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Clients&FriendsMemo

Lehman Bankruptcy Court Holds ISDA Swap Counterparty in Violation of Automatic Stay / Counterparty Seeks Modification[1]

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In a recent ruling from the bench, Judge James M. Peck of the United States Bankruptcy Court Southern District of New York held that Metavante Corporation's suspension of payments under an outstanding swap agreement with Lehman Brothers Special Financing Inc. ("LBSF") was not safe harbored, and instead violated the automatic stay of section 362(a) of the Bankruptcy Code.[2] As a result, Metavante is required to pay more than $6 million in past due payments, including default interest, to the Debtors' estates.[3] In addition, the Court ruled that, 12 months into the case, Metavante had waived its right to terminate the swap agreement under the applicable safe harbor provision.[4]

Metavante now requests, in a motion filed on September 25, that the court amend its earlier decision, in order to compel the Debtors to provide "adequate protection" to Metavante during the "grey" period in which the Debtors are determining whether to assume or reject the swap agreement, and to clarify the amount of default interest payable by Metavante. This motion may be viewed by the court as merely rehashing Metavante's unsuccessful defenses to the Debtors' Motion and ultimately prove unavailing.[5]

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[1] Written by Mark C. Ellenberg and Leslie W. Chervokas of Cadwalader's Financial Restructuring group.

[2] Title 11, United States Code, 11 U.S.C. §§ 101 *et seq.*

[3] *See* Order Pursuant to Sections 105(a), 362 and 365 of the Bankruptcy Code to Compel Performance of Contract and to Enforce the Automatic Stay, *In re Lehman Brothers Holdings Inc.,* No. 08-013555 (JMP) (Bankr. S.DN.Y. Sept. 17, 2009) (Docket no. 5209).

[4] *See generally* sections 362(b)(6), (7) and (17); 546(e), (f) and (g); 555, 556, 559 - 562 of the Bankruptcy Code.

[5] *See* Metavante Corporation's Motion to Alter or Amend the Court's Order Granting Lehman Brothers Special Financing Inc. and its Affiliated Debtors' Motion to Compel Performance and Enforce the Automatic Stay, *In re Lehman Brothers Holdings Inc.,* No. 08-013555 (JMP) (Bankr. S.DN.Y. Sept. 25, 2009) (the "Motion to Amend") (Docket no. 5284).

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Background

LBHI filed for Bankruptcy on September 15, 2008. LBSF filed for Bankruptcy on October 3, 2008. The 1992 ISDA Master Agreement that governed the parties' fixed to floating interest rate swap contained the standard provision entitling the non-defaulting party to terminate the contract upon the bankruptcy of the other party or its credit support provider. Upon termination, the non-defaulting counterparty would be required to obtain dealer quotations to value the remaining swap transactions under the master agreement to determine who was in or out of the money. Under then existing market conditions, if Metavante were to have terminated the swap, it would have owed a substantial payment to LBSF.

In October 2008, instead of terminating the ISDA agreement pursuant to the safe harbor, Metavante entered into a replacement swap with another counterparty[6] and ceased making net payments due to LBSF under the contract in reliance on Section 2(a)(iii) of the Master Agreement. Section 2(a)(iii) generally provides that a party's obligation to make payments under the Master Agreement is subject to the condition precedent that there is no outstanding event of default (*e.g.*, a bankruptcy filing) by its counterparty.

Subsequently, in May 2009, the Debtors filed a motion (the "Motion")[7] seeking to compel Metavante to perform its obligations under the Master Agreement. The Debtors argued that Metavante's withholding regularly scheduled payments pursuant to section 2(a)(iii) of the ISDA Master Agreement violated the automatic stay and was not sheltered by the swap safe harbor provisions of the Bankruptcy Code. In objecting to the Motion, Metavante argued that the safe harbor provisions did not specify the timeframe in which a non-debtor must exercise safe-harbored rights and that section 2(a)(iii) of the Master Agreement allowed a swap counterparty to suspend payment in the face of an outstanding default.

The Debtors countered that Metavante's failure to make required payments under the swap transaction implicated an unenforceable "*ipso facto*" clause that altered the parties' obligations due to the Debtors' bankruptcy filing. LBHI also argued that under the Bankruptcy Code, in order to preserve the assets of the estate during the period in which a debtor has the right to elect whether to assume or reject an executory contract, the non-debtor counterparty must continue to perform its

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[6] The replacement swap was intended to hedge against fluctuations in interest rates during the period from November 3, 2008 through February 1, 2010.

[7] *See* Debtors' Motion Pursuant to Sections 105(a), 362 and 365 of the Bankruptcy Code to Compel Performance of Metavante Corporation's Obligations under an Executory Contract and to Enforce the Automatic Stay, *In re Lehman Brothers Holdings Inc.,* No. 08-013555 (JMP) (Bankr. S.DN.Y. May 29, 2009 (Docket no. 3691). The Motion was supported by a Statement of Official Committee of Unsecured Creditors of Lehman Brothers, dated June 15, 2009 (Docket no. 3958) and a Statement of Ad Hoc Group of Lehman Brothers Creditors, dated July 10, 2009 (Docket no. 4326).

obligations under the contract. As a result, Metavante's failure to make net payments to LBSF under the swap represented control by Metavante over property of the estate in direct violation of the automatic stay. The Debtors also argued that Metavante's suspension of payments was not protected under the swap safe harbor, and that a non-debtor could not withhold payment in order to preserve future rights of setoff that potentially could result from a change in the market during the term of the swap agreement.

Analysis

With respect to the right of suspension under section 2(a)(iii) of the ISDA, the Court determined that a swap agreement that has not been terminated is like any other executory contract. As such, the automatic stay prohibited the Metavante from enforcing 2(a)(iii) against the Debtors. The Court rejected Metavante's suggestion that it needed to withhold payment in order to preserve potential setoff rights upon termination by finding that Metavante no longer had a right to terminate the swap. Under section 560 of the Bankruptcy Code, a non-debtor may exercise its contractual rights to accelerate, terminate, liquidate and offset, net and close out its positions under a swap agreement without violating the automatic stay or the Bankruptcy Code's prohibitions against *ipso facto* termination of executory contracts.[8] While the statute does not specify that parties must act promptly after such a filing in order to rely on the safe harbor, the legislative history quoted by Judge Peck establishes that Congress intended only to shield parties to financial contracts from the systemic risk that would result from cascading losses due to a counterparty's bankruptcy filing.[9] Because the degree of systemic risk that could result from a single filing diminishes over time, both this decision and existing precedent[10] held that the safe harbors only protect actions that are taken reasonably promptly after the filing date. Moreover, although the statute is silent as to whether the non-debtor may withhold payment pending its decision whether to exercise such rights, its language is narrow enough to preclude parties to safe harbored financial contracts from taking any actions other than those specified – such as termination, close out and netting – in reliance on these provisions.

As noted above, Metavante now seeks clarification of the court's ruling. It asks that, to protect Metavante from loss in the event that the market turns in its favor, the court compel the Debtors to provide "adequate protection" to Metavante pending the Debtors' decision whether to assume or reject the swap agreement. Although Metavante's request may seem innocuous -- that such

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[8] *See* 11 U.S.C. §§ 101(53B), 362(b)(17) and 560.

[9] *See* Transcript of Hearing *In re Lehman Brothers Holdings Inc.,* No. 08-013555 (JMP) (Bankr. S.DN.Y. Sept. 15, 2009) ("Transcript") at 111 (*citing* H.R. Rep. 97-420, at 1 (1982) and Sen. R. No. 101-285, at 1 (1990)).

[10] *See* Transcript at 111 "[n]oting that a counterparty's action under the safe harbor provisions must be made fairly contemporaneously with the bankruptcy filing, less the contract be rendered just another ordinary executory contract" *citing In re Enron Corp.*, Case No. 01-16034 (AJG), 2005 WL 3874285, at *4.

adequate protection consist of escrowing Metavante's post-petition payments in a segregated account -- query whether it is tantamount to seeking, again, to preserve the speculative right to setoff that the court already struck down. Metavante also seeks clarification of the amount of default interest that it is required to pay because, among other things, the Debtors "failure to do so is a tacit admission that even they are not sure what the default rate is ...[.]"[11] Metavante's Motion to Amend is scheduled to be heard on November 18, 2009 and may be regarded by the bankruptcy court as nothing more than a last ditch effort to avoid making immediate payment -- we will apprise you of any further developments.[12]

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If you have any questions regarding the foregoing, please contact:

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[11] Motion to Amend, at 8-9.

[12] *See* Motion to Amend.