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Application of Safe Harbor Provisions to Early Termination of Swap Agreement

William Accordino Jr.

ST. JOHN'S UNIVERSITY
SCHOOL OF LAW

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WILLIAM ACCORDINO JR.

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INTRODUCTION

Credit default swap agreements ("swaps") are contracts between two entities in which the counterparties are effectively taking opposing positions on the credit worthiness of a debt instrument that acts as the collateral underlying the swap. For example, counterparty A makes payments to counterparty B in the hopes that the debtor defaults or a counterparty commits an event of default specified in the agreement, such as filing for bankruptcy. Swaps are generally executory contracts and thus may generally be rejected by a trustee or a debtor in bankruptcy pursuant to section 365 of the United States Bankruptcy Code ("the Code").[1] However, pursuant to section 365 of the Code, a trustee may not reject an executory contract solely because of a provision in the agreement conditioned on a party filing for bankruptcy ("Anti-*Ipso Facto* Provision").[2] Swaps are also subject to section 560 of the Code (the "Safe Harbor Provision"), one of the Code's safe harbor provisions. Section 560 allows a swap participant to "cause the liquidation, termination, or acceleration" of a swap agreement even if a counterparty files for

[1] 11 U.S.C. § 365 (2012).
[2] 11 U.S.C. § 365 (2012).

bankruptcy.[3] The consequences of an event of default vary by agreement; penalty payments or a change in the payment priorities of the defaulting counterparty ("flip clause") are common. A flip clause is a provision which changes the party's payment priority for the proceeds from the liquidation of the collateral underlying the swap. Whether a flip clause is covered by the Safe Harbor Provision is the subject of this memo.

There are three cases involving the Lehman Bros. bankruptcy that are of particular importance to this issue. In the immediate fallout from the 2008 financial crisis, and the collapse of the swap market, Judge Andrew J. Peck decided two cases related to the early termination of swap agreements as a result of Lehman's bankruptcy. Judge Peck found the penalty payments were covered by the Safe Harbor Provision but the flip clauses were not because a change in payment priority created different rights than those the defaulting party held before the bankruptcy filing. Judge Peck retired in 2014 and in 2016 Judge Shelley C. Chapman decided another case from the Lehman Bros bankruptcy. Judge Chapman applied a plain reading of the Safe Harbor Provision to hold flip clauses were covered as a part of the "liquidation, termination, or acceleration of the agreement."

This memorandum addresses the issue of whether the safe harbor provisions set forth in the Code cover flip clauses triggered by the early termination of a swap agreement. Part I addresses Judge Peck's narrow reading of the Safe Harbor Provision in the aftermath of the financial crisis. Part II notes cases that addressed safe harbor provisions in between Judge Peck and Judge Chapman's rulings. Part III discusses Judge Chapman's plain reading of the Safe Harbor Provision. Part IV summarizes the case that dealt with another of the Code's safe harbor provisions.

[3] 11 U.S.C. § 560 (2012).

I. JUDGE PECK'S NARROW READING OF THE SAFE HARBOR PROVISION

In *Lehman Bros. Holdings Inc. v. BoNY Corporate Trustee Services Limited*, Judge Andrew J. Peck, United States Bankruptcy Judge for the Southern District of New York, held the swaps between Lehman and its counterparty were subject to the Anti-*Ipso Facto* Provision and were not protected by the Safe Harbor Provision.[4] He also described Lehman's operations as "perhaps the most complex and multi-faceted business ventures ever to seek the protection of chapter 11" and the "largest business in bankruptcy history."[5] Judge Peck found the contractual provisions that allowed the counterparty to terminate the agreement upon Lehman's bankruptcy were not actually a part of the swap agreement itself, nor were they incorporated by reference, and therefore not covered by the Safe Harbor Provision. Additionally, he found that a provision that changes a party's payment priority ("flip clause") was not included in the "liquidation, termination or acceleration" of swaps covered by that section.[6]

Judge Peck noted the Code's Anti-*Ipso Facto* provisions had never been construed under comparable circumstances. He also noted that was likely to make his ruling "a controversial one" because excluding flip clauses was a narrow reading of the Safe Harbor Provision.[7]

In *Lehman Bros. Special Financing Inc. v. Ballyrock ABS CDO 2007-1 Ltd.* ("*Ballyrock*"), 452 B.R. 31 (Bankr. S.D.N.Y. 2010), Judge Peck held the flip clause in swaps between Lehman and its counterparty was subject to the Anti-*Ipso Facto* provision and was not protected by the Safe Harbor Provision.[8] If Lehman was the defaulting party, the provision

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[4] *Lehman Bros. Holdings Inc. v. BoNY Corporate Tr. Serv. Ltd.* ("*BoNY*"), 422 B.R. 407, 421 (Bankr. S.D.N.Y. 2010).
[5] *Id.* at 420.
[6] *Id.* at 421.
[7] *Id.* at 422.
[8] *Lehman Bros. Special Financing Inc. v. Ballyrock ABS CDO 2007-1 Ltd.* ("*Ballyrock*"), 452 B.R. 31 (Bankr. S.D.N.Y. 2010)

caused Lehman's payment priority to drop from as high as third to as low as nineteenth.[9] Judge Peck relied on the "policy considerations" he discussed in *BoNY* to hold an "Event of Default may not be used to reallocate financial outcomes to the detriment" of a counterparty.[10] There were no penalty payments at issue in this case.

Judge Peck noted courts have not interpreted the words "liquidation, termination, or acceleration" in the Safe Harbor Provision beyond their plain meaning.[11]

In these two cases, Judge Peck applied a narrow reading to find flip clauses were not covered by the Safe Harbor Provision. Judge Peck distinguished between the "liquidation, termination, or acceleration" language in the Safe Harbor Provision and a flip clause. Judge Peck found a flip clause went beyond the "liquidation, termination, or acceleration" of a swap because it altered the rights of the defaulting party if that party was "in-the-money" by significantly lowering the party's payment priority. The protection provided by the Safe Harbor Provision is limited to the non-defaulting party's ability to terminate the swap as is. According to Judge Peck's ruling, any contractual clause that alters a party's rights, rather than simply terminates, accelerates, or liquidates, a swap is outside the scope of the Safe Harbor Provision.

As noted in some of the opinions in the following section, and Judge Peck himself, the ruling was controversial and created doubt as to the early termination of swap agreements as a result of a counterparty's bankruptcy.

II. INTERMEDIATE OPINIONS ADDRESSING CODE'S SAFE HARBOR PROVISIONS

In *In re Lehman Bros. Holdings Inc.*, Judge Colleen McMahon, United States District Court Judge for the Southern District of New York, granted BoNY's motion for leave to appeal Judge

[9] *Id.* at 36.
[10] *Id.* at 43.
[11] *Id.* at 40.

Peck's decision in the *BoNY* case.[12] Judge McMahon quoted Judge Peck's language from that opinion in which Judge Peck described his decision as "breaking new ground."[13] Judge McMahon noted that the holding from *BoNY* left substantial ground for a difference of opinion.[14] He also points out the majority of the commentary available at the time of the *BoNY* decision was critical. Lehman "meekly" cited a single article noting the response had been "mixed."[15] Additionally, the ruling from *BoNY* "triggered significant uncertainty in the financial community" with billions of dollars in the balance.[16] Judge McMahon noted that Judge Peck was faced with an extremely difficult question of first impression that required review from the district court.[17] However, the parties settled before the appeal was actually heard.

In *Swedbank AB v. Lehman Bros. Holding Inc.* ("*Swedbank*"), Judge Naomi Reice Buchwald, United States District Court Judge for the Southern District of New York, affirmed Judge Peck's holding which declined to apply the Safe Harbor Provision to an attempted setoff because the funds at issue were not related to the swap.[18] Judge Buchwald discussed the legislative history behind the Safe Harbor Provision to support the holding. In passing the Safe Harbor Provision, Congress intended to allow counterparties to free themselves from the obligations specific to the swap and not from "the general commercial obligations of parties to swap agreements."[19] This opinion did not discuss the Anti-*Ipso Facto* Provision. The setoff at issue was not automatically triggered by a bankruptcy filing but an attempt by a counterparty to

[12] *In re Lehman Bros. Holdings Inc.,* No. 08-13555 (JMP), 2010 WL 10078354 (S.D.N.Y. Sept. 23, 2010).
[13] *Id.* at *1.
[14] *Id.* at *6.
[15] *Id.* at *7.
[16] *Id.* at *9.
[17] *Id.* at *7.
[18] *Swedbank AB v. Lehman Bros. Holding Inc.* ("*Swedbank*"), 445 B.R. 130 (S.D.N.Y. 2011).
[19] *Id.* at 135.

use post-petition assets unrelated to a swap agreement.[20] Judge Buchwald also noted the need for the non-defaulting counterparty to be able to terminate the swap quickly in the interest of market stability.[21]

In *Michigan State Housing Development Authority v. Lehman Bros. Derivative Products Inc.* ("*MSHDA"*), Judge Peck held that a clause in a swap causing a reduction in the size of the termination payment based on a counterparty filing for bankruptcy was subject to the Anti-*Ipso Facto* Provision but was protected by the Safe Harbor Provision.[22] The issue in *MSHDA* was whether the right to liquidate a swap under the safe harbor provision was separate from the actual method of liquidation, as Lehman argued.[23] Lehman asserted the right to liquidate the swaps may be covered by the safe harbor provision, but the method of liquidation was not because it significantly lowered the payment Lehman was entitled to upon termination.[24] Judge Peck noted "[t]here is a significant difference between the reordering of priorities within a hierarchy of distributions" and "selecting which method to use when disposing and valuing collateral in connection with liquidating a terminated swap agreement."[25]

In *In re MPM Silicones*, No. 14-22503-rdd, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014), Judge Robert D. Drain, United States Bankruptcy Judge for the Southern District of New York, held lien trustees could not decelerate loans that had been automatically accelerated by a bankruptcy filing.[26] The agreements in that case did not implicate the Anti-*Ipso Facto* Provision or the Safe Harbor Provision because the right at issue did not arise

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[20] *Id.* at 137.
[21] *Id.* at 135—36.
[22] *Michigan State Housing Development Authority v. Lehman Bros. Derivative Products Inc.* ("*MSHDA"*), 502 B.R. 383 (Bankr. S.D.N.Y. 2013).
[23] *Id.* at 387.
[24] *Id.* at 386.
[25] *Id.* at 387.
[26] *In re MPM Silicones*, No. 14-22503-rdd, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014).

automatically from the filing of a bankruptcy nor was it a swap.[27] At issue was a securities contract; securities contracts have a safe harbor provision analogous to the Safe Harbor Provision.[28] However, Judge Drain cited to *BoNY* and *Ballyrock* to support the assertion that the Code's safe harbor provisions are "narrow provision[s] that should not be used to improve a contract party's standing or claim in the bankruptcy case."[29] Judge Drain also noted that the deceleration in this case was not the exercise of an existing contractual right, but an attempt by the lien trustees to create a new claim after a bankruptcy filing.[30]

In *Chohan v. Chohan* (*In re Chohan*), Judge Stephen V. Wilson, United States District Court Judge for the Central District of California affirmed the Bankruptcy Court's decision holding that the assignee of a counterparty's interest in a terminated swap was not a swap participant.[31] Judge Wilson discussed the legislative history of the Safe Harbor Provision in seeking to define swap participant.[32] He pointed out that history reflected a concern for market stability and a concern the non-defaulting party would be trapped in a swap agreement as interest rates moved in the defaulting party's favor.[33] This case did not involve credit default swaps but rather a swap agreement where one counterparty made fixed interest rate payments and the other counterparty made payments per a floating interest rate.[34]

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[27] *Id.* at 22.
[28] *Id.* at 21—22.
[29] *Id.* at 22.
[30] *Id.* at 21.
[31] *Chohan v. Chohan* (*In re Chohan*), 532 B.R. 130 (C.D. Cal. 2015), *aff'g*, No. 8:14-bk-136606-SC (Bankr. C.D. Cal. July 24, 2014).
[32] *Id.* at 137.
[33] *Id.* at 138.
[34] *Id.* at 132.

Judge Wilson noted that once the swap has been terminated and the payments calculated, there is no longer a need to protect the non-defaulting party from market volatility.[35]

The response to Judge Peck's ruling in *BoNY* and *Ballyrock* was mostly negative as noted by Judge McMahon in granting BoNY's appeal from that ruling. Judge McMahon noted that Judge Peck was in a difficult situation given the turmoil in the financial markets generally. However, Judge McMahon also noted that the ruling "triggered significant uncertainty in the financial community." While the case was settled prior to the district court hearing the appeal, Judge McMahon's language suggests Judge Peck's holdings in *BoNY* and *Ballyrock* would not have would have been scrutinized closely by the district court.

Judge Buchwald's ruling in *Swedbank* affirmed another one of Judge Peck's holdings but that case did not involve the termination or liquidation of swaps. The issue in that case involved setoffs and did not implicate the Anti-*Ipso Facto* clause or the Safe Harbor Provision. The opinion is relevant because Judge Buchwald discusses the need for non-defaulting counterparties to terminate swaps quickly in the interest of market stability.

In *MSHDA*, Judge Peck detailed the difference between a penalty payment triggered by a counterparty's bankruptcy and a shift in a counterparty's payment priority for the same reason. In that case, Lehman attempted to bifurcate the liquidation process by claiming the right to liquidate swaps was covered by the Safe Harbor Provision, but the actual process of liquidating the swap was not. Judge Peck rejected this reasoning but noted the distinction between changing a party's payment priority and the particular method of liquidation the parties agreed to. The crux of Judge Peck's reasoning is that a change in payment priority creates new rights for the parties

[35] *Id.* at 138—39.

upon the filing of a bankruptcy which is forbidden. A payment penalty, in contrast, does not change any rights of any parties.

The *MPM Silicones* case deals with the deceleration of loans as a result of a bankruptcy. It is relevant because Judge Drain cites to both *BoNY* and *Ballyrock* to support the assertion that the Code's safe harbor provisions are narrow and are not meant to change the rights of involved parties. Judge Drain makes a distinction between existing contractual rights and those created upon a counterparty filing for bankruptcy.

The *Chohan* case turned on the definition of swap participant and whether assignees were included in that definition. However, it is relevant because of Judge Wilson's comments on market stability. Judge Wilson noted the need to protect counterparties and promote market stability dissipates after the swap is terminated and the payment is determined. Judge Wilson's emphasis on market stability is a theme that is used frequently in cases related to the Code's safe harbor provisions.

Whether a broad or narrow reading of the Code's safe harbor provisions, including the applicability of the safe harbors, best supports market stability remains an open question.

III. JUDGE CHAPMAN'S PLAIN READING OF THE SAFE HARBOR PROVISION

In *Lehman Bros. Holdings Inc. v. Bank of America National Assoc.* ("*BoA*"), Judge Shelley C. Chapman, United States Bankruptcy Judge for Southern District of New York, found contrary to Judge Peck's holdings from *BoNY* and *Ballyrock*.[36] Judge Chapman held that an *ipso facto* provision that modified the defaulting party's payment priority if it filed for bankruptcy was covered by the Safe Harbor Provision.[37] She found the Safe Harbor Provision required a

[36] *Lehman Bros. Holdings Inc. v. Bank of America National Assoc.* ("*BoA*"), 553 B.R. 476 (Bankr. S.D.N.Y. 2016).
[37] *Id.* at 500—01.

broad interpretation "to promote the stability and efficiency of the financial markets."[38] Judge Chapman found the text of the Safe Harbor Provision was "unambiguously sweeping" and "plain and controlling on its face." and must be read that way to preserve Congress' intent.[39]

Judge Chapman noted that Judge Peck made his rulings on *BoNY* and *Ballyrock* during a difficult time but "perspectives on difficult legal questions [need to] develop and evolve over time."[40]

Judge Chapman's ruling in *BoA* effectively overturned Judge Peck's earlier rulings from the Lehman cases. Judge Chapman noted that Judge Peck was making his decisions during a very difficult time but that perspectives needed to evolve over time as conditions change. In contrast to Judge Peck's narrow ruling of the Safe Harbor Provision, as noted above, Judge Chapman found the language in the Safe Harbor Provision was "unambiguously sweeping" and only that type of reading would serve Congress' intent in protecting the markets.

In the absence of subsequent rulings on point, it remains an open question whether Judge Chapman's ruling represents a sort of return to normalcy after the dust from the financial crisis settled or whether Judge Peck's rulings hold up in different circumstances.

IV. ONE CASE THAT HAS CITED TO JUDGE CHAPMAN'S DECISION FROM *BOA*

In *In re Louisiana Pellets*, No. 16-80162, 2016 WL 4011318 (Bankr. W.D. La. July 22, 2016), Judge Robert Summerhays, United States Bankruptcy Judge for the Western District of Louisiana, held a forward commodities contract which termination was conditioned on contract performance was not covered by one of the Code's safe harbor provisions.[41] Similar

[38] *Id.* at 502.
[39] *Id.* at 501.
[40] *Id.* at 497.
[41] *In re Louisiana Pellets*, No. 16-80162, 2016 WL 4011318 at *4 (Bankr. W.D. La. July 22, 2016).

to the Safe Harbor Provision, the safe harbor at issue in this case protects transactions covered by the Anti-*Ipso Facto* Provision.[42] The language in section 365(e)(1) limits its application to the three specific instances listed and does not include a party's failure to perform under a contract.[43]

Judge Summerhays noted that, consistent with Judge Chapman's holding in *BoA*, the Code's safe harbor provisions are generally read broadly and according to their plain terms to promote their underlying purpose.[44]

Judge Summerhays' reading of the Code's safe harbor provisions is consistent with Judge Chapman's ruling from *BoA*. However, this case offers little guidance because it discusses the Code's safe harbor provisions generally and not the provision specific to the anti-*ipso facto* clause. It is notable that Judge Summerhays discussed the need for a broad reading to affect the underlying purpose of the provisions.

CONCLUSION

The Code's safe harbor provisions are applicable to penalty payments tied to the early termination of credit default swap agreements but whether the provisions are applicable to flip clauses remains uncertain because there has been no decision on point since Judge Chapman's holding in *BoA*.

[42] *Id.* at 4.
[43] *Id.*
[44] *Id.*