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Lehman Limits Exercise Of Setoff Right In ISDA Pacts

Law360, New York (May 20, 2010) -- On May 5, 2010, the United States Bankruptcy Court for the Southern District of New York issued a decision holding that the contractual right of setoff under an ISDA Master Agreement is unenforceable in bankruptcy unless strict mutuality exists.

The background to the decision is that before Lehman's bankruptcy, Swedbank AG ("Swedbank") and Lehman Brothers Holdings Inc. ("LBHI") entered into several ISDA Master Agreements (the "Agreements").

Each of the Agreements provides that bankruptcy is an event of default triggering the early termination of the Agreements. Early termination, in turn, results in a right to payment in favor of the party that is "in the money" under the Agreements.

Critically, one of the Agreements, as is often the case, contained a provision granting Swedbank a broad right of setoff upon the occurrence of an event of default.

On Sept. 15, 2008, LBHI filed for bankruptcy. At that time, LBHI had a general deposit account with Swedbank (the "Account") with a balance of roughly 2 million Swedish Krona. Swedbank placed an administrative freeze on the Account, which blocked LBHI from withdrawing funds but allowed funds to continue to flow into the Account. By Nov. 12, 2009, as a result of post-petition deposits, the balance had increased to 83 million Swedish Krona or approximately $12 million.

Swedbank advised LBHI that it intended to setoff the funds deposited in the Account post-petition against approximately $32 million in prepetition indebtedness allegedly owed by LBHI to Swedbank under the Agreements.

In response, LBHI and its debtor affiliates (the "Debtors") filed a motion arguing that setoff would be improper and the administrative freeze on the Account violated the automatic stay. The Debtors relied on the argument that Section 553 of the Bankruptcy Code only provides for setoff of prepetition debts and claims.

Swedbank countered that sections 560 and 561 of the Bankruptcy Code — certain of the so-called safe harbor provisions — specifically provide for the enforcement of broad rights of setoff unfettered by Section 553.

Section 560, for example, provides that "'[t]he exercise of any contractual right of any swap participant ... 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.'"

The court did not accept Swedbank's arguments. It agreed with the Debtors that three requirements must be satisfied for a counterparty to be eligible for setoff under section 553 of the Bankruptcy Code.

First, the amount owed by the debtor must be a prepetition debt. Second, the debtor's claim against the creditor must also be prepetition. And third, the debtor's claim against the creditor and the debt owed the creditor must be mutual. For mutuality to exist, the court quoted the familiar test that mutuality exists when the debts and credits are in the same right and are between the same parties, standing in the same capacity.

As to Swedbank's argument concerning sections 560 and 561 of the Bankruptcy Code, the court held that the safe harbor provisions, by their plain terms, "[d]o not alter the axiomatic principle of bankruptcy law, codified in section 553, requiring mutuality in order to exercise a right of setoff."

The court stated, "If Congress had intended to establish a plainly worded exception to the rule limiting setoff to mutual prepetition claims, it would have done so explicitly."

The court also found support in the legislative history surrounding sections 560 and 561, reasoning that the safe harbor provisions were intended by Congress to permit parties to derivative contracts "to exercise the right 'to offset or net termination values' despite the automatic stay and without having to seek relief from the stay" but "[t]hese exceptions do not repeal or nullify the basic legal precepts that govern the right to setoff in bankruptcy cases, nor do they authorize a party to a swap agreement to effectuate a setoff without satisfying the underlying requirements for such a setoff (i.e., mutuality)."

Separately, Swedbank made the argument, by reference to the automatic stay of Section 362 of the Bankruptcy Code, that Congress had expressly removed the requirement of mutuality for safe harbor contracts. The basis for this argument is that Congress, in the Financial Netting Improvement Act of 2006 ("FNIA"), had expressly eliminated the phrase "mutual debt and claim" from the safe harbor exceptions to the automatic stay and replaced it with the phrase "any contractual right."

Thus, for example, under new 362(b)(17), the filing of a bankruptcy does not operate as a stay of the exercise by a swap participant of "any contractual right" to offset or net out amounts due under or in connection with swap agreements.

The court also rejected this argument, relying again on legislative history and finding that the FNIA amendments "[c]annot be read as authority for so fundamental a change in creditor rights," namely the elimination of the mutuality requirement for safe harbor contracts.

After determining that sections 560 and 561 of the Bankruptcy Code did not override the requirements of Section 553, the court held that Swedbank violated the automatic stay by freezing the Debtors' assets to effect a setoff, and ordered Swedbank to release LBHI's funds deposited in the Account post-petition. Swedbank has filed a notice of appeal.

It is important to note that the court was not faced with a situation where a creditor was relying on the ISDA Agreements and the safe harbor provisions to setoff prepetition debts and claims between multiple parties. Rather, a creditor was seeking to setoff post-petition deposits in its possession against prepetition indebtedness due itself. It was in that temporal context that the court held mutuality must be shown.

Nonetheless, the court did find that Section 553 trumps the safe harbor provisions, not the other way round, even though: (i) those provisions state that the contractual rights of swap participants and other safe harbor parties shall not be stayed, avoided, or otherwise limited by operation of any provision of the Bankruptcy Code; and (ii) Congress eliminated the phrase "mutual debt and claim" from the automatic stay safe harbor exceptions.

The Swedbank decision follows other decisions in the Lehman case that have limited the scope of the protections afforded by the safe harbor provisions, such as the Metavante decision, which held that safe harbor protections do not permit a party to withhold performance under a swap agreement if the swap has not been terminated.

It also follows a recent decision from the SemCrude bankruptcy case, where the United States Bankruptcy Court for the District of Delaware ruled, and the District Court affirmed, that contractual exceptions to the mutuality requirement that allow for triangular setoff are not enforceable based on the plain language of section 553.

These decisions, individually and collectively, are undoubtedly affecting market expectations concerning the enforceability of contract provisions in ISDA Agreements and other safe harbor agreements, provisions that parties have relied upon in the past to manage credit and other risks in the financial and commodity markets.

As a result, these decisions are forcing an accelerated review of the terms of safe harbor contracts and best credit practices.

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