

# Clients & Friends Memo

## Litigation Challenges Counterparty Right to Withhold Payments under Section 2(a)(iii) of ISDA Master Agreement as Violation of Automatic Stay Provisions of U.S. Bankruptcy Code

August 11, 2009

In a recently filed motion in the United States Bankruptcy Court Southern District of New York (the "Motion"), Lehman Brothers Holdings Inc. ("LBHI") is seeking to compel Metavante Corporation ("Metavante") to perform its obligations under a swap agreement between Metavante and Lehman Brothers Special Financing Inc. ("LBSF") (guaranteed by LBHI).<sup>1</sup> LBHI contends in the Motion that Metavante's attempt to suspend regularly scheduled payments pursuant to Section 2(a)(iii) of the ISDA Master Agreement is in violation of the automatic stay provisions of the United States Bankruptcy Code<sup>2</sup> ("the Bankruptcy Code") and not protected by the swap safe harbor provisions of the Bankruptcy Code.<sup>3</sup> In its objection to the Motion, Metavante argues that the Bankruptcy Code does not dictate a specific timeframe in which a non-debtor party must terminate a swap contract to preserve the protection afforded by the safe harbor provisions and Section 2(a)(iii) of the Master Agreement specifically permits a swap counterparty to suspend its payment obligations under swap transactions subject to a Master Agreement if an "event of default" has occurred and is continuing with respect to its counterparty.

The Master Agreement is a standard 1992 ISDA Master Agreement. LBSF and Metavante entered into an interest swap transaction under the Master Agreement pursuant to which Metavante was obligated to pay LBSF a fixed rate on an amortizing notional amount until February 1, 2012 and LBSF was obligated to pay Metavante a floating rate based on three-month LIBOR on the same notional amount during the same period. The bankruptcy of either party or its credit support

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<sup>1</sup> See, Lehman Brothers Holdings Inc., et al. (Chapter 11 Case No 08-013555 (JMP) (Jointly Administered), 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. The Motion has been supported by a Statement of Official Committee of Unsecured Creditors of Lehman Brothers, dated June 15, 2009 (the "Unsecured Creditors Statement") and a Statement of Ad Hoc Group of Lehman Brothers Creditors, dated July 10, 2009 (the "Ad Hoc Group Statement").

<sup>2</sup> These provisions are contained in Sections 362 and 365 of the Bankruptcy Code.

<sup>3</sup> These provisions are contained in Sections 362(b)(6), (7) and (17); 546(e), (f) and (g); 555, 556, 560 and 561 of the Bankruptcy Code.

provider is an event of default with respect to such party and entitles the other party to terminate all swap transactions under the Master Agreement. Upon a termination, the non-defaulting party determines the amount payable upon termination by seeking dealer quotations for the remaining term of all swap transactions and such amount is payable by either the defaulting party or the non-defaulting party depending on the value of such quotations. If no dealer quotations are available the termination amount is determined by the non-defaulting party on the basis of such party's reasonable determination of its loss or gain in connection with such termination.

LBHI filed for Bankruptcy on September 15, 2008. LBSF filed for Bankruptcy on October 3, 2008. Metavante has not terminated the swap transaction but did enter into a replacement swap with another counterparty in October 2008 covering the period from November 3, 2008 through February 1, 2010 to hedge against fluctuations in interest rates during that period. Since October, 2008, Metavante has not made the net payments required to be made by it to LBSF in reliance on Section 2(a)(iii) of the Master Agreement which generally provides that a party's obligation to make payments under the Master Agreement is subject to the condition precedent that there exist no event of default with respect to the other party at the time such payment is required to be made. Under current market conditions, if Metavante was to terminate the swap transaction in accordance with the terms of the Master Agreement it would be required to make a substantial payment to LBSF.

LBHI argues that the failure by Metavante to make payments required to be made by it under the swap transaction violates the automatic stay provisions of the Bankruptcy Code because such suspension modifies an executory contract solely because of the bankruptcy filing of LBHI and LBSF. LBHI also argues that under the Bankruptcy Code, while a debtor has the right to elect whether to assume or reject an executory contract, a non-debtor counterparty to such contract must continue to perform its obligations thereunder until the debtor makes such an election in order to preserve the assets of the estate during such period. Thus, LBHI argues that the failure by Metavante to make payments to LBSF under the swap transaction represents the control by Metavante over property of the estate, i.e., the net payments due to LBSF under the swap transaction, in direct contravention of the automatic stay provisions.

Moreover, LBHI argues that the suspension of payments by Metavante is not protected under the safe harbor provisions. Generally speaking, the safe harbor provisions are designed to provide certain non-debtor counterparties with specified rights to terminate, liquidate or accelerate qualifying derivatives contracts and offset or net out related transaction notwithstanding the bankruptcy filing of its counterparty. As such, the safe harbor provisions afford relief from the automatic stay otherwise imposed by the Bankruptcy Code. As noted above, however, in this case Metavante has not taken any steps toward terminating the swap transaction. Instead, it has decided not to terminate while at the same time suspending its obligations to make payments to LBSF, presumably while it waits for the market value of the swap transaction to move in its favor

(thereby avoiding or reducing the otherwise sizable termination payment it would be required to make to LBSF under the Master Agreement). Such a suspension, LBHI argues, does not constitute the termination, liquidation or acceleration of the swap transaction and therefore is not protected by the safe harbor provisions and thus is prohibited by the automatic stay provisions. By electing not to terminate the swap transaction under the protection of the safe harbor provisions, LBHI argues, Metavante should permanently forfeit the ability to seek protection thereunder and must now continue to perform.

The Ad Hoc Group Statement filed on July 10, 2009 on behalf of Elliott Management Corporation, King Street Capital Management, L.P. and Paulson & Co. Inc. also asserts that Metavante's suspension of payments in reliance on Section 2(a)(iii) does not fall within the safe harbor provisions because the Bankruptcy Code does not extend the safe harbor provisions to contractual provisions which are "in anticipation" of future termination and/or set-off rights under the Master Agreement. Under this argument, the wait and see approach espoused by Metavante, whereby it simultaneously withheld payment from the estate and yet did not terminate the Master Agreement, represents the forfeiture of its right to terminate the Master Agreement under the protections afforded by the safe harbor provisions in the future.

In its response to the Motion, Metavante argues that it was entitled to suspend payments because the LBHI and LBSF bankruptcy filings constituted events of default under the Master Agreement and, as a result, the condition precedent to its obligation to make payments had not been satisfied in accordance with Section 2(a)(iii) of the Master Agreement. Metavante further contends that if the Bankruptcy Court was to grant the Motion it would deprive Metavante of its contractual rights to net or set-off its damages against LBSF upon termination of the swap transaction in direct contravention of the safe harbor provisions and deny it the essential right conferred by such provisions to determine when to terminate a swap transaction. Metavante points out that the Bankruptcy Code does not specify a timeframe during which Metavante must exercise its termination right and that the right to determine the timing of termination is critical to a non-debtor counterparty to permit it to manage the termination process and preserve its rights against the debtor. In short, Metavante is seeking to suspend payments under the swap transaction to preserve its future rights of set-off if LBSF owes Metavante any amount upon the ultimate termination of the swap transaction. Thus, even though Metavante has not yet terminated the swap transaction, it is seeking to reserve its right to do so at a later date on the basis of the continued availability of the safe harbor provisions of the Bankruptcy Code.

LBHI and the Committee of Unsecured Creditors have replied to Metavante's response by arguing that although the safe harbor provisions are intended to protect qualifying swap participants against market risk if termination was precluded by the automatic stay, the rights provided by such provisions do not grant counterparties an unlimited period of time in which it may delay termination in hopes of improving market conditions. Rather, they argue that the legislative history behind the

safe harbor provisions indicates that it was the intent that swap participants would immediately, or at least “fairly contemporaneously”, terminate the contracts in order to take advantage of the protections afforded by the safe harbor provisions. There seems to be no support in the law, they conclude, for the proposition that the safe harbor provisions provide, or were intended to provide, swap participants with a free option to “play the market” with respect to their right to terminate a qualifying swap contract.

The issues raised by the Motion were argued before The Honorable James M. Peck in the United States Bankruptcy Court Southern District of New York last month. Although a final ruling has not yet been issued, Judge Peck seemed unsympathetic to Metavante’s position that it is entitled to suspend payments under the Master Agreement indefinitely without terminating the swap transaction while it waits to see if the markets will turn in their favor.

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Please feel free to contact any of the following attorneys if you have any questions about this memorandum.

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