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Bankruptcy ADVISORY ▪

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SDNY Bankruptcy Court Upholds Swap Provision That Modifies the Method to Calculate Amounts Owing Upon the Counterparty's Bankruptcy

The ***Lehman Brothers*** bankruptcy court has determined that the contractually specified methodology for conducting the liquidation of a swap agreement is protected by the safe harbor provisions of the bankruptcy, even if the selected methodology would be more favorable to the non-defaulting counterparty than the liquidation methodology that would apply absent the bankruptcy. *See* ***Michigan State Housing Dev. Auth. v. Lehman Bros. Deriv. Prods. Inc.*** (***In re Lehman Bros. Holdings Inc.***), No. 08-13555, ---B.R. ----, 2013 WL 6671630 (Bankr. S.D.N.Y. Dec. 19, 2013).

Background Facts

The Michigan State Housing Development Authority (MSHDA) and Lehman Brothers Derivative Products Inc. (LBDP) entered into an ISDA master agreement on May 10, 2000. The parties subsequently entered into 20 interest-rate swap transactions under the terms of the master agreement.

After Lehman Brothers Holdings filed for bankruptcy protection, LBDP and MSHDA entered into an assignment and amendment agreement with Lehman Brothers Special Financing Inc. (LBSF). This agreement assigned all of LBDP's rights and obligations under the master agreement and the schedule to LBSF. It also provided that, upon early termination of the agreements pursuant to an event of default, the settlement amount would be calculated using the "Mid-Market" method, unless termination was due to non-payment or to the bankruptcy of LBSF, in which case the "Market Quotation" methodology would be used.

When LBSF later filed its own bankruptcy petition, MSHDA declared an event of default and specified an early termination date. Applying the Market Termination methodology, MSHDA asserted that it owed approximately $36 million to LBSF. In litigation that followed in connection with the bankruptcy filing, LBSF argued that the Mid-Market methodology should have been applied, in which case MSHDA would owe approximately $59 million.

LBSF argued that the provision changing the calculation methodology based on its bankruptcy filing was an unenforceable *ipso facto* clause. MSHDA argued that the provision was protected by the safe harbor provisions. The bankruptcy court agreed with MSHDA.

Bankruptcy Court's Analysis and Reasoning

As a general matter, *ipso facto* clauses—i.e., clauses that purport to terminate or modify a contractual term when a party files for bankruptcy—are unenforceable. However, the Bankruptcy Code contains certain safe harbors for certain types of *ipso facto* clauses in certain financial contracts. The safe harbor provision for swap contracts is found in Section 560 of the Code, which provides in relevant part that the "exercise of any contractual right . . . to cause the liquidation . . . of one or more swap agreements . . . shall not be stayed, avoided, or otherwise limited by operation of any provision of this title . . . ."

In concluding that the provision that specified which methodology applied was protected by this safe harbor provision, the bankruptcy court relied on the ordinary meaning of the term "liquidation," namely "the act of determining by agreement the exact amount of something that otherwise would be uncertain." Therefore, the court determined that "the right to cause the liquidation of a swap agreement must mean the right to determine the exact amount due and payable under the swap agreement. The amount can only be fixed by following the liquidation methodology specified in the swap agreement . . . . The choice of the method is an essential part of being able to carry out the act of liquidation. The method employed in the act of liquidation is what allows the non-defaulting party to determine the Settlement Amount."

The bankruptcy court further distinguished its holding from three prior decisions cited by LBSF. First, in ***Lehman Brothers Special Finance Inc. v. BNY Corporate Trustee Services Ltd.***, the Lehman Brothers court held that a "flip-clause" subordinating Lehman's right to certain collateral upon Lehman's default was an unenforceable *ipso facto* clause that was not protected by the safe harbors. 422 B.R. 407 (Bankr. S.D.N.Y. 2010). The *MSHDA* court distinguished that case because, unlike the provision at issue here, (i) the flip-clause was not part of the swap agreement and (ii) the flip-clause did not deal expressly with liquidation, termination or acceleration.

Second, the court distinguished ***Lehman Brothers Special Finance Inc. v. Ballyrock ABS CDO 2007-1 Ltd.***, 452 B.R. 31 (Bankr. S.D.N.Y. 2011) because it dealt "with a provision altering priority of payment and not a provision strictly dealing with liquidation, termination, or acceleration."

Finally, the court distinguished its holding in ***Calpine Energy Services, L.P. v. Reliant Energy Elec. Solutions, L.L.C.***, Adv. Pro. No. 08-1251, 2009 WL 1578282 (Bankr. S.D.N.Y. May 7, 2009). In that case, the court "held that a clause requiring a defaulting party to provide a written explanation for disputing the non-defaulting party's calculation of a Settlement Amount within two days of receipt was not entitled to safe harbor protection." But "the provision in ***Calpine*** was merely 'incidental or ancillary' to the rights protected by the safe harbors." On the other hand, liquidation and the liquidation methodology specified in a swap agreement "are so closely connected to one another that they flow together and become virtually inseparable."

Conclusion

While this case only involved a series of swaps, if courts follow its reasoning, certain *ipso facto* clauses in safe-harbored transactions may be enforceable on a very limited basis. Specifically, at least in the Southern District of New York, it appears that parties to safe-harbored transactions can specify a separate calculation methodology upon a bankruptcy of one party, so long as this concept is built into the liquidation provisions. However, given the holdings in ***Ballyrock*** and ***Calpine***, without careful drafting, there is a risk that a bankruptcy court could find such a provision to be ancillary and therefore unenforceable.

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