

# Clients & Friends Alert

## Lehman Bankruptcy Court Issues Safe Harbor Decision

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On December 19, 2013, Judge James M. Peck of the United States Bankruptcy Court for the Southern District of New York issued his latest decision in the Lehman Brothers cases addressing the scope of the safe harbor provisions of the Bankruptcy Code. *Michigan State Housing Development Authority v. Lehman Brothers Derivatives Products Inc. and Lehman Brothers Holdings Inc. (In re Lehman Brothers Holdings Inc.)*. Judge Peck's decision confirms that the contractual provisions specifying the method of calculating the settlement amount under a swap agreement are protected by the Bankruptcy Code's safe harbors. The decision follows the reasoning of the amicus brief filed by the International Swaps and Derivatives Association ("ISDA"), which was prepared by Cadwalader.

### Background

Michigan State Housing Development Authority ("MSHDA") entered into an ISDA master agreement (the "Swap Agreement") with Lehman Brothers Derivatives Products ("LBDP") in May 2000, pursuant to which MSHDA and LBDP entered into interest rate swaps. The Swap Agreement provided that upon the occurrence of an Event of Default with respect to a party, the non-defaulting party had the right to terminate outstanding transactions and calculate the settlement amount due using "Market Quotation" and "Second Method." The Schedule to the Swap Agreement also included "Trigger Events" that constituted additional termination events. If a Trigger Event occurred with respect to a party, the Schedule provided that the non-defaulting party had the right to calculate the settlement amount using the "Mid-Market" valuation method.

Following the September 2008 bankruptcy of Lehman Brothers Holdings Inc. ("LBHI"), MSHDA and LBDP entered into an assignment and amendment agreement with Lehman Brothers Special Financing ("LBSF") (a non-debtor at the time) pursuant to which LBDP assigned all of its rights and obligations under the Swap Agreement to LBSF. The assignment agreement also contained a paragraph, referred to as the "Liquidation Paragraph," that amended the valuation method to be used in the event of a termination. The Liquidation Paragraph provided that if MSHDA terminated the Swap Agreement due to the non-payment or bankruptcy of LBSF, MSHDA was to use Market Quotation to calculate the settlement amount. However, if the Swap Agreement was terminated for

any other reason, the non-defaulting party was required to use Mid-Market to calculate the settlement amount.

Following LBSF's bankruptcy filing in October 2008, MSHDA terminated the Swap Agreement and paid a \$36 million settlement amount which it calculated using the Market Quotation Method. In response, LBSF argued that the Liquidation Paragraph was an *ipso facto* provision unenforceable under Section 365(e)(1) of the Bankruptcy Code, and that as a result, MSHDA was required to calculate the settlement amount using the Mid-Market method, which would have increased the settlement amount due to LBSF by approximately \$23 million.

ISDA submitted a brief of *amicus curiae* in support of MSHDA's position, arguing that the Bankruptcy Code safe harbors protect the right to terminate, liquidate and accelerate swap agreements in accordance with their terms, and that the act of liquidating necessarily includes calculating the settlement amount owed in accordance with the contractually specified methodology. ISDA emphasized that such protections are necessary to insulate the financial markets from the uncertainty that would result if counterparties to financial contracts were not permitted to enforce their rights upon default.

### **The Court's Opinion**

The question before the Court was whether the Liquidation Paragraph, despite its *ipso facto* nature, fell within the safe harbor protections under Section 560 of the Bankruptcy Code, which permits "the liquidation, termination or acceleration" of swap agreements.

In addressing the breadth of Section 560, the Court first noted that where the statutory language is clear, the court's duty is to enforce the statute according to its terms. The Court reviewed the ordinary meaning of the word "liquidation," and found that "liquidation" means "the act of determining by agreement the exact amount of something that otherwise would be uncertain." Based on this definition, the Court determined that the right to liquidate a swap agreement must mean the right to determine the exact amount payable under the swap agreement. Accordingly, the Court found that MSHDA's use of Market Quotation to calculate the settlement amount due to LBSF was a part of MSHDA's protected contractual right to liquidate the Swap Agreement. The Court noted that unless the act of liquidation is performed in accordance with the agreed method, the right to liquidate would lose all practical meaning.

The Court was unpersuaded by LBSF's argument that the right to calculate a settlement amount was ancillary to the right to liquidate, which was based on the Court's previous decisions in the *BNY Trustee*, *Ballyrock* and *Calpine Energy* cases. In each of these previous cases, the Court determined that certain ancillary or incidental rights fell outside of the protections of the safe harbor.

However, the Court found that each of these three cases was distinguishable from the MSHDA case.

In the *BNY Trustee* case, the Court held that a “flip clause” that subordinated payments due to LBSF as a result of its bankruptcy filing was an unenforceable *ipso facto* clause that was not protected by Section 560. In that case, the flip clause was contained in a supplemental agreement that was not part of the swap agreement, and the Court determined that the flip clause did not expressly deal with liquidation, termination or acceleration. In the MSHDA case, the Court found that *BNY Trustee* was inapplicable because the Liquidation Paragraph was part of the Swap Agreement and the Liquidation Paragraph dealt expressly with the liquidation of the Swap Agreement. The Court noted that the act of liquidating and the method of calculation “are so tightly intertwined to the point that liquidation without a defining methodology is impossible to perform.” The Court similarly found that *Ballyrock* was distinguishable because that case also dealt with a provision that altered payment priorities and that did not directly deal with liquidation, termination or acceleration.

### Conclusion

The MSHDA decision is important because it firmly establishes that calculation of a termination payment is an integral part of liquidation. In addition, the MSHDA decision places clear limits on the reach of the *BNY Trustee* and *Ballyrock* decisions.

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