OTC Derivative Contracts in Bankruptcy: The Lehman Experience

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I. Introduction

U.S. bankruptcy law, and more specifically Chapter 11 of the U.S. Bankruptcy Code[1] ("Bankruptcy Code"), is generally designed to protect the interests of two broad constituencies: creditors, who have an interest in maximizing the portion of their claims they recover from the estate, and shareholders and other stakeholders, who may receive an interest in a reorganized entity. The insolvency of certain Lehman Brothers entities has dramatically illustrated the fact that in cases involving debtors who have a significant presence in the financial markets, bankruptcy law should also take into account the interests of another large constituency, namely, all the other participants in the relevant markets. When a debtor is a party to a significant number of financial contracts there is a risk that its failure will have a domino effect and precipitate the failure of its counterparties.[2]

This article will discuss some of the special provisions of the Bankruptcy Code that are believed to address systemic risk.[3] It will provide a brief overview of the legislative framework dealing with the bankruptcy of parties to over-the-counter (OTC) derivative contracts.[4] It will also provide a snapshot of the proceedings under the Bankruptcy Code with respect to the insolvency of certain Lehman Brothers entities.[5]

II. Bankruptcy Code

The Bankruptcy Code contains several provisions that alter non-bankruptcy entitlements in order to protect the interests of the debtor and its creditors. First, the automatic stay provisions of the Bankruptcy Code are meant to protect the estate by preventing creditors from fragmenting the debtor's assets into parts that are worth less than the whole and from receiving more than they would be entitled to in the bankruptcy estate and to give the debtor time to reorganize.[6] Second, the provisions rendering *ipso facto*[7] clauses unenforceable ensure that a debtor's creditors continue to honor their agreements even after the debtor has filed for bankruptcy protection in order to allow the debtor to continue to operate as a going concern. Third, the avoidance powers serve to maximize the value of the estate by returning to the debtor's estate any property transferred prior to insolvency when such transfer constitutes a fraudulent conveyance or preference.[8] Fourth, the Bankruptcy Code provides that the trustee or debtor-in-possession has the discretion, within prescribed limits, to reject or assume its prepetition contracts.[9] This last right allows a debtor to choose which contracts it wishes to preserve, assuming those that are in the estate's interest, while rejecting those that are not. These provisions increase the debtor's estate but at the expense of a solvent creditor that must continue to perform under contracts that are assumed but must wait until acceptance of a plan[10] before it can recoup amounts (perhaps cents on the dollar) on the contracts the debtor rejects.

OTC derivative contracts benefit from substantial protections under the Bankruptcy Code because they are largely exempt from virtually all of the rules mentioned above. These exemptions and protections are often referred to collectively as the "safe harbor provisions." The current regime has its origins in the 1978 Bankruptcy Code,[11] which has evolved over time in certain material respects. Recent updates have notably included the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005[12] (the "2005 Act"), which expanded the definition of certain "financial contracts" (which include OTC derivative contracts) and clarified the status of these financial contracts as protected contracts under the Bankruptcy Code. The Financial Netting Improvements Act of 2006[13] builds on the 2005 Act and strengthens the netting provisions with respect to these contracts. As a result, the Bankruptcy Code now establishes a separate regime for treatment of OTC derivative contracts entered into by the debtor. One of the purposes behind this separate regime is to prevent the bankruptcy of a debtor from disrupting international financial markets.[14]

The safe harbor provisions apply to OTC derivative contracts as follows:

A. Automatic Stay

The Bankruptcy Code provides that

> [t]he filing of a petition . . . does not operate as a stay under subsection (a) of this section . . . of the exercise by a swap participant or financial participant[15] of any contractual right . . . under any security agreement or arrangement or other credit enhancement forming part of or related to any swap agreement, or of any contractual right . . . to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such agreements, including any master agreement for such agreements.[16]

A similar exemption also applies to master netting participants[17] under master netting agreements.[18] Swap agreements which provide rights of "netting, setoff, liquidation, termination, acceleration, or close-out . . . " are master netting agreements.[19]

B. Termination/Liquidation

Sections 560 and 561 of the Bankruptcy Code provide that

> . . . the exercise of any contractual right . . . to cause the liquidation, termination, or acceleration of . . . swap agreements [or master netting 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 . . . [20]

The combined effect of exempting OTC derivative contracts from the automatic stay and the *ipso facto* rule is to allow the debtor's counterparty to terminate or liquidate an OTC derivative contract even after the debtor has filed a petition under Chapter 11, and to protect any netting or setoff rights that the debtor has under these contracts.

C. Avoidance Powers

Section 546 provides that the trustee or debtor-in-possession may not avoid a transfer in connection with a swap agreement that is made before the commencement of the case, except under section 548(a)(1)(A) (that is, if the transfer is made fraudulently).[21]

As a result of these provisions, no prepetition transfer made by the debtor or obligation incurred by the debtor in connection with financial contracts is subject to avoidance by the bankruptcy trustee unless such transfer was made fraudulently.

III. OTC Derivative Contracts

It is important to recognize that the safe harbor provisions of the Bankruptcy Code only intend to preserve the actual contractual rights of the debtor's counterparties. Therefore, parties to OTC derivative contracts covered by these provisions must ensure their contracts provide them the protection they need in the event of a counterparty insolvency.

Most OTC derivative contracts are documented under standard forms created by the International Swaps and Derivatives Association, Inc. (ISDA). ISDA was established in 1985 and has been developing and standardizing documentation with respect to OTC derivative contracts ever since. ISDA has developed various forms of master agreements (each an "ISDA Master") that provide the legal framework that governs the large majority of trading relationships between parties entering into various OTC derivatives trades. A standard form ISDA Master is completed and amended through the negotiation of its "Schedule." In the event the parties choose to collateralize their trades, they will enter into a "Credit Support Annex" to the Schedule. The ISDA Master, together with the Schedule, its Credit Support Annex and confirming evidence of trades, represent a single agreement between the parties. While the 2002 ISDA Master is more recent, the 1992 ISDA Master continues to be frequently used. The distinctions between the 1992 and the 2002 ISDA Masters are not particularly relevant for purposes of this article, except with respect to the calculation of the termination payment.

Section 5 of the ISDA Master establishes that upon the occurrence of certain "events of default" with respect to a party, the other party has the right to terminate all transactions under the ISDA Master. The filing of a petition for insolvency (and similar events) by a party (the "defaulting party") or its guarantor is an event of default under the ISDA Master (a "Bankruptcy Event").[22] Upon the occurrence of a Bankruptcy Event (which may, in the case of certain insolvency events, involve the expiration of a grace period) the other party (the "non-defaulting party") may, but is not obligated to, deliver a notice of early termination of the ISDA Master (the "Notice of Early Termination") to the defaulting party. The Notice of Early Termination will, upon effective delivery, have the effect of terminating all outstanding trades under the ISDA Master as of the early termination date specified in the Notice of Early Termination (which date must be within 20 days of effective delivery of the Notice of Early Termination).

Once an early termination date has been established, the non-defaulting party will calculate the value of all outstanding trades based on the applicable valuation methodology. The non-defaulting party will provide a calculation statement to the defaulting party that details how it determined the termination payment (owed by one party to the other). The non-defaulting party may also net out any collateral held by either party under the Credit Support Annex from the termination payment. Finally, the non-defaulting party may be entitled to setoff amounts owed between the parties under the ISDA Master and any other agreement if a setoff provision were to have been included in the ISDA Master.

A non-defaulting party that is out-of-the-money may elect not to terminate the ISDA Master. This is a slightly risky proposition because a party that waits too long to declare an event of default based on a Bankruptcy Event could be deemed to have waived its rights to do so.[23] However, some parties may still choose not to terminate as Section 2(a)(iii) of the ISDA Master provides that a party's obligation to perform under the ISDA Master is predicated on no event of default having occurred with respect to its counterparty. Therefore, in the event a non-defaulting party to an ISDA Master does not terminate, it is no longer required to perform under the ISDA Master.[24] As a result the non-defaulting party: (a) does not have to terminate the ISDA Master, (b) therefore does not have to pay the termination amount to the defaulting party and (c) does not have to perform under the ISDA Master.

The safe harbor provisions of the Bankruptcy Code have protected the Lehman ISDA Master counterparties with respect to the bankruptcy proceedings of certain Lehman Brothers entities by preserving the counterparties' contractual rights to terminate, liquidate, net and setoff obligations.

IV. Lehman Brothers Holdings Inc.'s (LBHI) Proceeding Under the Bankruptcy Code

LBHI filed a Chapter 11 bankruptcy petition on September 15, 2008 and was soon followed by several affiliated debtors (collectively, the "Lehman Debtors").[25] Since initiating bankruptcy proceedings, the Lehman Debtors have been operating their businesses as debtors-in-possession under the Bankruptcy Code.

Prior to LBHI's filing, as of September 12, 2008, the Lehman Debtors had 6,120 outstanding ISDA Masters, in which they calculated that they were owed $23.8 billion, and that they owed $13 billion.[26] As of January 2, 2009, 3,453 of the ISDA Masters had been terminated by the Lehman Debtors' counterparties, representing $14.3 billion payable to the Lehman Debtors and $11 billion payable by the Lehman Debtors.[27]

On November 13, 2008, the Lehman Debtors filed a motion[28] (the "Motion") for an order from the Bankruptcy Court of the Southern District of New York (the "Court") to establish procedures for assigning and settling various "derivative contracts" (which they defined as securities contracts, forward contracts, repurchase agreements and swap contracts (the "Derivative Contracts")). At the time of the Motion, the Lehman Debtors estimated that they were party to approximately 930,000 Derivative Contracts and that over 190,000 of these contracts had not been terminated by their counterparties and remained outstanding. The Lehman Debtors believed that in some instances the counterparties had not exercised their right to terminate the Derivative Contracts because the Lehman Debtors were in-the-money and the counterparties did not wish to make a termination payment to Lehman. In addition, the Lehman Debtors contended that their counterparties refused to make ongoing payments, in accordance with the terms of the Derivative Contracts, based upon the Lehman Debtors' "alleged defaults."[29] As a result, the Lehman Debtors could not realize the value of such Derivative Contracts unless their counterparties defaulted or other termination events occurred, giving the Lehman Debtors the right to terminate. Therefore the Lehman Debtors petitioned the Court for the ability to realize the value of some of their Derivative Contracts by assigning them to third parties.

The Court, in an order dated December 16, 2008[30] (the "Order"), granted the Motion, with certain modifications that reflect various objections from creditors. The Order granted the Lehman Debtors the right to: (1) enter into final settlement agreements with counterparties that have terminated Derivative Contracts; and (2) assign Derivative Contracts that have yet to be terminated to third parties in order to realize their value. In proposing an assignment, the Lehman Debtors may submit as many as 12 potential assignees to their counterparties and the counterparties are entitled to object to the assignment on various bases enumerated in the Order. The Lehman Debtors, however, may not consummate an assignment transaction or a final settlement agreement pursuant to the procedures set forth in the Order unless: (i) the Official Committee of Unsecured Creditors (the "Committee") consents to the transaction, through written notice or pursuant to the terms of an agreed protocol, or (ii) the Bankruptcy Court authorizes consummation of such transaction.[31]

Not completely satisfied with this outcome, on January 16, 2009, the Lehman Debtors filed a subsequent motion[32] (the "Second Motion") for an order from the Court requesting that the Court approve the consensual assumption and assignment of prepetition contracts. The Lehman Debtors sought an order that would limit the costs of assignment, and increase the marketability of Derivatives Contracts which are to be consensually assigned, by eliminating the requirement of Court approval for such assignments.

The Court, in an order dated January 28, 2009[33] (the "Second Order"), granted the Second Motion authorizing the Lehman Debtors to proceed with the assumption and assignment of Derivative Contracts that have not been terminated (other than with respect to special purpose entities, for which there are different procedures), with the approval of the Committee or in accordance with the terms of a protocol agreed to with the Committee, and with the written consent of the relevant counterparty.

At the hearing for the Motion, counsel for the Lehman Debtors stated that the number of Derivative Contracts that had not been terminated had gone from 190,000 at the time of the filing of the Motion to 30,000 at the date of the hearing. It is clear that counterparties to the Lehman Debtors are not particularly interested in continuing the transactions under their Derivative Contract with a third party.

V. Conclusion

The Lehman Debtors' bankruptcy has provided a dramatic test of the safe harbor provisions in the context of the failure of a major financial institution. OTC derivative counterparties have relied on those provisions to terminate and close out their ISDA Masters and thereby limit their exposure. It will be determined over the coming months and years to what extent this has served to reduce systemic risk and limit the disruption of financial markets.

Endnotes

1. 11 U.S.C. §§ 101–1532 (2006) (incorporating the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005), and the Financial Netting Improvements Act of 2006, Pub. L. No. 109–390, 120 Stat. 2692 (2006)).
2. Ellen H. Clark, *Developments in Derivatives and Synthetic Securitization Following the US Bankruptcy Reforms of 2005*, in Innovation in Securitization Yearbook 2006, 85–110 (De Vries Robbe and Ali ed. 2006).
3. *Id.*
4. OTC derivatives contracts are privately negotiated bilateral trades. For further explanation of the OTC market, *see* Lauren Teigland-Hunt and GuyLaine Charles, *The Evolution of Standardization of the OTC Derivatives Market*, MFA Reporter, January/ February 2009.
5. This article will not address the liquidation of Lehman Brothers Inc. (LBI) under the Securities Investors Protection Act of 1970 (SIPA) nor will it explore issues raised by the fact that a number of Lehman Brothers entities were subject to foreign laws and the jurisdiction of foreign courts, although these factors have had a significant impact on creditors and the bankruptcy.
6. The automatic stay is akin to a temporary injunction levied against creditors immediately upon a debtor filing under the Bankruptcy Code pursuant to which any activity which may result in the erosion of a debtor's assets is prohibited (e.g., lawsuits, foreclosures etc . . .). *See* 11 U.S.C. § 362(a) (2006).
7. An "*ipso facto* clause" in a contract provides that the insolvency of one party is a breach of contract, therefore allowing the non-insolvent party to the contract to terminate the agreement. Section 365(e)(1) of the Bankruptcy Code renders such *ipso facto* clauses unenforceable. *See* 11 U.S.C. § 365(e)(1) (2006).
8. Avoidance powers are powers afforded to the bankruptcy trustee pursuant to which the trustee may set aside transfers deemed to be preferences or fraudulent transfers or fraudulent obligations. *See* 11 U.S.C. §§ 544, 547–48 and 550 (2006).
9. *See* 11 U.S.C. § 365(a) (2006).
10. *See* 11 U.S.C. § 1126 (2006).
11. *See* An Act to Establish a Uniform Law on the Subject of Bankruptcies, Pub. L. No. 95-598, 92 Stat. 2549 (1978). As originally drafted, Section 362 exempted from the automatic stay "the setoff of any mutual debt and claim that are commodity futures contracts, forward commodity contracts, leverage transactions, options, warrants, rights to purchase or sell commodity futures contracts or securities, or options to purchase or sell commodities or securities." 11 U.S.C § 362(b)(6) (2006).
12. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109–8, 119 Stat. 23.
13. The Financial Netting Improvements Act of 2006, Pub. L. No. 109-390, 120 Stat.2693.
14. "Since 1978, we have been faced with a number of situations where Congress has concluded that certain rapid, high volume financial transactions warrant special bankruptcy treatment so as not to disrupt international capital markets." 136 Cong. Rec. H2281-06, H2282 (1990) (statement of Congressman Brooks).
15. "Financial participant" is defined in 11 U.S.C. § 101(22A) (2007) and "swap participant" is defined in 11 U.S.C. § 101(53C) (2007).
16. 11 U.S.C. § 362; swap agreements (§ 101(53B)) (2006) are exempt under § 362(b)(17) (2006).
17. "Master netting agreement participant" is defined in 11 U.S.C. § 101(38B) (2007).
18. "11 U.S.C. § 362(b)(27) (2007).
19. "Master netting agreement" is defined in § 101(38A) (2007).
20. A counterparty may exercise the right to terminate, liquidate or accelerate, despite the prohibition on *ipso facto* clauses in Section 365(e)(1), among other financial contracts, a swap agreement (§ 560), and a master netting agreement (§ 561).
21. 11 U.S.C. § 546(f)(g) (2006).
22. *See* ISDA Master § 5(a)(vii).
23. *See In re Amcor Funding Corp. fka Lincoln Am. Fin. Inv. Co.*, No. CIV 89-1231 PHX-RMB (D. Ariz. 1990).
24. In the Australian case of *Enron Australia v. TXU Electricity* (2003) 204 A.L.R. 658, Enron had entered into electricity swap transactions governed by the 1992 ISDA before going into administration and then liquidation. The court held that TXU, as the non-defaulting party, had no obligation to make any payments to Enron related to open trades due to the condition precedent in Section 2(a)(iii) of the ISDA Master. The court held that the payment obligation of the non-defaulting party would only arise under a pre-existing trade once the condition precedent was satisfied.
25. The term "Lehman Debtors" does not include Lehman Brothers, Inc., which is subject to proceedings under the SIPA.
26. Lehman Brothers Holdings Inc., First Creditors § 341 Meeting, January 29, 2009, p.19 and 20, *available at* http://www.lehmanbrothersestate.com/341_Meeting_01_29_09_FINAL_SS.pdf.
27. *Id.*
28. Debtors' Motion for an Order pursuant to Sections 105 and 365 of the Bankruptcy Code to Establish Procedures for the Settlement or Assumption and Assignment of Prepetition Derivatives Contracts, Lehman Brothers Holdings Inc., *et al*, No. 08-13555 (U.S. Bankr. Ct., S.D.N.Y. Nov. 13, 2008). [Docket No.1612].
29. Section 2(a)(iii) of the ISDA Master, pursuant to which the non-defaulting party is not required to perform during the existence of an event of default with respect to its counterparty, is not necessarily present in all financial contracts.
30. Order Pursuant to Sections 105 and 365 of the Bankruptcy Code to Establish Procedures for the Settlement or Assumption and Assignment of Prepetition Derivative Contracts, Lehman Brothers Holdings Inc., *et al.*, No. 08-13555 (U.S. Bankr. Ct., S.D.N.Y. Dec. 16, 2008). [Docket No. 2257].
31. There remain some outstanding objections to the Order. The terms of the Order are not applicable to any party whose objection remains outstanding.
32. Debtors' Motion for an Order Approving Consensual Assumption and Assignment of Prepetition Derivatives Contracts, Lehman Brothers Holdings Inc., *et al.*, No. 08-13555 (U.S. Bankr. Ct., S.D.N.Y. Jan. 16, 2009). [Docket No.2561].
33. Order Approving Consensual Assumption and Assignment of Prepetition Derivatives Contracts, Lehman Brothers Holdings Inc., *et al.*, No.08-13555 (U.S. Bankr. Ct., S.D.N.Y. Jan. 28, 2009). [Docket No. 2667].

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