ORRICK

RESTRUCTURING LAW ALERT | MAY 7, 2010

Lehman Decision Limits Setoff Rights in ISDA Master Agreements

On May 5, 2010, the United States Bankruptcy Court for the Southern District of New York issued a decision declaring that a party's right to setoff in an ISDA Master Agreement is unenforceable in bankruptcy unless strict mutuality exists. (Decision and Order).

The dispute arose out of several ISDA Master Agreements (the "Agreements") that were entered into between Lehman Brothers Holdings Inc. ("LBHI") (sometimes as guarantor, sometimes as counterparty) and Swedbank AG ("Swedbank"). Each of these agreements provided that bankruptcy was 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. One of the Agreements contained a provision allowing Swedbank a right of setoff upon the occurrence of an event of default.

On September 15, 2008, LBHI filed for bankruptcy protection. On this date, LBHI had a general deposit account with Swedbank (the "Account") with a balance of 2,140,897.40 Swedish Krona. Shortly after LBHI commenced its bankruptcy case, Swedbank placed an administrative freeze on the Account, blocking LBHI from withdrawing any amounts but still allowing funds to flow into the Account. As a result of post-petition deposits, the balance increased to 82,765,466.45 Swedish Krona or approximately $11.7 million. Swedbank informed LBHI that it intended to use the funds in the Account to set off approximately $32 million allegedly owed by LBHI to Swedbank.

On January 20, 2010, LBHI and its debtor affiliates (the "Debtors") filed a motion arguing that Swedbank should not be allowed to set off the funds in the Account and that the administrative freeze on the Account violated the automatic stay. In support of their argument, the Debtors asserted that the funds comprised post-petition deposits, lacking the requisite mutuality to be set off against LBHI's alleged pre-petition indebtedness. In response, Swedbank asserted that sections 560 and 561 of the Bankruptcy Code, certain of the so-called safe harbor provisions, allowed Swedbank to set off the funds under the contractual provisions of the Agreements without violating the automatic stay.

The court determined that three factors are necessary for setoff under section 553 of the Bankruptcy Code: (1) the amount owed by the debtor must be a pre-petition debt, (2) the debtor's claim against the creditor must also be pre-petition, and (3) the debtor's claim against the creditor and the debt owed the creditor must be mutual. Further, the court determined, "mutuality, in turn, exists, when 'the debts and credits are in the same right and are between the same parties, standing in the same capacity.'"

In response to Swedbank's argument concerning sections 560 and 561 of the Bankruptcy Code, the court held that these safe harbor provisions, by their plain terms, "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 went on to state: "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."

Contact a Team Member

Jonathan P. Guy
Partner
Washington, D.C.
(202) 339-8516
jguy@orrick.com

Thomas C. Mitchell
Partner
San Francisco
(415) 773-5732
tcmitchell@orrick.com

Courtney M. Rogers
Managing Associate
New York
(212) 506-5106
crogers@orrick.com

Additional Resources

www.orrick.com

The court also reviewed the legislative history surrounding sections 560 and 561 and found that it did not support Swedbank's argument that the prepetition claim/prepetition debt requirement of section 553(a) was overridden in the safe harbor context. Critically, the court also found that the legislative history surrounding the amendments to the Bankruptcy Code made by the Financial Netting Improvement Act of 2006 did not support Swedbank's argument that such amendments, which substituted the phrase "mutual debt and claim" in sections 362(b)(6), (b)(17), and (b)(27) with "any contractual right," removed the requirement of mutuality from safe-harbored exceptions to the automatic stay.

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

This decision follows the 2009 decision from the *SemCrude* bankruptcy case where the United States Bankruptcy Court for the District of Delaware ruled that parties to non-safe harbor contracts cannot contractually agree to non-mutual setoff. It also follows other decisions in the *Lehman* case that have limited the scope of the protections afforded by the safe harbor provisions.