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## Bankruptcy Court Prohibits Counterparty's Suspension Of Payments to Lehman Under Open Derivative Contract

In a significant decision recently handed down in the Lehman bankruptcy case, the United States Bankruptcy Court for the Southern District of New York held that a non-defaulting counterparty acted improperly by suspending payments under an open derivative contract with Lehman Brothers Special Financing Inc. ("LBSF"). In a 17 September 2009 decision,<sup>[1]</sup> Judge James Peck determined that the Bankruptcy Code required the counterparty to either terminate the agreement or continue making payments, and prohibited the counterparty from suspending performance based on the bankruptcy filings of LBSF and its credit support provider, Lehman Brothers Holdings, Inc. ("LBHI").

### Facts

LBSF and Metavante Corporation were parties to a fixed-to-floating interest rate swap agreement documented by an ISDA Master Agreement dated 20 November 2007 and related trade confirmation (the "Agreement"). Under the Agreement, Metavante agreed to pay a fixed rate of 3.865% to LBSF in exchange for payment of a variable rate of interest based on the three month LIBOR rate on an initial notional amount of \$600 million. The Agreement contemplates quarterly net payments by the party owing the higher amount.

Under the Agreement, the bankruptcy of a party or a credit support provider constituted an Event of Default, which allows the Non-Defaulting Party to designate an Early Termination Date. Once the Non-Defaulting Party designates an Early Termination Date, a final payment is to be made in accordance with the method and payment measure specified in the Agreement. However, Metavante did not terminate the swap based on the chapter 11 filings of LBSF and LBHI. Instead, Metavante suspended performance and stopped making the regularly scheduled payments under the swap beginning in November 2008.

Given the interest rate environment during the period following Lehman's chapter 11 filings, the swap was significantly "out of the money" to Metavante. As a result, Metavante owed substantial payments to LBSF. LBSF asserted that as of 29 May 2009, Metavante owed \$6.640 million in quarterly payments (plus default interest) and filed a motion with the Bankruptcy Court seeking to compel Metavante to make those payments.

### The Court's Decision

The Bankruptcy Court held that Metavante acted improperly by suspending performance under the Agreement because the "[t]he case law makes clear that [until] a debtor determines whether to assume or reject an executory contract, the counterparty to such contract must continue to perform."<sup>[2]</sup> The Court determined that the Agreement was a "garden variety" executory contract because material performance remained due by both LBSF and Metavante in the form of future payment obligations. Therefore, the Court stated, 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."

Metavante pointed to section 2(a)(iii) of the Agreement, which provides that the obligation to make payments "is subject to . . . the condition precedent that no Event of Default or Potential Event of Default with respect to the other party has occurred and is continuing." Relying on the New York contract law principle that the failure of a condition precedent excuses the counterparty's obligation to perform,<sup>[3]</sup> Metavante argued that it had the right to suspend payments pending termination of the swap because the Agreement conditioned its payment obligations on there being no Event of Default.

The Lehman Court rejected this argument, determining that "the Bankruptcy Code trumps a state law excuse of nonperformance" and that the bankruptcy laws compelled a different result. The Bankruptcy Code provides that a so-called ipso facto clause in a contract -- a provision that terminates or modifies a contract based on a bankruptcy filing -- is unenforceable.<sup>[4]</sup> Lehman argued that the application of section 2(a)(iii) to a default based on a bankruptcy filing was void as an ipso facto clause. The Bankruptcy Code's "safe harbor provisions"<sup>[5]</sup> provide for limited exceptions to the prohibition on ipso facto clauses and allow counterparties to exercise certain rights based on a contractual provision providing for a default based on a bankruptcy filing. As the Bankruptcy Court determined, however, those provisions are available "only to the extent that a counterparty seeks to one, liquidate, terminate or accelerate its positions or two, net out its positions. All other uses of ipso facto provisions remain unenforceable under the Bankruptcy Code."

Metavante further asserted that its right to postpone termination and suspend interim payments while it waited for the markets to turn in its favor were preserved by the safe harbor provisions. Metavante first argued that the safe harbor provisions foreclosed any limitation on its right to terminate following a bankruptcy default and therefore it could postpone termination indefinitely and exercise those rights at any time. Metavante further argued that

compelling it to make interim payments would deprive it of its right -- in the event the markets turned such that Metavante was later rendered "in the money" under the swap -- to setoff any amount owed by LBSF upon termination against the quarterly payments owed by Metavante.

The Bankruptcy Court also rejected these arguments, reiterating that the safe harbor provisions protect a Non-defaulting Party's contractual rights *solely* to liquidate, terminate or accelerate derivative transactions and in connection therewith to set off or net out termination values or payment amounts. The Court observed that Metavante "has attempted neither to liquidate, terminate or accelerate the Agreement, nor to offset or net out its position as a result of the events of default caused by the filing of bankruptcy petitions by LBHI and LBSF" and instead had merely suspended performance. Thus, the Court determined that the safe harbor provisions do not apply when a counterparty has merely suspended performance. The Court further held that "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."

The Bankruptcy Court also held that Metavante's failure to make the payments under the Agreement was a violation of the "automatic stay," a statutory injunction that prohibits, among other things, attempts to exercise control over a debtor's property and directed Metavante to comply with the Agreement.

## Conclusion

Under the Metavante decision, a Non-defaulting Party to a derivative transaction documented by an ISDA Master Agreement cannot unilaterally suspend performance, but must instead choose between invoking early termination based on a bankruptcy default provision or complying fully with its payment obligations. Outside of bankruptcy, New York law would support an argument that a default relieves the Non-defaulting Party of the obligation to make interim payments under a provision such as section 2(a)(iii) of the Agreement. However, under the Metavante ruling, the application of section 2(a)(iii) to a default based on a bankruptcy filing is void as an *ipso facto* clause and, therefore, a Non-defaulting Party cannot rely on section 2(a)(iii) as a basis for suspending payments in the event of bankruptcy.

In addition, the Metavante decision imposes a timeliness requirement on the Non-defaulting Party's right to terminate. The Court did not specify the length of time a Non-defaulting Party has to invoke early termination, but did indicate that there is no obligation to terminate "immediately upon the filing." However, under the decision, it appears that waiting a year to terminate could result in a waiver of the right to do so.

Lehman will likely take action against similarly situated counterparties based on the Metavante decision. We recommend that counterparties with open derivative contract positions with Lehman entities that have suspended performance contact counsel to discuss the implications of this decision.

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[1] See Order to Compel Performance of Contract and to Enforce the Automatic Stay, In re Lehman Brothers Holding Inc., No. 08-13555 (S.D.N.Y. September 17, 2009) (Docket No. 5209).

[2] The Bankruptcy Code provides that a debtor in bankruptcy may either "assume" or "reject" an executory contract, but Lehman had not yet made that decision. 11 U.S.C. § 365(a). If the debtor assumes the contract, all existing defaults must be cured and the debtor must provide adequate assurance of future performance under the contract. 11 U.S.C. § 365(b). If the debtor decides to reject the contract, then the contract is deemed breached as of the bankruptcy date and the counterparty has a general unsecured claim for damages caused by the rejection. 11 U.S.C. § 365(g).

[3] See, e.g., Ergonomic Sys. Phillipines Inc. v. CCS Int'l Ltd., 777 N.Y.S.2d 446, 447 (N.Y. App. Div. 2004) (failure of party to contract to satisfy condition precedent excuses counterparty from performance).

[4] 11 U.S.C. § 365(e)(1).

[5] See, e.g., 11 U.S.C. §§ 560, 561.

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