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Legal Update
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Lehman Bankruptcy Court Addresses Scope of the Bankruptcy Code's Safe Harbor for Liquidation, Termination and Acceleration of Swap Agreements

In *Michigan State Housing Development Authority v. Lehman Brothers Derivatives Products, Inc., et al. (In re Lehman Brothers Holdings Inc., et al.)* (Michigan State Housing),[1] the US Bankruptcy Court for the Southern District of New York (the Bankruptcy Court) recently held that a provision in a swap agreement that shifted the methodology for calculating termination amounts upon the debtor counterparty's bankruptcy was enforceable under the Bankruptcy Code's safe harbor for liquidating, terminating and accelerating swap agreements. This decision is significant in that it affirms that the safe harbor for swap agreements extends beyond the mere right of a counterparty to cause the liquidation of a swap agreement to include terms that set forth the manner for determining the amounts due under a swap agreement. *Michigan State Housing* is arguably in tension with two earlier decisions of the Bankruptcy Court in the Lehman chapter 11 cases that found certain provisions that shifted payment priority in favor of the non-debtor counterparty based on the bankruptcy of a Lehman entity to not be protected by the Bankruptcy Code's safe harbor for swap agreements.

The Swap Agreement Safe Harbor

Sections 365(e)(1) and 541(c)(1) of the Bankruptcy Code both operate to invalidate so-called *ipso facto* contractual provisions (i.e., provisions that purport to terminate or modify a contractual term when a party files for bankruptcy).[2] Section 362(a) of the Bankruptcy Code provides as a general matter for an automatic stay of substantially all creditor enforcement action, including the exercise of setoff rights and enforcement against collateral.

The Bankruptcy Code contains certain safe harbors that are designed to insulate qualified counterparties to certain financial contracts from some of the negative effects of a counterparty's bankruptcy, including the Bankruptcy Code's invalidation of *ipso facto* provisions and the operation of the Bankruptcy Code's automatic stay. For example, notwithstanding the Bankruptcy Code's provisions regarding the unenforceability of certain *ipso facto* provisions and the automatic stay, section 560 of the Bankruptcy Code protects the "contractual right" of a "swap participant" or a "financial participant" to liquidate, terminate or accelerate a "swap agreement" based on the bankruptcy filing or financial condition of the swap counterparty, as well as such party's "contractual right" to, among other things, offset or net out termination values, payment amounts or other transfer obligations arising under or in connection with one or more "swap agreements." Section 560 provides, in pertinent part, that:

> [t]he 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 [which would otherwise be an unenforceable *ipso facto* condition] 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 [the Bankruptcy Code].[3] (emphasis added)

Michigan State Housing

In *Michigan State Housing*, the Bankruptcy Court addressed the scope of the section 560 safe harbor. Specifically, the Bankruptcy Court was required to address whether the right of a protected party to cause the "liquidation" of a swap agreement under section 560 is broad enough to allow for the enforcement of a contractually specified method for determining the termination value under a swap that was triggered by the Lehman counterparty's bankruptcy filing.

The Michigan State Housing Development Authority (MSHDA) and Lehman Brothers Derivative Products (LBDP) entered into an ISDA Master Agreement and related schedules (the Swap Agreement), pursuant to which the parties entered into a series of interest rate swap transactions. The Swap Agreement provided that certain events, including the bankruptcy filing of Lehman Brothers Holdings Inc. (LBHI), would constitute grounds to terminate the Swap Agreement. The parties agreed that, under normal circumstances, termination amounts in relation to outstanding transactions would be calculated using the "Market Quotation" and the "Second Method," which are each well-defined and commonly used calculation methods under the industry standard ISDA swap documentation.

Under the Second Method, if the lump sum termination amount is a positive number, then the defaulting party will pay it to the non-defaulting party; if the lump sum termination amount is a negative number, then the non-defaulting party will pay the absolute value of that number to the defaulting party. Under Market Quotation, the termination value is calculated by referring to several objective third-party quotations that are provided by reference market-makers. However, if default and termination were caused by the bankruptcy of LBHI, the parties agreed that the termination value would be calculated using the "Mid-Market" method, rather than Second Method or Market Quotation methods. Under the Mid-Market method, the termination amount is calculated using certain readily obtainable market rates and volatilities and polling a group of well-respected dealers to find the mid-market value of the relevant transactions as of the close of business on the date of early termination.

The MSHDA did not terminate the outstanding transactions under the Swap Agreement upon LBHI's bankruptcy filing. Instead, LBDP and the MSHDA agreed that LBDP would assign its rights and obligations under the Swap Agreement to Lehman Brothers Special Financing Inc. (LBSF), which had not yet filed for bankruptcy. As part of this assignment, the parties amended the Swap Agreement to provide that termination amounts would be calculated using the Mid-Market method, *unless* termination was caused by the bankruptcy of LBSF, in which case the Market Quotation method would be used.

On October 3, 2008, LBSF filed for bankruptcy, and, on November 4, 2008, the MSHDA acted to terminate the Swap Agreement, specifying November 5, 2008, as the early termination date. Using the Market Quotation method, the

MSHDA determined that it owed approximately $36.3 million to LBSF on account of outstanding transactions (the Settlement Amount), which it promptly paid to LBSF.

Approximately one year later, the MSHDA filed a complaint against LBHI, LBSF and LBDP to recover approximately $2.4 million in funds transferred by the MSHDA's bond trustee to LBDP. LBSF answered and asserted counterclaims asserting that the MSHDA had improperly valued the Settlement Amount, and subsequently filed an amended counterclaim asserting that the use of the Market Quotation methodology as a result of LBSF's bankruptcy was an ineffective *ipso facto* alteration of Lehman's rights. In this respect, LBSF alleged that it would have been owed a total of approximately $54.9 million had the MSHDA calculated the Settlement Amount under the Mid-Market method rather than the Market Quotation method.

The MSHDA filed a motion for partial summary judgment, arguing that the contractual shift to Market Quotation based on LBSF's bankruptcy filing was protected under the safe harbor for swap agreements found in section 560 of the Bankruptcy Code, even if it were otherwise an invalid *ipso facto* provision. LBSF responded with its own motion for partial summary judgment, arguing that the contractual shift to Market Quotation was a classic *ipso facto* clause, and that the safe harbor did not extend to rights (such as the choice of calculation methodology) beyond the bare right to cause liquidation.

The Bankruptcy Court found that the contractual shift from Mid-Market to Market Quotation was within the scope of the plain language of the safe harbor. This finding was largely based on the notion that the dictionary definition of the word "liquidation," in the context of section 560, meant "the act of determining by agreement the exact amount of something that otherwise would be uncertain."[4] The Bankruptcy Court reasoned that it naturally followed that the right to cause liquidation must also include the means to determine the amounts that would be due and payable as part of that liquidation.

The Bankruptcy Court further noted that section 560 expressly exempts the "exercise of any contractual right" to liquidate, including the right under the Swap Agreement to use the Market Quotation method following LBSF's bankruptcy default. According to the Bankruptcy Court, this choice of method was an essential part of being able to carry out the liquidation and was, therefore, a necessary part of the exercise by the MSHDA of its "contractual right" to "cause the liquidation" of the Swap Agreement.

Lehman attempted to argue that the shift in payment methodology in *Michigan State Housing* was akin to the "flip clauses" that the Bankruptcy Court had found not to be protected by the section 560 safe harbor for swap agreements in *Lehman Bros. Special Fin. Inc. v. BNY Corporate Tr. Servs. Ltd. (In re Lehman Bros. Holdings Inc.)*, 422 B.R. 407, 415-16 (S.D.N.Y. Bankr., 2010) (BNY Trustee) and *Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007-1 Ltd., et al. (In re Lehman Bros. Holdings Inc.)* 452 B.R. 31 (Bankr. S.D.N.Y. 2011) (Ballyrock). Those decisions involved provisions providing for the change in the priority of distributions between Lehman, as swap counterparty, and investors in notes issued by special purpose vehicles. In those transactions, Lehman had entered into swap agreements with the trusts that had issued the notes with respect to the underlying assets held by the trusts.

The Bankruptcy Court recognized that the distinction it drew between this decision and its *BNY Trustee* and *Ballyrock* decisions was nuanced. Ultimately, the Bankruptcy Court appeared to rely heavily on its view that the methodology for determining the termination value of the swap agreement in *Michigan State Housing* was incapable from being divorced from the act of liquidating the swap agreement itself.

Consistent with this view, the Bankruptcy Court considered the flip clauses in *BNY* and *Ballyrock* as being ancillary provisions that dealt with altering Lehman's priority of payment, as opposed to provisions strictly dealing with the liquidation of a swap agreement. The Bankruptcy Court also noted that the trust deeds in *BNY Trustee* (where the flip clauses were contained) were ancillary documents and were, therefore, not protected "swap agreements" (in *BNY Trustee*, the Bankruptcy Court placed significant weight on its view that the flip clause provisions did not comprise part of the swap agreements themselves). Finally, it appears that the Bankruptcy Court may have been ultimately influenced by the fact that the change in methodology from Mid-Market to Market Quotation did not result in a near complete forfeiture by LBSF of its payment entitlement under the swap because the Market Quotation method is a widely used and relatively objective means of determining damages under swap agreements (though, interestingly, in *Ballyrock*, the Bankruptcy Court noted that the "flip clause" at issue was likely not an unenforceable forfeiture or penalty under New York law).[5]

Implications

On its face, the decision by the Bankruptcy Court in *Michigan State Housing* provides swap counterparties with an example of a decision broadly construing the section 560 swap safe harbor to permit enforcement of a contractual provision determining the termination value under a swap that is triggered by a debtor's bankruptcy. It remains to be seen whether other courts will similarly interpret section 560.

Interestingly, it is not clear that the distinction between the flip clauses at issue in *BNY Trustee* and *Ballyrock* and the settlement methodology provision at issue in *Michigan State Housing* is truly significant for purposes of construing section 560 if one assumes that the trust deeds in *BNY Trustee* and the indenture in *Ballyrock* containing the flip clauses are themselves "swap agreements" under the Bankruptcy Code, because they constitute a "security agreement or arrangement … related to [a swap agreement]," which the Bankruptcy Code expressly defines to be a "swap agreement.[6] Indeed, the trust deeds in *BNY Trustee* expressly provided for the grants of liens on collateral to secure obligations under the relevant swap agreements and expressly referred to the relevant swap agreements. Likewise, the indenture in *Ballyrock* provided for liens on collateral to secure obligations under the relevant swap agreements and was expressly designated as a "credit support document" in the schedule to the swap agreements.

If the agreements containing the flip clauses in *BNY Trustee* and *Ballyrock* are viewed as "swap agreements," such provisions determining the allocation of proceeds among Lehman and the noteholders would seem as integral to the liquidation of a "swap agreement" (as such provisions would determine how much each party is owed under such agreements) as the settlement methodology provision found to be protected by the section 560 safe harbor in *Michigan State Housing*. As the *Ballyrock* litigation is still ongoing, it is possible that there will be further case law regarding the scope of the section 560 safe harbor as it relates to a party's right to "liquidate" a "swap agreement."

If you have questions about the issues addressed in this Legal Update, please contact your usual Mayer Brown lawyer or either of the following lawyers:

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Endnotes

[1] Case No. 09-01728, 2013 WL 6671630 (Bankr. S.D.N.Y. Dec. 19, 2013).

[2] Section 365(e)(1) generally renders unenforceable any provision that purports to terminate or modify an executory contract as a result of (1) the insolvency or financial condition of the debtor (2), a bankruptcy filing or (3) the appointment of a trustee or custodian. Similarly, Section 541(c)(1) of the Bankruptcy Code also invalidates *ipso facto* clauses by providing that a debtor's interest in property becomes property of the estate "notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law … that is conditioned on … the commencement of a case under [the Bankruptcy Code] … and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property."

[3] 11 U.S.C. § 560.

[4] *Michigan State Housing*, at *7 (*citing to Black's Law Dictionary* (9th ed. 2009)).

[5] *See L.B.S.F. v. Ballyrock*, 452 B.R. at 38, FN 21.

[6] *See* section 101(53)(B)(A)(vi) of the Bankruptcy Code. The parties in *BNY Trustee* ultimately settled their dispute, so the issue of whether the trust deeds in that case are swap agreements under the Bankruptcy Code will not be determined by an appellate court. In *Ballyrock*, the trustee and noteholders did not brief the section 560 issue at the motion to dismiss stage, reserving their rights to address this issue at a later stage of the litigation.

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