No Safe Harbor in a Bankruptcy Storm: Mutuality "Baked Into the Very Definition of Setoff"

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"Safe harbors" in the Bankruptcy Code designed to insulate nondebtor parties to financial contracts from the consequences that normally ensue when a counterparty files for bankruptcy have been the focus of a considerable amount of scrutiny as part of evolving developments in the Great Recession. One of the most recent developments concerning this issue in the courts was the subject of a ruling handed down by the New York bankruptcy court presiding over the Lehman Brothers chapter 11 cases. In *In re Lehman Bros. Holdings, Inc.*, Judge James M. Peck ruled that, absent mutuality of obligation, funds on deposit with a bank are not protected by the Bankruptcy Code's safe-harbor provisions and cannot be used to set off an obligation allegedly owed by the debtor under a master swap agreement. "A contractual right to setoff under derivative contracts," Judge Peck wrote, "does not change well established law that conditions such a right on the existence of mutual obligations."

Setoff Rights in Bankruptcy

Section 553(a) of the Bankruptcy Code provides, subject to certain exceptions, that the Bankruptcy Code "does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case . . . ."

Under section 553(b), a bankruptcy trustee or chapter 11 debtor in possession can recover the amount of most setoffs effected within 90 days before the filing of a bankruptcy case that improve the creditor's economic position.

Section 553 does not create setoff rights—it merely preserves any such rights that exist under contract or applicable nonbankruptcy law to set off mutual prepetition debts. A creditor is generally precluded by the automatic stay from exercising its setoff rights without bankruptcy-court approval. The stay, however, merely suspends the exercise of such a setoff pending an orderly examination of the respective rights of the debtor and the creditor by the court, which will generally permit the setoff if the requirements under applicable law are met, except under circumstances where it would be inequitable to do so. Debts ("debt" being defined by section 101(12) as a "liability on a claim") are considered mutual when they are due to and from the same persons in the same capacity.

Financial Contract Safe-Harbor Provisions

Although one of the Bankruptcy Code's primary policies is to provide for the equitable distribution of a debtor's assets among its creditors, Congress recognized the potentially devastating consequences that might ensue if the bankruptcy or insolvency of one financial firm were allowed to spread to other market participants, thereby threatening the stability of entire markets. Beginning in 1982, lawmakers formulated a series of changes to the Bankruptcy Code to create certain "safe harbors" to protect rights of termination and setoff under "securities contracts," "commodities contracts," and "forward contracts." Those changes were subsequently refined and expanded to cover "swap agreements," "repurchase agreements," and "master netting agreements" as part of a series of legislative developments, including the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") and the Financial Netting Improvements Act of 2006 ("FNIA").

These special protections are codified in, among other provisions, sections 555, 556, and 559 through 562 of the Bankruptcy Code. Without them, sections 362 and 365(e)(1) of the Bankruptcy Code would prevent a nondebtor party to a financial contract from taking immediate action to limit exposure occasioned by a bankruptcy filing by or against the counterparty. Lawmakers, however, recognized that financial markets can change significantly almost overnight and that nondebtor parties to certain types of complex financial transactions may incur heavy losses unless the transactions are promptly and finally closed out and resolved. Congress therefore exempted most kinds of financial contracts from these prohibitions and amended the Bankruptcy Code to insulate these transactions from avoidance as preferential or fraudulent transfers unless the transactions were made with actual intent to hinder, delay, or defraud creditors of the debtor.

For example, section 560 provides in relevant part as follows:

> The exercise of *any contractual right* of any swap participant or financial participant to cause the liquidation, termination, or acceleration of one or more swap agreements because of a condition of the kind specified in section 365(e)(1) of this title or to offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of one or more swap agreements *shall not be stayed, avoided, or otherwise limited by operation of any provision of this title* or by order of a court or administrative agency in any proceeding under this title (emphasis added).

This provision was added to the Bankruptcy Code in 1990. It was amended by BAPCPA to clarify that the provisions of the Bankruptcy Code that protect: (i) liquidation rights under securities contracts, commodity contracts, forward contracts, and repurchase agreements also protect termination or acceleration rights under such contracts; and (ii) termination rights under swap agreements also protect rights of liquidation and acceleration.

Section 561 addresses the contractual right to resolve positions under a master netting agreement and across financial contracts. Added to the Bankruptcy Code in 2005 as part of BAPCPA, it provides in relevant part that:

> Subject to subsection (b), the exercise *of any contractual right*, because of a condition of the kind specified in section 365(e)(1), to cause the termination, liquidation, or acceleration of or to offset or net termination values, payment amounts, or other transfer obligations arising under or in connection with one or more (or the termination, liquidation, or acceleration of one or more) . . . [delineated financial contracts] . . . *shall not be stayed, avoided, or otherwise limited by operation of any provision of this title* or by any order of a court or administrative agency in any proceeding under this title (emphasis added).

The setoff procedures in section 553 were also modified after its enactment in 1978 to clarify that the safe harbor for financial contracts encompasses setoff rights. In particular, setoffs of the kind described in, among other provisions, sections 555, 556, 559, 560, and 561 are protected from certain of the strictures of section 553(a) or avoidance under section 553(b). The interplay among the section 560 and 561 safe harbors and a creditor's preserved setoff rights under section 553 was the subject of the bankruptcy court's ruling in *Lehman Brothers*.

Lehman Brothers

Prior to filing for chapter 11 protection in September 2008 in New York, Lehman Brothers Holdings, Inc. ("Lehman"), maintained a general deposit account with Swedbank AB ("Swedbank") in Stockholm. On the bankruptcy petition date, the account contained approximately 2.14 million krona. Swedbank placed an administrative freeze on the account shortly after Lehman filed for bankruptcy protection. Although the bank allowed deposits into the account, Swedbank prevented Lehman from withdrawing funds from it. The account balance eventually grew to 85 million krona, 83 million krona of which was deposited by Lehman postpetition.

Prior to filing for chapter 11, Lehman (through a U.K. branch) and certain of its affiliates had entered into various International Swaps and Derivatives Association master agreements (the "ISDA Master Agreements") with Swedbank. Lehman acted as the guarantor. Each of the ISDA Master Agreements defined "event of default" to include bankruptcy. The ISDA Master Agreements further provided that the occurrence of such an event of default triggers the early termination of the ISDA Master Agreements. Early termination in turn gave rise to a right to payment in favor of the party to the agreement that was then "in the money." Finally, the ISDA Master Agreement between Lehman and Swedbank contained a provision granting Swedbank a right of setoff upon the occurrence of an event of default:

> In addition to any rights of set-off a party may have as a matter of law or otherwise, upon the occurrence of an Event of Default or an Additional Termination Event and the designation of an Early Termination Date pursuant to section 6 of this Agreement with respect to a party ("X"), the other party ("Y") will have the right (but not be obliged) without prior notice to X or any other person to setoff or apply any obligation of X owed to Y (and to any affiliate of Y) (whether or not matured or contingent and whether or not arising under this Agreement, and regardless of the currency, place of payment or booking office of the obligation) against any obligation of Y (and of any affiliate of Y) owed to X (whether or not matured or contingent and whether or not arising under this Agreement, and regardless of the currency, place of payment or booking office of the obligation).

Claiming that Lehman owed it $32 million, Swedbank announced its intent in November 2008 to use $11.7 million of the funds on deposit as a setoff for Lehman's obligations. Of the $32 million, approximately $14 million (approximately 97.5 million krona) was an obligation of Lehman as either counterparty or guarantor under the ISDA Master Agreements, and the remainder allegedly was based on a senior promissory note held by Swedbank.

Lehman responded by, among other things, seeking an order of the bankruptcy court enforcing the automatic stay and compelling Swedbank to surrender the funds on deposit. According to Lehman, Swedbank's administrative freeze of funds violated the automatic stay because the funds comprised postpetition deposits that lacked the requisite mutuality with Lehman's alleged prepetition debt under section 553. Swedbank countered that its contractual setoff rights in the ISDA Master Agreements were unaffected by the automatic stay because the swap agreements were protected by the safe harbors of sections 560 and 561 of the Bankruptcy Code.

The Bankruptcy Court's Ruling

Judge Peck ruled in Lehman's favor. The safe-harbor provisions, he wrote, "simply do not directly address the requirement of mutuality under section 553(a)." Instead, Judge Peck observed, "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, avoid or otherwise limit that right, but that right must exist in the first place."

In order to establish a setoff right under section 553(a), Judge Peck explained, the following prerequisites must be satisfied: (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 to the creditor must be mutual. Mutuality, he wrote, "exists when the debts and credits are in the same right and are between the same parties, standing in the same capacity." No mutuality existed in this case, Judge Peck concluded, because the funds in the Swedbank account were deposited postpetition, while Lehman's indebtedness to Swedbank arose prepetition under the ISDA Master Agreements.

Judge Peck rejected Swedbank's contention that "the mutuality requirement of section 553 is rendered inapplicable by the safe harbor provisions of sections 560 and 561 of the Bankruptcy Code." According to Swedbank, the reference in section 560 that permits a derivative-contract counterparty to exercise "any" contractual right notwithstanding the automatic stay should permit Swedbank to exercise its contractual right to setoff arising from the ISDA Master Agreement, notwithstanding the undisputed lack of mutuality under section 553. Judge Peck found this argument to be untenable, observing that "Swedbank's self-interested interpretation of the relevant provisions of the Bankruptcy Code is without precedent and unsupported by a fair reading of the textual language."

By their plain terms, Judge Peck explained, the 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." Given the silence of sections 560 and 561 with respect to the mutuality requirement of section 553, the judge declined to read an exception into the statute.

Judge Peck also rejected Swedbank's contention that the safe-harbor provisions "implicitly override the mutuality requirement." According to Swedbank, the "theoretical underpinning" of the prepetition mutuality requirement in section 553—the "well-established fiction that the debtor changes on the petition date"—is irrelevant when dealing with setoff under safe-harbored derivative contracts in light of the language in section 560 dealing with the application of the automatic stay (*i.e.*, "shall not be stayed . . . or otherwise limited by operation of any provision of this title"). Judge Peck wrote that "Swedbank disregards the plain language of section 553(a),

which expressly memorializes the pre- and postpetition distinction, independent of the so-called 'fiction' regarding the newly created debtor-in-possession." Moreover, the judge emphasized, this argument ignores the fact that section 553 itself delineates a number of specific exceptions, and "setoff under safe harbored derivative contracts is not one of them."

"Mutuality," Judge Peck concluded, "is baked into the very definition of setoff." He further explained that sections 560 and 561 were enacted long after the mutuality requirement of section 553 had been codified. "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," he wrote.

Judge Peck remarked that "[s]ections 560 and 561 preserve contractual rights of setoff for mutual pre-petition obligations—essentially assuring the nondebtor swap counterparty that the advent of bankruptcy will not frustrate pre-petition commercial expectations relating to setoff and netting." Although "the contractual rights of parties are to be respected and enforced," he added, "that does not justify overriding applicable bankruptcy jurisprudence."

Judge Peck rejected Swedbank's argument that changes to section 553 as part of BAPCPA "explicitly exclude" from the mutuality requirement transactions or setoffs covered by the safe-harbor provisions:

> Plainly, then, the 2005 amendments to section 553 with respect to sections 560 and 561 are narrow and leave intact the mutuality requirement of section 553(a). Such an interpretation dovetails with common sense. If Congress had intended to eliminate the mutuality requirement of section 553(a), it would have done so directly and with clarity.

He was similarly unpersuaded by Swedbank's contention that FNIA removed the requirement of mutuality from the automatic-stay exceptions found in section 362(d) of the Bankruptcy Code. The legislative history of FNIA, Judge Peck wrote, 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, the judge remarked, "cannot be read as authority for so fundamental a change in creditor rights."

Judge Peck ruled that Swedbank's administrative freeze was unjustified and constituted a continuing violation of the automatic stay. He granted Lehman's motion and directed Swedbank immediately to release the freeze and allow Lehman access to all the funds deposited postpetition.

Outlook

Lehman Brothers illustrates that, although the Bankruptcy Code's safe-harbor provisions for financial contracts are broad, they do not necessarily override other provisions in the statute designed to protect debtors and to preserve the bankruptcy estate consistent with the bedrock principle of equality of distribution. It also indicates that bankruptcy courts are increasingly casting a critical eye on the efforts of financial participants to limit their exposure by resorting to the Bankruptcy Code's safe-harbor provisions for financial contracts.

The scope and operation of the Bankruptcy Code's safe harbor for financial contracts continue to be a source of controversy and litigation in the courts, particularly in the Lehman Brothers chapter 11 cases. For example, in *Securities Investor Protection Corp. v. Lehman Bros. Inc.*, Judge Peck ruled on June 1 that section 562 of the Bankruptcy Code—which provides that when

a debtor rejects a securities contract with a financial participant or when a financial participant terminates a securities contract with a debtor, the parties shall use the date of rejection or termination as the reference point to calculate damages—does not conflict with a provision in the Securities Investors Protection Act that designates the filing date of a stockbroker liquidation case as the correct date for determining claims based on a customer's short positions. Judge Peck also ruled in *Lehman Brothers Special Financing, Inc. v. BNY Corporate Trustee Services, Ltd. (In re Lehman Brothers Holdings, Inc.)* that a "flip clause" in an agreement executed as part of a swap transaction that shifted the priority of payments upon a bankruptcy filing by one of the participants was not saved from invalidation as an unenforceable "ipso facto" clause by the safe harbor for swap agreements in section 560 because the provisions were clearly not part of (or even referred to in) the swap agreements and because the provisions did not relate to "the liquidation, termination, or acceleration" of a swap agreement. The disputes in the bankruptcy courts regarding safe-harbored financial contracts are likely to persist for some time.

In re Lehman Bros. Holdings, Inc., 2010 WL 1783395 (Bankr. S.D.N.Y. May 5, 2010).

Securities Investor Protection Corp. v. Lehman Bros. Inc., 2010 WL 2163358 (Bankr. S.D.N.Y. June 1, 2010).

Lehman Brothers Special Financing, Inc. v. BNY Corporate Trustee Services, Ltd. (In re Lehman Brothers Holdings, Inc.), 422 B.R. 407 (Bankr. S.D.N.Y. 2010).