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Lehman, Setoff, and the Inapplicability of the "Safe Harbor" Provisions: Mutuality Remains Intact

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This article examines a recent decision in Lehman Brothers Holdings Inc. *which held that the Bankruptcy Code's safe harbor exceptions contained in Sections 560 and 561 do not permit setoff where the mutuality requirements of Section 553(a) of the Bankruptcy Code have not otherwise been satisfied.*

On May 5, 2010, the Honorable James M. Peck of the U.S. Bankruptcy Court for the Southern District of New York held in *Lehman Brothers Holdings Inc.*[1] that the Bankruptcy Code's safe harbor exceptions contained in Sections 560 and 561 do not permit setoff where the mutuality requirements of Section 553(a) of the Bankruptcy Code have not otherwise been satisfied.[2] Swedbank AB ("Swedbank"), the nondebtor counterparty to a series of swap agreements standardized by the International Swaps and Derivatives Association Inc. (collectively, the "ISDA Master Agreements"), was therefore ordered to immediately release a post-petition administrative freeze placed on the debtor's general deposit account

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and return to the debtor all funds deposited subsequent to the debtor's bankruptcy filing.[3]

The decision answers an open question from last year's *SemCrude*[4] decision — an opinion authored by the Honorable Brendan L. Shannon of the U.S. Bankruptcy Court for the District of Delaware — namely, whether the ability to effect setoff under so-called "safe harbor" contracts remained subject to the mutuality requirements contained in Section 553.[5] Unequivocally yes, according to *Lehman* — mutuality is still required. *SemCrude* similarly held that a valid, prepetition contract could not vitiate the strict mutuality requirement in the "triangular setoff" context. Assuming the mutuality requirements of Section 553(a) apply equally to "triangular setoffs," energy trading and marketing companies that are parties to swap agreements should carefully reevaluate the enforceability of contractually based cross-affiliate or "triangular setoff" provisions.

SETOFF AND TRIANGULAR SETOFF DEFINED

A traditional setoff in bankruptcy, as defined by Section 553(a) of the Bankruptcy Code, involves the offset of mutual, valid, and enforceable prepetition debts between the same parties in the same capacities — *i.e.*, a prepetition debt owing by a creditor ("Party A") to a debtor ("Party B") against a prepetition claim of Party A against Party B.[6] The requisite elements of a Section 553 setoff are met where:

- The creditor holds a claim against the debtor that arose before the commencement of the case;
- The creditor owes a debt to the debtor that also arose before the commencement of the case;
- The claim and debt are mutual; and
- The claim and debt are each valid and enforceable.[7]

Setoff, in effect, elevates an unsecured claim to secured status, to the extent that the debtor has a mutual, prepetition claim against the creditor.[8] Section

553 does not define "mutual." The most common use of "mutual" includes the requirement that the prepetition claim and debt be owed by and among the "same parties" and that the parties be acting in the same "capacity."[9]

By comparison, a triangular setoff typically involves the setoff of a debt owing from Party A to Party B against a debt of Party B owing to an affiliate of Party A, rather than directly to Party A.[10] In the energy-trading marketplace, triangular setoff is used to manage risk among multiple affiliates trading under the same ultimate parent. Triangular setoff is considered to be a much more efficient means of managing credit exposure and maximizing the efficiency of collateral than limiting setoff to the obligations of the parties under each contract.[11] The need for triangular setoff is even more acute when affiliates share the same guarantor of their obligations.[12]

"SAFE HARBOR" PROVISIONS AT ISSUE IN *LEHMAN*

Generally, "safe harbor" provisions of Sections 560 and 561 of the Bankruptcy Code are designed to enable a nondebtor party to terminate and close out certain derivative contracts, notwithstanding the automatic stay. The "safe harbor" provisions were strengthened and expanded in 2005 under the Bankruptcy Abuse and Prevention and Consumer Protection Act of 2005 (the "2005 Amendments"). For example, Section 560 was expanded to cover the liquidation and acceleration of swap agreements:

> The 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.[13]

As part of the 2005 Amendments, Congress added Section 561, which provides a contractual right to terminate, liquidate, accelerate, or offset under a "master netting agreement" with respect to a variety of derivative contracts, including swap agreements. Section 561 states, in part:

> [T]he exercise of any contractual right…to cause the termination, liquidation, or acceleration of or 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 or by any order of a court or administrative agency in any proceeding under this title.[14]

CASE SUMMARY

Background

Swedbank and the debtors had a longstanding business relationship. Prior to LBHI's bankruptcy filing, (i) Swedbank was a party to four ISDA Master Agreements with Lehman entities; (ii) LBHI served as a guarantor in connection with those agreements; (iii) LBHI maintained a deposit account with Swedbank in Stockholm, Sweden (the "Swedbank Account"); and (iv) LBHI was a party to an ISDA Master Agreement with Swedbank. A provision in this ISDA Master Agreement granted Swedbank a right of setoff upon the occurrence of an event of default.

LBHI filed bankruptcy on September 15, 2008, triggering certain events of default under the ISDA Master Agreements, and resulting in, according to Swedbank, termination payments of approximately $13.9 million owing from LBHI to Swedbank. Upon the bankruptcy filing, the Swedbank Account contained 2,140,897.40 Swedish Krona (approximately $283,191.27 based on the current conversion rate).[15] Shortly after the bankruptcy filing, Swedbank placed an administrative freeze on the Swedbank Account, thereby preventing LBHI from withdrawing funds from the account, but nonetheless allowing additional funds to be deposited into the account. Swedbank informed LBHI that it intended to set off the indebtedness purportedly owed to Swedbank against the funds contained in the Swedbank Account.

By November 12, 2009, as a result of post-petition deposits, the Swedbank Account contained approximately $11.7 million. Arguing that Swedbank had no right to offset the funds in the Swedbank Account and that

the administrative freeze violated the automatic stay, the debtors filed a motion for entry of an order enforcing the automatic stay and compelling Swedbank to turn over the funds in the Swedbank Account.

Decision

The court granted the debtors' motion for an order enforcing the automatic stay and compelling payment to LBHI of approximately $9.7 million, representing the funds that were deposited in the Swedbank Account subsequent to LBHI's bankruptcy filing. The court specifically rejected Swedbank's argument that the "safe harbor" provisions of the Bankruptcy Code created an exception to the mutuality requirement with respect to setoffs under Section 553(a).

According to the decision, the requirement that a claim and debt be mutual in order to exercise a right of setoff is "an axiomatic principle of bankruptcy law."[16] All parties agreed that mutuality was lacking because LBHI's indebtedness to Swedbank arose prepetition, yet the funds in the Swedbank Account were deposited post-petition. Nonetheless, while mutuality is a statutory requirement of any setoff under Section 553 of the Bankruptcy Code, Swedbank argued that "this seemingly fatal flaw does not matter" because mutuality is not explicitly required by the "safe harbor" provisions of the Bankruptcy Code.[17] Swedbank maintained that the "safe harbor" provisions "implicitly override the mutuality requirement"[18] of Section 553(a) because they provide that a creditor's "contractual right" to offset shall not be "stayed, avoided, or otherwise limited…" and because these sections do not explicitly refer to the mutuality requirement of Section 553. Swedbank argued, therefore, that the requirement of prepetition mutuality was irrelevant when dealing with setoff under safe-harbored derivative contracts.[19]

The court rejected Swedbank's reading of the "safe harbor" provisions on a number of grounds, holding that "mutuality is baked into the very definition of setoff"[20] and that the "silence of the safe harbor provisions with respect to the mutuality requirement of section 553(a)" did not provide a basis for the court to "read an exception into the statute."[21] In the court's view, Swedbank confused the language used in the "safe harbor"

provisions with the common phrase "notwithstanding any other provision of law."[22] While "notwithstanding" clauses have been interpreted to supersede all other laws, the text of the "safe harbor" provisions merely "renders the automatic stay inapplicable in the context of safe harbored contracts — the central purpose of the safe harbor provisions — and does not eliminate the mutuality requirement of section 553(a)."[23]

Furthermore, the court stated: "Congress enacted sections 560 and 561 well after section 553 had become established as the statutory basis for permitting setoff in bankruptcy and with full knowledge of that section's mutuality requirement."[24] Accordingly, if Congress had intended to create an exception to mutuality, "it would have done so explicitly."[25] To further support its holding, the court examined the legislative history relating to the safe harbor provisions and concluded that "the enactment of sections 560 and 561 has done nothing to alter the mutuality requirement found in section 553(a)."[26]

Finally, the court rejected Swedbank's argument that Congress intentionally removed the mutuality requirement relating to automatic stay exceptions in the Bankruptcy Code. Swedbank pointed to amendments to the Financial Netting Improvement Act of 2006 that substituted the phrase "mutual debt and claim" in certain subsections of Section 362(b) with the phrase "any contractual right" in arguing that Congress eliminated the mutuality requirement from the safe harbor exceptions to the automatic stay. The court viewed such amendments as "technical" and, looking to the legislative history surrounding the amendments, declined to read such amendments as "authority for so fundamental a change in creditor rights."[27]

Swedbank has appealed the *Lehman* decision to the United States District Court for the Southern District of New York.

CONCLUSION

Lehman and *SemCrude* will likely be cited by debtors when challenging a nondebtor counterparty's efforts to set off in the absence of meeting the strict requirements of Section 553(a). Although *Lehman* dealt specifically with traditional setoff, to the extent the "safe harbor" provisions keep

the strict requirements of Section 553(a) intact, its holding applies equally to triangular setoff. In both contexts, nondebtor counterparties now face additional risk when offsetting post-petition funds against a debtor's prepetition indebtedness.

NOTES

[1] *In re Lehman Brothers Holdings Inc.*, No. 08-13555 (JMP), 2010 Bankr. Lexis 1260 (Bankr. S.D.N.Y. May 5, 2010) (hereinafter, "*Lehman*"). The Lehman entity Lehman Brothers Holdings Inc. shall be referred to herein as "LBHI" or the "debtor" (LBHI, together with its affiliated debtors, the "debtors").

[2] *Id.* at *13.

[3] *Id.* at *27.

[4] *In re SemCrude, L.P.,* 399 B.R. 388 (Bankr. D. Del. 2009) (hereinafter *"SemCrude"*), aff'd, No. 08-11525 (BLS), 2010 U.S. Dist. Lexis 42477 (D. Del. Apr. 30, 2010). For a summary of the *SemCrude* decision and its potential implications, *see* Norman R. Rosenbaum, Alexandra Steinberg Barrage, and Jordan A. Wishnew, *SemCrude*, Setoff, and the Collapsing Triangle: What Contract Parties Should Know, *Pratt's Journal of Bankruptcy Law*, May/June 2009 at 341.

[5] On January 20, 2009, Chevron (one of the non-debtor contract counterparties in *SemCrude*) filed a motion for reconsideration (the "Reconsideration Motion") requesting that the bankruptcy court make additional findings on the issue of whether the agreements at issue are "safe harbor" contracts that are not subject to the mutuality requirements of Section 553. In an order dated March 19, 2009, the Reconsideration Motion was denied on procedural grounds without addressing the merits of the Chevron's arguments pertaining to the "safe harbor" provisions. On April 30, 2010, the U.S. District Court for the District of Delaware affirmed the bankruptcy court's denial of the Reconsideration Motion, noting that "[r]econsideration is not a proper vehicle to advance new legal theories…." *Chevron Prods. Co. v. SemCrude, L.P. (In re SemCrude, L.P.)*, 2010 U.S. Dist. Lexis 42477, at *7 (D. Del. Apr. 30, 2010). In addition, the district court agreed with the bankruptcy court's conclusion that a "'contract exception' to the mutuality requirement does not exist based upon the plain language of Section 553" as well as the "primary goal of the

Bankruptcy Code to ensure equal and fair treatment among similarly situated creditors." *Id.* at *6. Chevron has appealed the district court's ruling to the U.S. Court of Appeals for the Third Circuit.

[6] 11 U.S.C. § 553(a).

[7] *In re Stienes*, 285 B.R. 360, 362 (Bankr. D. N.J. 2002); *see also Scherling v. Hellman Elec. Corp. (In re Westchester Structures)*, 181 B.R. 730, 739 (Bankr. S.D.N.Y. 1995)(noting that mutuality is found only when the debts / credits exist between "the same parties, standing in the same capacity.").

[8] *See* 11 U.S.C. § 506(a).

[9] *See SemCrude*, 399 B.R. at 396 ("The overwhelming majority of courts to consider the issue have held that debts are mutual only if "they are due to and from the same persons in the same capacity.")(citations omitted).

[10] *See* Collier on Bankruptcy, ¶ 553.03[3][b] at 553-28 (15th ed. rev. 2009).

[11] Craig R. Enochs, Fundi A. Mwamba, and Paul E. Vrana, *Early Termination and Liquidation Provisions As Risk Tools in Master Energy Agreements* at 12 (2004), http://images.jw.com/com/publications/419.pdf.

[12] *Id.*

[13] 11 U.S.C. § 560(a).

[14] 11 U.S.C. § 561(a).

[15] The conversion of this amount was not provided in the opinion. All other conversion amounts referenced herein are based on the conversion amounts cited in the opinion.

[16] *Lehman*, 2010 Bankr. Lexis 1260, at *16.

[17] *Id.* at *14.

[18] *Id*. at *17.

[19] *Id.*

[20] *Id.* at *19.

[21] *Id.* at *16.

[22] *Id.* at *20.

[23] *Id.* at *20.

[24] *Id.* at *20-21.

[25] *Id.* at *21.

[26] *Id.* at *21.

[27] *Id.* at *25-26.