether it will pursue an appeal to the U.S. Court of Appeals for the Second Circuit. Swedbank has until early March to file a Notice of Appeal.

Market participants now face increased uncertainty about the enforceability of their cross-affiliate netting rights. Although the district court's ruling is not binding outside of New York, and cross-affiliate netting was not the central issue presented in the appeal, there is a chance that it will influence other courts. Until another court holds to the contrary, counterparties run the risk that cross-affiliate setoff may not be enforceable.

Nevertheless, it may be worthwhile to continue to include such provisions in new contracts. Cross-affiliate netting may be useful upon defaults that are based on events other than bankruptcy. Moreover, the

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possibility remains for other courts to reach different results, more consistent with the explicit statutory language.

Still, we expect that traders' risk management practices will likely be modified as a result of the two rulings. Less reliance can be placed on setoff rights that extend beyond the traditional bilateral form. Going forward, the Swedbank rulings may even cause different decisions in terms of corporate formation – it may now be more advisable to aggregate all trading divisions into one legal entity.

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