SUTHERLAND

LEGAL ALERT

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Lehman Brothers Ruling Calls into Question Enforceability of Cross-Affiliate Netting in Bankruptcy

The U.S. Bankruptcy Court for the Southern District of New York recently issued an opinion in the case of *In re Lehman Brothers Holdings Inc.* that significantly restricts the scope of setoff rights for energy traders and other participants in derivatives and forward commodity markets. Traditionally, bankruptcy law has required mutuality between the debtor and a creditor as a prerequisite for the exercise of setoff rights by the creditor. In 2005, however, Congress enacted section 561 of the Bankruptcy Code, which provided safe harbor protections for master netting agreements – thus appearing to allow cross-affiliate netting when specifically provided in trading contracts. The *Lehman* opinion rejects that notion, and instead imposes a strict mutuality requirement on any instances of setoff, including those that fall under the "safe harbor" statutes of the Bankruptcy Code. That decision, if upheld on appeal, could significantly reduce the protection and security that many in the trading markets believed they had.

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On January 22, 2010, Lehman Brothers Holdings Inc. (LBHI) and its debtor affiliates (collectively, including LBHI, Lehman Brothers or Lehman) filed a motion, seeking to have the bankruptcy court enforce the automatic stay against Swedbank AB. The motion noted that Swedbank was a depository bank for LBHI, and that following the filing of the bankruptcy petitions, Swedbank had instituted an administrative freeze upon certain Lehman funds. The administrative freeze prevented Lehman from gaining access to its funds, including some deposits that were made after its bankruptcy filing. The motion suggested that Swedbank had informed Lehman that it intended to offset Lehman's deposits against amounts owed by Lehman to Swedbank under various ISDA Master Agreements (the Master Agreements). The motion alleged that the administrative freeze and any prospective setoff were in violation of the automatic stay, to the extent that the relevant deposits were made post-petition.

Section 553 of the Bankruptcy Code governs most instances of setoff. It provides 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 [bankruptcy case] against a claim of such creditor against the debtor that arose before the commencement of the case." In the motion, Lehman Brothers emphasized that section 553 specifies that the requirements of mutuality and that the relevant obligations arose pre-petition. In the course of its discussion of mutuality, the motion argued that it too included a component that prohibited the setoff of pre-petition obligations against post-petition obligations.

Swedbank filed an objection on February 3, 2010. The objection did not dispute any of the operative facts from the motion. Instead, the objection argued that Swedbank was protected by the safe harbor provisions in sections 560 and 561 of the Bankruptcy Code. Swedbank detailed the four separate Master Agreements that it had executed with LBHI and four other separate Lehman entities. The objection then explained how the initial bankruptcy filing by LBHI constituted an Event of Default under each of the Master Agreements, which in some instances automatically terminated the contract and, in other instances, allowed Swedbank to voluntarily terminate the contract. Thereafter, the Master Agreements called for Swedbank (as the non-defaulting party) to calculate the amounts owed by each party.

One of the means by which Swedbank was to make those calculations was the setoff provisions found in the Master Agreements. The Master Agreement with LBHI (the LBHI Master Agreement) contained setoff language that allowed a non-defaulting party to elect to setoff its obligations under the LBHI Master Agreement against any other obligations owed by LBHI, regardless of whether it was under the LBHI Master Agreement. Swedbank therefore maintained that it was entitled to offset the post-petition amount in LBHI's depository account against the amount LBHI owed Swedbank under the LBHI Master Agreement.

Swedbank argued that the setoff was protected by the safe harbor provisions of the Bankruptcy Code. Section 561 of the Bankruptcy Code provides that "the exercise of any contractual right, because of [a bankruptcy filing] … to offset or net termination values, payment amounts or other transfer obligations arising under or in connection with one or more … swap agreements … shall not be stayed, avoided or otherwise limited by operation of any provision of this title." As a result of such expansive language in the safe harbor provisions, despite the apparent lack of connection between the post-petition deposits and the swap agreements, Swedbank asserted it was entitled to offset LBHI's deposits against the amounts owed by LBHI under the LBHI Master Agreement.

In a Reply, Lehman disputed Swedbank's contention that section 553 was inapplicable. Instead, Lehman Brothers argued that the mutuality requirements contained in section 553 also applied to instances when a creditor seeks to exercise setoff rights under the Bankruptcy Code's safe harbor provisions.

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The bankruptcy court agreed with Lehman's argument, including the broader contentions in its Reply. The bankruptcy court first found that no mutuality existed in the dealings between LBHI and Swedbank, based on the post-petition nature of the deposits made by LBHI. Next, the court concluded that sections 560 and 561 remain subject to the traditional requirement of mutuality under the language and case law of section 553. It stated that 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." The court also pointed to two pieces of legislative history that arguably support the proposition that the mutuality requirement should be applied to the safe harbor provisions.

As a result, the bankruptcy court held that the actions of Swedbank in effecting the administrative freeze constituted a violation of the automatic stay. The court therefore directed Swedbank to release its administrative freeze immediately and to return all post-petition deposits to the bankruptcy estate.

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The bankruptcy court's analysis mainly focused on a plain reading of section 553. It is noteworthy, however, that the court seemed to focus less on the plain language of sections 560 and 561. The language in the safe harbor statutes specifies that they apply notwithstanding the provisions of any other Bankruptcy Code provisions. The decision also leads to some lingering questions concerning the meaning of some of the Bankruptcy Code's safe harbor language that appears to be inconsistent with the ruling.

Swedbank has filed a notice of appeal, and presumably the problems outlined above will be among the issues argued on appeal. Participants in derivatives markets will want to monitor the developments in this appeal. Since the adoption of the 2005 amendments, many in the trading community have relied on their ability to exercise contractual setoff rights across products, agreements and affiliates in connection with the termination of a contract.

Within the industry, many believed that cross-affiliate netting rights in master netting agreements executed by affiliated companies likely would be enforceable in connection with their termination and the liquidation of safe harbor contracts, particularly in light of the broad safe-harbor language enacted in the 2005 amendments. As a result, the *Lehman* decision potentially represents a significant change in the landscape if the mutuality requirement is read to preclude netting and offset across affiliated entities. If bankruptcy courts will not allow cross-affiliate netting under the safe harbor provisions of the Bankruptcy Code, then traders are sure to reevaluate their credit and risk strategies accordingly to the extent that they assumed the protection of cross-affiliate netting – especially when they are trading with multiple affiliates of a counterparty. The restriction of such setoff rights reduces the protections and security a creditor has when its counterparty goes bankrupt and may mean that parties should take a closer look at collateral and margin posted on an entity-by-entity basis.

In addition, a Delaware district court recently affirmed another setoff opinion from the *SemCrude, L.P.* bankruptcy court, in which the court determined that there was no contract exception to the strict mutuality requirements outside of the safe harbor provisions. Reading the *Lehman* and the *SemCrude* decisions together, there appears to be a broader attack by debtors in bankruptcy against the setoff rights and safe harbor protections of their trading counterparties.

Given those circumstances, we expect that derivatives and trading companies and their trade associations will follow this *Lehman* appeal closely, and we would not be surprised to see them take a proactive role in the appellate proceedings.

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If you have any questions about this Legal Alert, please feel free to contact the attorneys listed below or the Sutherland attorney with whom you regularly work.

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