

# Lehman Brothers Bankruptcy Filings: Issues for Replacement Swap Counterparties and their Municipal Clients

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*The authors examine some of the key issues in the Lehman  
Brothers bankruptcy filing.*

Voluntary petitions for protection under Chapter 11 of the United States Bankruptcy Code (the “Code”) were filed on September 15, 2008 by Lehman Brothers Holdings Inc. (“Holdings”), on October 3, 2008 by Lehman Brothers Special Financing Inc. (“LBSF”), and on October 5, 2008 by Lehman Brothers Financial Products Inc. (“LBFP”) and Lehman Brothers Derivative Products Inc. (“LBDP”). As a result, state and municipal entities (“Municipal Counterparties”) and other entities that have entered into interest rate swaps or other derivative transactions with these or other affiliates of Holdings (“Lehman Swap Entities”) are evaluating their ability to terminate these transactions and enter into replacement transactions with other swap providers. Municipal Counterparties are also considering whether, even if they have the right to terminate a transaction, they should forgo termination at the present time, particularly if they are out-of-the-money and would owe the

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Lehman Swap Entity a termination payment for which they may not have a readily available source. These matters must be evaluated in light of which Lehman Swap Entity served as the swap provider and the precise terms of the related agreement. Although many of the same considerations are raised for any end-user of derivative contracts with Lehman Swap Entities, this memo is intended to focus primarily on the issues confronting Municipal Counterparties and swap providers considering entering into a replacement transaction with a Municipal Counterparty. This article, in all respects, is subject to the specific terms of the related documentation and is intended solely to provide general guidance as to issues for further consideration.

## **LEHMAN SWAP PROVIDERS**

Lehman Swap Entities that have typically served as swap providers with Municipal Counterparties include (i) LBSF, which is unrated but traded under guaranties from previously “A-rated” Holdings as its Credit Support Provider (“CSP”), (ii) LBFP, which was structured to be “AAA-rated” based upon, among other things, its capitalization and other program features, including continuation following a Holdings bankruptcy, and (iii) LBDP, which was structured as a “termination” swap vehicle that was “AAA-rated” based upon, among other things, its capitalization and counterparty and hedging criteria, including the requirement that all of its transactions terminate at mid-market in the event of a Holdings bankruptcy. Lehman Brothers Inc. (“LBI”), which is Holdings’ broker-dealer affiliate, also entered into derivative transactions with end-users.<sup>1</sup> We believe the majority of Lehman Swap Entity derivative transactions in the municipal market are with LBSF.

## **RIGHTS OF MUNICIPAL COUNTERPARTIES**

### **Against LBSF**

Under the terms of typical LBSF swap documentation, Municipal Counterparties have the right (but not the obligation) to terminate transactions with LBSF — initially as a result of the Holdings bankruptcy,

because Holdings is the CSP under the related documentation and the bankruptcy of a CSP is treated as an Event of Default of LBSF, and now also as a result of the LBSF bankruptcy filing.

### **Against LBFP**

Under the terms of typical LBFP swap documentation, Municipal Counterparties do not have the right to terminate transactions with LBFP solely as a result of the bankruptcy of Holdings or any affiliate other than LBFP. Under this structure LBFP was intended to be able to remain in existing trades with end-users, but not enter into new trades, following bankruptcy of another Lehman entity. The bankruptcy filing by LBFP, however, gives a Municipal Counterparty the right (but not the obligation) to terminate its transactions under typical documentation.

### **Against LBDP**

Under the terms of typical LBDP swap documentation, LBDP is obligated to notify end-users of the Holdings bankruptcy. Termination is to occur without the election of any party and LBDP is to establish the mid-market value of all trades and notify each end-user of the amount it owes or is owed. One recent report indicated that LBDP transactions already have been terminated. Under typical documentation the LBDP bankruptcy filing does not give a Municipal Counterparty the right to terminate its transactions.

## **TERMINATION OF AGREEMENTS**

Upon the occurrence of a Bankruptcy Event of Default when LBSF or LBFP is the Defaulting Party under the applicable swap documentation, the Municipal Counterparty has the right (but not the obligation), so long as the Event of Default is continuing, to designate an Early Termination Date (“ETD”) by not more than 20 days’ notice to the Defaulting Party.<sup>2</sup> If it is out-of-the-money under its agreement after netting all transactions and does not want to make a payment to the Defaulting Party at a given time, the Municipal Counterparty can defer designating an ETD. The Municipal Counterparty should be aware, how-

ever, that (unless the relevant provision has been modified) it cannot selectively terminate transactions governed by the same agreement on the basis of the Event of Default and that there may be limits under state law and bankruptcy law as to how long it can wait to designate an ETD as the result of a bankruptcy. Some bankruptcy courts have held that the right to designate an ETD as the result of a bankruptcy filing under a safe-harored swap agreement may become stale. While there is no clear guidance on how quickly a Non-defaulting Party must exercise its right to terminate a swap agreement, a Municipal Counterparty should have at least several months under the Code to decide whether to terminate.

In addition, a Municipal Counterparty that does not promptly terminate its swap agreement with a Lehman Swap Entity takes the risk that the mark-to-market value of the agreement will change during the delay thereby exposing it to the credit of the Lehman Swap Entity and, if the Lehman Swap Entity is a debtor under the Code, that the agreement could be assigned by the bankruptcy court to another party. A bankruptcy trustee or debtor in possession is permitted to assume and assign a swap agreement to a new counterparty curing all existing monetary defaults and demonstrating "adequate assurance of future performance" by the new counterparty. The bankruptcy court may base its finding of adequate assurance of future performance upon the rating of the new counterparty or other criteria that the court deems relevant. The Municipal Counterparty may oppose the assignment in the bankruptcy proceeding, but does not have a right to terminate the swap solely on the basis of the assignment or defaults that preceded the assignment.<sup>3</sup>

If the Municipal Counterparty's obligations under an agreement with a Lehman Swap Entity have been insured, the agreement should be reviewed to determine any limitations on the ability of either party to terminate transactions or exercise any other rights without insurer consent.

## VALUATION FOLLOWING TERMINATION

Valuation of the terminated swap transaction is the responsibility of the Municipal Counterparty (or, as noted above, of LBDDP with respect to its transactions) and should not be assumed by the replacement swap

provider, who is not a party to the terminated agreement. If the relevant LBSF or LBFP documentation is a standard 1992 ISDA Master and specifies Market Quotation, the Non-defaulting Party is obligated to request market quotes “promptly” after the ETD from swap providers that are “Reference Market-makers.” If the Municipal Counterparty cannot obtain at least three quotes from Reference Market-makers, the Municipal Counterparty has the right to revert to a “Loss” calculation. It is advisable to keep careful records of the attempts that are made to obtain quotes. The Loss calculation is, generally, an amount that the Non-defaulting Party reasonably determines in good faith to be its total losses and costs with respect to the terminated transactions, including any loss of bargain, cost of funding or the loss or cost incurred as a result of its terminating, liquidating, obtaining or reestablishing any hedge or related trading position. The Loss calculation may (but need not) be determined by reference to quotations from one or more Reference Market-makers. Under a standard 2002 ISDA Master relating to LBSF or LBFP transactions, Close-out Amount is determined by the Non-defaulting Party following termination on the basis of losses or gains that would be realized in replacing or providing the economic equivalent of the terminated transactions and related option rights. This determination may take into account third-party market data, internal sources and market quotations. In valuing terminated transactions under any of these methods, Municipal Counterparties should be mindful of any duty they may have under state law to mitigate damages and to act in a commercially reasonable manner.

## **SUSPENSION OF CERTAIN OBLIGATIONS PENDING TERMINATION**

Following an Event of Default, the Non-defaulting Party would have the right to suspend regularly scheduled payments under a typical swap agreement, as well as any obligation to post additional collateral under a Credit Support Annex, regardless whether an ETD has been designated. Under the terms of the agreement, the Defaulting Party would generally be obligated to continue making payments to the Municipal Counterparty and to post additional collateral when required under the CSA. If the

Defaulting Party is a debtor under the Code, the Municipal Counterparty should consult with counsel to determine whether such provisions will continue to be respected.

## **SPECIAL CONSIDERATIONS CONCERNING MUNICIPAL COUNTERPARTIES**

In any transaction involving a replacement swap with a Municipal Counterparty, it is important that a review be made to confirm the capacity and authority of the Municipal Counterparty to enter into the replacement trade because a subsequent determination that it was *ultra vires* could result in the swap provider being unable to enforce the obligations of the Municipal Counterparty under the agreement. In making this determination, counsel must ascertain whether prior authorization is sufficient or new authorization will be required, as well as whether the new swap provider and/or its swap agreement are subject to consents, approvals or other requirements imposed by statutory, contractual, resolution or swap policy provisions. If the new trade will be off-market, counsel must also determine whether the payment from the replacement swap counterparty is subject to any legal or contractual restrictions (such as an indenture waterfall) or may be used to make the termination payment to the Lehman Swap Entity. If the new trade will be on-market, the Municipal Counterparty will need a source of payment for any termination payment to be paid to the Lehman Swap Entity.

## **REPLACEMENT OF LEHMAN SWAP ENTITIES**

A replacement swap provider may not accept an assignment or novation of a trade from a Lehman Swap Entity that is a debtor under the Code without the approval of the bankruptcy court. The most efficient means for the replacement swap provider to avoid this issue is for the Municipal Counterparty to establish and be solely responsible for the termination and valuation of its transactions with the Lehman Swap Entity, while the new replacement swap provider enters into new replacement transactions directly with the Municipal Counterparty.

## NOTES

<sup>1</sup> Because LBI is a regulated broker-dealer and the subject of a court order issued under the Securities Investor Protection Act appointing a SIPC trustee and placing it under the jurisdiction of the Holdings bankruptcy court for purposes of liquidation, LBI presents issues that are beyond the scope of this memo. For further information refer to Cadwalader Clients & Friends Memo dated September 21, 2008 and entitled “Lehman Court Orders Outline Rights of Counterparties to Safe Harbored Financial Contracts.”

<sup>2</sup> If the parties have elected Automatic Early Termination, the agreement would terminate as of the date of the related bankruptcy filing, without notice.

<sup>3</sup> On November 13, 2008, the debtors in the Lehman bankruptcy proceedings filed a motion requesting approval of expedited procedures for the assignment and assumption of derivative contracts that had not been terminated by the counterparties but were in the money to the Lehman Swap Entities. Among other things, debtors sought approval to assign these contracts to any assignee with a rating of A- or A3, or higher, except that no rating would be required in certain cases. Counterparties would be given five business days’ prior notice with an opportunity to object, but only on specific grounds, following which the debtor could assign the derivative contracts without counterparty consent. Municipal Counterparties and potential assignees of transactions pursuant to any such procedures should recognize that various matters would need to be considered for each potential assignment of a transaction, including the “Special Considerations Concerning Municipal Counterparties” discussed below. The Municipal Counterparty and potential assignee should also consider, among other things, whether (i) compliance with the federal bankruptcy court’s approved procedures for assignments will provide sufficient authority to bind the Municipal Counterparty under the assigned transaction if the Municipal Counterparty has not properly authorized the resulting transaction with that assignee and (ii) the assignment will have an adverse effect on outstanding Municipal Counterparty ratings.