# In Brief: District Court Affirms *Lehman Brothers* Safe-Harbor Setoff Ruling

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In the July/August 2010 edition of the *Business Restructuring Review*, we reported on an important ruling handed down by bankruptcy judge James M. Peck in the Lehman Brothers chapter 11 cases addressing the interaction between the Bankruptcy Code's general setoff rules (set forth in section 553) and the Code's safe harbors for financial contracts (found principally in sections 555, 556, and 559 through 562). In *In re Lehman Bros. Holdings, Inc.*, 433 B.R. 101 (Bankr. S.D.N.Y. 2010), Judge Peck held that, absent mutuality of obligation, funds on deposit with a bank are not protected by the 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." According to the judge, "[M]utuality is baked into the very definition of setoff."

Among other things, Judge Peck found that: (a) the requisite mutuality did not exist under section 553(a) to permit the setoff of funds in the bank account because the derivatives claims against the debtor arose prepetition, whereas the obligation to the debtor (*i.e.*, the postpetition deposits in the bank account) arose postpetition; (b) the plain language of the safe-harbor provisions, as well as their legislative history, demonstrated that the provisions do not nullify the

mutuality requirement of section 553(a); and (c) the administrative freeze of the accounts by the bank counterparty—Swedbank AB—violated the automatic stay.

The district court affirmed the ruling in all respects on January 26, 2011, for the most part without comment. *See In re Lehman Bros. Holdings Inc.*, 2011 WL 350280 (S.D.N.Y. Jan. 27, 2011). However, in its opinion, the district court specifically addressed Swedbank's argument on appeal that the legislative history supports its construction of the safe-harbor provisions. Surveying the legislative history, the court found no indication that the safe-harbor provisions displaced mutuality or functioned as an exception to section 553. Consequently, the court determined that the legislative history does not support Swedbank's position that the safe harbors permitted its attempted setoff against the debtor's postpetition assets, which were fortuitously deposited at Swedbank and which had no connection to the underlying swap agreements.

According to the court, a contrary rule would mean that a swap participant is entitled to a type of super-priority status that extends to all of its commercial transactions with the debtor, and Congress neither wrote nor intended to write such a rule. Together with the ruling in *In re SemCrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009), the decision would appear to make it more difficult to contract around the mutuality requirements of section 553, potentially prohibiting triangular setoffs in swap agreements. In a footnote, the district court wrote: "Similarly, Swedbank argues that the Safe Harbor Provisions permit parties to contract out of the requirements of the Bankruptcy Code, including out of the mutuality requirement. We note that there is a paucity of support for this argument, which runs counter to the fundamental purposes of the bankruptcy law."