Court Explores Termination Rights Under Bankruptcy Code Section 560

WILBUR F. FOSTER, JR., ADRIAN C. AZER AND CONSTANCE BEVERLEY

The authors examine a recent bankruptcy court decision limiting termination rights under Section 560 of the Bankruptcy Code and ordering the performance of a swap counterparty's payment obligations under a prepetition swap agreement with Lehman Brothers Special Financing Inc.

In a ruling that was recently issued in the Lehman bankruptcy case,[1] the United States Bankruptcy Court for the Southern District of New York held[2] that Metavante Corporation ("Metavante"), a swap counterparty under a prepetition interest-rate swap agreement (the "Swap Agreement") with Lehman Brothers Special Financing Inc. ("LBSF"), must perform its payment obligations despite events of default triggered by the commencement of the bankruptcy cases of LBSF and Lehman Brothers Holdings Inc. ("LBHI"). Metavante contended that (1) under the terms of the Swap Agreement, the commencement of these bankruptcy cases constituted events of default that excused Metavante's performance of its obligations under the Swap Agreement, and (2) pursuant to Section 560 of the Bankruptcy Code,[3] it had an unlimited right to terminate the Swap Agreement "at any time prior to maturity."

Rejecting Metavante's argument, the bankruptcy court held that, al-

Wilbur F. Foster, Jr., is a partner, and Adrian C. Azer and Constance Beverley are associates, in the Financial Restructuring Group of Milbank, Tweed, Hadley & McCloy. The authors can be reached at wfoster@milbank.com, aazer@milbank.com and cbeverley@milbank.com, respectively.

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though Section 560 protected Metavante's contractual right to terminate the Swap Agreement based on the commencement of LBSF's or LBHI's bankruptcy case, that protection was not open-ended. The bankruptcy court held that Metavante's failure to exercise its termination right constituted a waiver of that right, meaning that LBSF could assume or reject the Swap Agreement as an executory contract under Section 365 of the Bankruptcy Code.[4] As a result, under the rules governing executory contracts, although the Swap Agreement would not be enforceable against LBSF until it was assumed, it was enforceable against Metavante until it was rejected, notwithstanding the events of default. Metavante therefore had to make the periodic, postpetition payments that it owed to LBSF under the Swap Agreement.

This ruling is significant because it clarifies in two respects the scope of the "safe harbor" protections that the Bankruptcy Code provides to counterparties under swap agreements with debtors in cases under the Bankruptcy Code. First, it holds that the termination protection provided to such counterparties under Section 560 of the Bankruptcy Code has temporal limits, stating that a swap counterparty must exercise its contractual termination right "fairly contemporaneously with the bankruptcy filing, lest the contract be rendered just another executory contract."[5] Second, it holds that the safe harbors protect only the actions that are listed in those provisions — in this instance, a swap counterparty's liquidation, termination, or acceleration of a swap agreement, or its offsetting or netting out of claims under or in connection with such liquidation, termination, or acceleration. Because Metavante was not taking one of those actions, but instead was withholding its performance (that is, the net payments due from it) under the Swap Agreement, the safe harbors did not apply, and therefore did not protect Metavante from application of the general rules regarding the performance of obligations under executory contracts.[6]

THE SIGNIFICANCE OF THE SWAP AGREEMENT SAFE HARBORS

The automatic stay provided under Section 362(a) of the Bankruptcy Code[7] generally prohibits most actions against a bankruptcy debtor or property of the debtor's estate, including the termination of contracts with

the debtor and the exercise of setoff rights against the debtor. In addition, Section 365(e)(1) of the Bankruptcy Code[8] generally prohibits the enforcement of so-called ipso facto provisions, that is, contract provisions that terminate or modify an executory contract, or any right or obligation under an executory contract, because of the commencement of a bankruptcy case or other specified events.

Section 560 of the Bankruptcy Code excepts swap counterparties from these general prohibitions. Section 560 provides that a swap counterparty's exercise of its contractual right to cause the liquidation, termination, or acceleration of a swap agreement because of a condition of the kind specified in Section 365(e)(1), or to offset or net out termination values or payment amounts arising under or in connection with such termination, liquidation, or acceleration, "shall not be stayed, avoided, or otherwise limited by operation of any provision of [the Bankruptcy Code] or by any order of a court or administrative agency in any proceeding under [the Bankruptcy Code]." Section 362(b)(17) of the Bankruptcy Code[9] also excepts from the automatic stay a swap counterparty's rights to offset and net out under or in connection with a swap agreement.

Two issues with respect to the swap agreement safe harbors are (1) whether a swap counterparty's Section 560 termination right could be deemed to have been waived through the passage of time, and (2) whether the safe harbors authorize a swap counterparty to withhold performance under an unterminated swap agreement. These were the central issues in the Metavante ruling.

FACTUAL BACKGROUND REGARDING THE METAVANTE RULING

LBSF and Metavante entered into the Swap Agreement pursuant to a standard 1992 ISDA Master Agreement (the "Master Agreement"), dated November 20, 2007, and a trade confirmation, dated December 4, 2007. Under the Swap Agreement, the filing of a voluntary bankruptcy petition by either LBSF or LBHI, which was the credit support provider to LBSF under the Swap Agreement, constituted an event of default with respect to LBSF that permitted Metavante to terminate the Swap Agreement.[10]

Although LBHI and LBSF filed voluntary petitions under chapter 11 of the Bankruptcy Code on September 15 and October 3, 2008, respectively, Metavante never terminated the Swap Agreement. Under Section 2(a)(iii) of the Master Agreement, however, Metavante's performance of its payment obligations under the Swap Agreement was subject to the condition that no event of default "has occurred and is continuing." Metavante contended that the bankruptcy filings of each of LBSF and LBHI constituted such an event of default that, under Section 2(a)(iii), excused Metavante's performance of its obligations under the Swap Agreement.

On May 29, 2009, LBSF filed a motion to compel the performance of Metavante's obligations under the Swap Agreement. LBSF argued that (1) the Swap Agreement, as an executory contract, can be enforced by LBSF; (2) Metavante cannot withhold the performance of its payment obligations in reliance on Section 2(a)(iii) of the Master Agreement based on the bankruptcy filings of LBSF or LBHI because, in that situation, Section 2(a)(iii) would be an unenforceable ipso facto provision that is proscribed by Section 365(e)(1) of the Bankruptcy Code and is not protected under the swap agreement safe harbors; and (3) Metavante's nonperformance constituted an attempt to exercise control over the property of LBSF's estate, which is prohibited by the automatic stay provided under Section 362(a) of the Bankruptcy Code.

On June 15, Milbank, as counsel for the Official Committee of Unsecured Creditors in Lehman's bankruptcy case, filed a statement in support of LBSF's motion. The Official Committee argued that:

(1) an executory contract, such as the unterminated Swap Agreement, is enforceable by a debtor, and a nondebtor must pay to the debtor amounts due and owing to the debtor's estate under the contract, until the debtor rejects the contract;

(2) the Section 365(e)(1) prohibition on ipso facto provisions barred Metavante from relying on the commencement of LBSF's or LBHI's bankruptcy case as a predicate to excuse its performance under Section 2(a)(iii);

(3) the swap agreement safe harbors did not protect Metavante because, by their plain terms, the safe harbors protect only the liquidation, ter-

mination, or acceleration of a swap agreement, and the offsetting or netting out of positions under or in connection with a swap agreement, none of which Metavante had done or was seeking to do through its withholding of performance under Section 2(a)(iii); and

(4) Metavante's withholding of performance violated the automatic stay.[11]

That same day, Metavante filed its objection to LBSF's motion. Metavante asserted that, under Section 560, it had "[t]he right to elect to terminate — or not to terminate — the [Swap Agreement] at any time prior to maturity," stating: "The non-defaulting party is not required to terminate its swap within any fixed or specified period of time, but is instead permitted to wait as long as it deems appropriate to permit the market to recover so that its termination payments upon any such termination will be reduced and so that it will not be penalized by the defaulting party's conduct." Metavante also argued that, under Section 2(a)(iii) of the Swap Agreement, it had a right not to perform because, pursuant to New York contract law, Section 2(a)(iii) acted as a condition precedent to performance, and a failure of this condition precedent (i.e., the defaults arising from LBSF's and LBHI's bankruptcy filings) excused performance.

After LBSF and the Official Committee filed replies to Metavante's objection, the bankruptcy court heard oral argument from the parties on July 14, and issued its oral ruling from the bench at a hearing on September 15, 2009.

THE METAVANTE RULING

The bankruptcy court rejected Metavante's arguments. The bankruptcy court held that Metavante failed to timely exercise its termination right under Section 560 of the Bankruptcy Code, with the result that the Swap Agreement was to be treated as a "garden variety executory contract."[12] As a result, notwithstanding Section 2(a)(iii) of the Swap Agreement, Metavante was obligated to perform its obligations under the Swap Agreement, and its "attempts to control LBSF's rights to receive payment under the Agreement constitute[d], in effect an attempt to control property of the estate"[13] that was "a violation of the automatic stay."[14]

The bankruptcy court recognized that LBSF's and LBHI's bankruptcy filings constituted events of default under the Swap Agreement, and that Section 2(a)(iii) of the Swap Agreement conditioned Metavante's payment obligations on the absence of any events of default. The bankruptcy court also recognized that Metavante had a right under Section 560 of the Bankruptcy Code to liquidate, terminate, or accelerate the Swap Agreement because of a condition of the kind specified in Section 365(e)(1), and to offset or net out any termination values or payment amounts arising under or in connection with such liquidation, termination, or acceleration. The bankruptcy court stated, however, that these safe harbors "protect a non-defaulting swap counterparty's contractual rights solely to" take these specified actions.[15] Metavante had not sought to take any of these specified, protected actions; rather, it sought to withhold performance based on Section 2(a)(iii) of the Swap Agreement.

The bankruptcy court noted that the legislative history of Section 560 of the Bankruptcy Code "evidences Congress's intent to allow for the prompt closing out or liquidation of open accounts upon the commencement of a bankruptcy case,"[16] as well as Congress's "stated rationale that the immediate termination for default and the netting provisions are critical aspects of swap transactions and are necessary for the protection of all parties in light of the potential for rapid changes in the financial markets."[17] The bankruptcy court stated that "[Metavante's] conduct of riding the market for the period of one year, while taking no action whatsoever, is simply unacceptable and contrary to the spirit of these provisions of the Bankruptcy Code."[18] The bankruptcy court found that, because Metavante failed to promptly exercise its termination right (indeed, never exercised its termination right) after the commencement of LBHI's and LBSF's bankruptcy cases in September and October 2008, "Metavante's window to act promptly under the safe harbor provisions has passed, and while it may not have had the obligation to terminate immediately upon the filing of LBHI or LBSF, its failure to do so, at this juncture, constitutes a waiver of that right at this point."[19]

IMPLICATIONS FOR SWAP COUNTERPARTIES

The Metavante ruling has significant implications for a swap counterparty's exercise of its termination rights under Section 560 of the Bankruptcy Code. The ruling says that (1) absent the prompt exercise of those rights, they may be lost, and (2) in that event, the swap agreement could be treated as ordinary executory contract (a) that the debtor would have the right to assume or reject, and (b) under which the swap counterparty may be obligated to perform, even if the debtor is in default under the swap agreement, and provisions of the swap agreement purport to excuse the swap counterparty's performance because of such default.

POSTSCRIPT: SUBSEQUENT PROCEEDINGS

On September 25, 2009, Metavante filed, pursuant to Federal Rule of Bankruptcy Procedure 9023, a motion to alter or amend the bankruptcy court's September 17 order granting LBSF's motion and compelling Metavante's performance of its obligations under the Swap Agreement. In its motion, Metavante requests that the bankruptcy court alter or amend the order "to clarify…(1) the Debtors' future obligations to Metavante under the [order]; and (2) the precise amount that Metavante owes as default interest under the [order]." On October 8, Metavante also filed a motion to stay the bankruptcy court's order.

LBSF filed a response to these motions on October 13, contending, among other things, that (1) the motion to alter or amend should be denied because it sought relief based on grounds that could have been, but were not, raised in Metavante's objection to LBSF's motion, and (2) the motion to stay should be denied because Metavante did not meet its burden of establishing its entitlement to such extraordinary relief. Metavante filed a reply and additional materials on October 16 and 22, respectively. On October 23, following a hearing, the bankruptcy court entered orders denying both of Metavante's motions, and Metavante filed a notice of appeal with respect to the bankruptcy court's September 17 order.

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NOTES

[1] *In re Lehman Brothers Holdings Inc., et al.*, Case No. 08-13555 (JMP) (Bankr. S.D.N.Y.).

[2] *See id., Transcript of Sept. 15, 2009 Hearing*, at 99-113 (Docket No. 5261, filed Sept. 17, 2009) [hereinafter *Transcript*], and *Order Pursuant to Sections 105(a), 362 and 365 of the Bankruptcy Code To Compel Performance of Contract and To Enforce the Automatic Stay* (Docket No. 5209, filed Sept. 17, 2009).

[3] 11 U.S.C. § 560. Metavante also cited Section 561 of the Bankruptcy Code, 11 U.S.C. § 561, the relevant provisions of which track those of Section 560. The bankruptcy court treated the two sections as identical for purposes of the issues raised in this matter.

[4] 11 U.S.C. § 365.

[5] *Transcript* at 111 (citing *In re Enron Corp.*, 2005 WL 3874285, at *4 (Bankr. S.D.N.Y. 2005)).

[6] *See Transcript* at 107-10.

[7] 11 U.S.C. § 362(a).

[8] *Id.* § 365(e)(1), which provides:

> Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on — (A) the insolvency or financial condition of the debtor at any time before the closing of the case; (B) the commencement of a case under this title; or (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

[9] 11 U.S.C. § 362(b)(17).

[10] *See Master Agreement* §§ 5(a)(vii)(4), 6(a).

[11] An ad hoc group of creditors also filed a statement in support of LBSF's motion.

[12] *Transcript* at 109; see *also id*. at 108 ("Metavante takes issue with LBSF and LBHI in asking the Court to treat the Agreement like a garden variety executory contract…").

[13] *Id.* at 112 (citing *In re Enron Corp.*, 300 B.R. 201, 212 (Bankr. S.D.N.Y. 2003)).

[14] *Id.* at 113.
[15] *Id.* at 108-09 (emphasis added).
[16] *Id.* at 111 (emphasis added) (citing H.R. Rep. No. 97-420, at 1 (1982)).
[17] *Id.* (emphasis added) (citing S. Rep. No. 101-285, at 1 (1990)).
[18] *Id.* at 110.
[19] *Id.* at 111-12.