Structured Finance Litigation Update

Recent Court Decisions Clarify Enforceability of Setoff Provision in Structured Finance Transactions Following Counterparty Bankruptcy Filing: Contractual setoff and netting rights are among the more common protections bargained for in derivatives and structured finance transactions. In addition to the netting of gains and losses across multiple transactions after early termination under an International Swaps and Derivatives Association ("ISDA") master agreement, counterparties may also contract for setoff of non-derivative obligations between the same counterparties against derivatives obligations ("cross-product netting") and setoff of the obligations of one counterparty against obligations of affiliates of the other counterparty ("cross-affiliate netting").

Of concern to any party is the enforceability of cross-affiliate and cross-product netting following its counterparty's bankruptcy filing. Section 553 of title 11 of the United States Code (the "Bankruptcy Code") governs setoff following the commencement of a bankruptcy case. Section 553 provides, in relevant part, that a bankruptcy filing "does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case." 11 U.S.C. § 553(a).

Financial participants facing exposure as the result of a counterparty bankruptcy have argued that setoff should be permissible, even in the absence of mutuality, because their contracts create mutuality, even if mutuality may not have otherwise existed. Until recently, there had been very little case law discussing this "contractual exception" to mutuality. A pair of court decisions have recently construed the "mutuality" requirement of section 553 strictly and denied cross-affiliate and cross-product netting regardless of the language of the contract. The opinions held that parties cannot contract around provisions of the Bankruptcy Code, even in the context of a derivatives contract for which close-out netting is protected by statutory safe harbors.

Delaware District Court Affirms Decision Holding No Contractual Exception to Bankruptcy Code Mutuality: On April 30, 2010, the Delaware District Court affirmed a ruling by the Bankruptcy Court for the District of Delaware that disallowed the setoff of a creditors' claims against a corporate debtor against claims that a subsidiary of the debtor owed to the creditor because such "triangular setoff" failed to satisfy the mutuality requirement of section 553 of the Bankruptcy Code.

In *In re SemCrude, L.P.*, 428 B.R. 590 (D. Del. 2010), Chevron entered into futures contracts for the purchase or sale of oil with affiliated debtors SemCrude, SemFuel, and SemStream. The transactions resulted in Chevron owing money to SemCrude; however, SemFuel and SemStream each owed money to Chevron. Chevron argued that the automatic stay of Bankruptcy Code section 362 should be lifted to permit Chevron to offset its liability to SemCrude against the amounts owed by SemFuel and SemStream, contending that such setoff was permitted by Chevron's agreements. The agreements had identical setoff provisions, which provided that, "in the event either party fails to make a timely payment of monies due and owing to the other party, or in the event either party fails to make timely delivery of product or crude oil due and owing to the other party, the other party may offset any deliveries or payments due under this or any other Agreement between the parties and their affiliates."

The bankruptcy court denied stay relief, holding that even if "triangular setoff" is permissible under the parties' agreements, there is no contractual exception to the mutuality requirements of the Bankruptcy Code. It noted that for the purposes of section 553, debts are "'mutual' only when 'they are due to and from the same persons in the same capacity.'" *In re SemCrude, L.P.*, 399 B.R. 388, 393 (Bankr. D. Del. 2009). The bankruptcy court the rejected Chevron's argument regarding a contractual exception to mutuality, holding that "mutuality cannot be supplied by a multi-party agreement contemplating a triangular setoff." *Id.* at 397.

The district court affirmed the bankruptcy court's decision, holding that it was "not only consistent under the facts and applicable case law, but also consistent with general bankruptcy principles concerning the strict construction of mutuality against the party seeking setoff." The case is *In re SemCrude, L.P.*, 428 B.R. 590 (D. Del. 2010).

New York District Court Affirms That Pre-Petition Derivatives Claims Cannot Be Offset Against Post-Petition Deposits: On January 26, 2011, the Southern District of New York affirmed a bankruptcy court decision that the Bankruptcy Code derivatives safe harbor provisions do not create an exception to the section 553 mutuality requirements. *See Swedbank AB v. Lehman Brothers Holdings Inc.*, 10 CV 4532 (S.D.N.Y. January 26, 2011).

Beginning in 1990, Congress had enacted revisions to the Bankruptcy Code creating "safe harbor" protections for counterparties facing risk on, among other things, obligations in respect of swap contracts that arose from a counterparty bankruptcy. Section 560 of the Bankruptcy Code permits a counterparty to "cause the liquidation, termination, or acceleration of one or more swap agreements" and to "offset or net out any termination values or payment amounts" arising thereunder. Section 561 of the Bankruptcy Code, enacted in 2005, provides similar protections to parties under master netting agreements.

Prior to its chapter 11 filing in 2008, Lehman Brothers Holdings Inc. ("LBHI"), through its UK branch, was a party to an ISDA Master Agreement with Swedbank AB. LBHI also guaranteed certain ISDA Master Agreements between Swedbank and LBHI affiliates. LBHI held a deposit account at Swedbank. Following LBHI's chapter 11 petition, third parties deposited approximately $11.7 million into LBHI's Swedbank account. Subsequently Swedbank informed LBHI that it intended to offset amounts owing to Swedbank under LBHI's derivatives obligations (as either counterparty or guarantor) against amounts in the LBHI account, including the post-petition deposits. LBHI then filed a motion to enforce the automatic stay, arguing, among other things, that Swedbank was improperly attempting to offset pre-petition derivatives claims against post-petition deposits. In response, Swedbank acknowledged the lack of mutuality, but argued that sections 560 and 561 of the Bankruptcy Code preserved Swedbank's right to setoff notwithstanding the lack of mutuality. The Bankruptcy Court granted LBHI's motion holding that the safe harbor provisions did not create an exception to the section 553 mutuality requirements.

The district court affirmed, writing separately to discuss the interplay between section 553 of the Bankruptcy Code and the safe harbor provisions. The court explained that the mutuality requirement of section 553 had its genesis in pre-Bankruptcy Code law, and was a "fundamental principle" of bankruptcy law. The court explained that if Congress had intended to alter this fundamental principle, there would have been some discussion in the legislative history; because the legislative history was silent, the court concluded that Congress did not intend for the safe harbor provisions to affect section 553 mutuality. The court observed that, "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 . . . . We think this silence is significant." *Slip Op.* at 13.

The court further noted that the legislative history addressed three themes that focused narrowly on swap transactions, and that expanded setoff rights was not implicit in any of them. It concluded that Congress: (i) intended to permit swap counterparties to terminate swap transactions, but did not address the extension of this protection to the general commercial obligations of the counterparties; (ii) intended to prevent swap counterparties from being exposed to risk associated with short term market movements; and (iii) was motivated by fairness considerations and believed that counterparties should be permitted to terminate and net out swap transactions without fear of either violation of the automatic stay or challenge as an avoidable preference. The district court finally noted that the safe harbor provisions were not intended to create a "super-priority status" extending to all commercial transactions with the debtor.

Although *Swedbank* is not a "triangular setoff" case, it has implications for the contractual exception to mutuality argument that underlies triangular setoff. Like the *SemCrude* court, the *Swedbank* court rejected the notion of a contractual exception to mutuality requirements of the Bankruptcy Code. Instead, it held that such an exception would "run counter to the fundamental purposes of the bankruptcy law." *Swedbank* is thus another instance of courts narrowly construing the mutuality requirements of Bankruptcy Code section 553.

The *Swedbank* decision is one of several in the Lehman Brothers' bankruptcy proceedings that have narrowly construed setoff rights. In another example, the bankruptcy court held that Bank of America violated the automatic stay when it wrongfully offset collateral LBHI pledged for overdrafts against Bank of America's Lehman derivatives exposure. In so holding, the court rejected, among other things, Bank of America's argument that the setoff was protected by the derivatives safe harbors. A more detailed discussion of the case will follow in a future client alert.