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Lehman Bankruptcy Court Rules Safe Harbors Do Not Override Setoff Mutuality Requirement

On May 5, 2009, Judge James Peck, the bankruptcy judge in the Lehman Brothers bankruptcy cases, held that the safe harbor provisions of the Bankruptcy Code do not override the mutuality requirements for setoff under section 553(a) of the bankruptcy Code. As a consequence, the bankruptcy court prohibited Swedbank, a non-debtor counter party to a swap agreement, from setting off pre-petition claims against Lehman against funds collected for Lehman's account post-petition. See In re Lehman Bros. Holdings Inc., Bankr. Case No. 08-13555 (JMP) (Bankr. S.D.N.Y. May 5, 2010) (the "Opinion"). While Swedbank does not involve a triangular setoff, the analysis of the Swedbank court should equally apply to triangular setoff situations (or to any setoff lacking mutuality).

This ruling comes on the heels of a 2009 decision by the Delaware Bankruptcy Court in the SemCrude case, see In re SemCrude, L.P., 399 B.R. 388 (Bankr. D. Del. 2009). In SemCrude, the Court ruled that a contractual agreement permitting non-mutual (triangular) setoff could not be enforced against the Debtor, due to a lack of the mutuality among the parties. The SemCrude decision did not directly address whether the Bankruptcy Code's safe harbor provisions, which are applicable to certain types of derivatives and other trading contracts, could override the mutuality requirements of section 553(a). The trading community has been waiting to see if the application of the safe harbors would produce a different result. The Swedbank decision unequivocally answers that question in the negative. Also, while the Swedbank decision does not cite SemCrude, Swedbank reinforces the basic SemCrude ruling against the waiver of mutuality by contract, extending the rule to the Southern District of New York Bankruptcy Court.

Background

Lehman Brothers Holdings Inc. ("LBHI") and Swedbank AB had a longstanding relationship that included several components. As of the petition date: (1) LBHI maintained a general deposit account with Swedbank; (2) LBHI functioned as guarantor on certain ISDA Master Agreements between Swedbank and LBHI affiliates; and (3) LBHI was party to an ISDA Master Agreement with Swedbank dated November 29, 2004.

Under the ISDA Master Agreements, a bankruptcy by either party triggered an early termination, and thus, a right to payment in favor of the party that is "in the money" at the time of termination. One of the ISDA Master Agreements also included a provision that granted Swedbank a right to setoff certain non-mutual obligations in connection with an early termination. On the date that LBHI filed its bankruptcy petition, the relevant bank account at Swedbank contained approximately two million Swedish Krona. Swedbank then placed an administrative freeze on the account, blocking LBHI from withdrawing any funds, but allowing parties to deposit additional amounts into the account. By November 12, 2009 (more than a year after the petition date), the funds in the account had increased to approximately 85 million Swedish Krona (approximately $11.7 million).

Swedbank sought to setoff the $11.7 million in its account against approximately $32 million in alleged claims against LBHI (consisting of approximately $13.9 million for LBHI's obligation as counterparty or guarantor under the relevant ISDA Master Agreements and approximately $18 million under a pre-petition note held by Swedbank). The Debtors filed a motion to enforce the automatic stay against Swedbank to prohibit setoff and to compel payment of the post-petition funds held in the Swedbank account.

Analysis

The court granted the motion, required Swedbank to turn over the post-petition amounts in the Swedbank account and held that the automatic stay prohibited the administrative freeze effectuated by Swedbank. Along the way, the court rejected each setoff argument offered by Swedbank.

First, the court held that a lack of mutuality prohibits Swedbank from effectuating the proposed setoff. The court stated that, to effect a setoff, "(1) the amount owed by the debtor must be a prepetition debt; (2) the debtor's claim against the creditor must also be prepetition; and (3) the debtor's claim against the creditor and the debt owed must be mutual." The Court found mutuality lacking here, because most of the funds in the Swedbank account were deposited post-petition, while Swedbank's claims against LBHI arose pre-petition.

Swedbank did not dispute the lack of mutuality. However,

Swedbank argued that the safe harbor provisions of sections 560 and 561 of the bankruptcy code, overrode the mutuality requirements of section 553 of the bankruptcy code with respect to a safe harbored contract. Swedbank stated that because sections 560(a) and 561(a) of the bankruptcy code permit a non-debtor swap counterparty to exercise termination rights and that those rights "shall not be stayed, avoided or otherwise limited by operation of any provision of" the bankruptcy code, Swedbank should be free to enforce any contractual setoff rights, regardless of the provisions of section 553(a) of the Bankruptcy Code.

The Court rejected Swedbank's argument, stating: "By their plain terms, these safe harbor provisions do not alter the axiomatic principle of bankruptcy law, codified in section 553, requiring mutuality in order to exercise a right of setoff. These safe harbor provisions simply do not directly address the requirement of mutuality under section 553(a). Instead, these exceptions permit the exercise of a contractual right of offset in connection with swap agreements, notwithstanding the operation of any provision of the Bankruptcy Code that could operate to stay...that right, but that right must exist in the first place."

Given the silence of the safe harbor provisions with respect to the mutuality requirement of section 553(a), the Court declines to read an exception into the statute.

The Court continued, "If Congress had intended to establish a plainly worded exception to the rule limiting setoff to mutual pre-petition claims, it would have done so explicitly."

The Court also dismissed Swedbank's argument based on the 2006 Bankruptcy Code amendments, part of the Financial Netting Improvement Act of 2006 ("FNIA"). As explained by the Court,

> "Swedbank submits that the amendments to FNIA, which replaced the phrase 'mutual debt and claim' in sections 362(b)(6), (b)(17) and (b)(27) with 'any contractual right,' effectively removed the mutuality requirement from the safe-harbored exceptions to the automatic stay. The legislative history of FNIA reveals that Congress intended merely to make 'technical changes to the netting and financial provisions' of the Bankruptcy Code to 'update the language to reflect current market and regulatory practices.'...These technical amendments cannot be read as authority for so fundamental a change in creditor rights."

Finally, the Court held that Swedbank's administrative freeze on the account violated the automatic stay under section 362 of the bankruptcy code and ordered Swedbank to immediately release the frozen funds and return the post-petition deposits to LBHI.

The enforceability of provisions permitting cross-party setoff in master agreements relating to swap, repurchase, securities and forward transactions has long been a topic of discussion in the trading community. The tandem of SemCrude and Swedbank have provided the first judicial holdings on the issue. These cases suggest that cross-party setoff provisions cannot be relied upon. Alternative approaches, such as cross-pledges of receivables under master netting agreements, should be considered where mitigation of counterparty credit risk is required.

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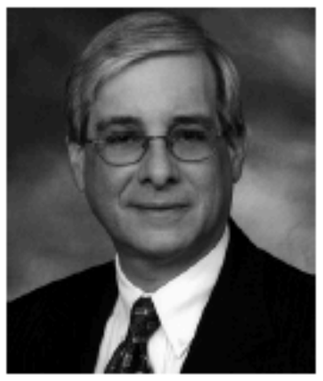

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