



EMORY
LAW

Emory Bankruptcy Developments Journal

Volume 31
Issue 2 *The Twelfth Annual Emory Bankruptcy
Developments Journal Symposium*

Article 5

2015

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Recommended Citation

Peter Marchetti, *Amending the Flaws in the Safe Harbors of the Bankruptcy Code: Guarding Against Systemic Risk in the Financial Markets and Adding Stability to the System*, 31 Emory Bankr. Dev. J. 305 (2015).

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**AMENDING THE FLAWS IN THE SAFE HARBORS OF THE
BANKRUPTCY CODE: GUARDING AGAINST SYSTEMIC
RISK IN THE FINANCIAL MARKETS AND ADDING
STABILITY TO THE SYSTEM**

*Peter Marchetti**

ABSTRACT

This Article discusses derivative transactions in bankruptcy. Generally, the parties to these transactions are major participants in the financial markets. On a worldwide basis, the estimated outstanding notional amounts of derivative transactions are approximately \$693 trillion. Certain provisions of derivative trading contracts get special exemptions under the Bankruptcy Code. This Article will refer to these exemptions as the “Safe Harbors.” Congress enacted the Safe Harbors to prevent systemic risk, i.e., to prevent a domino effect of bankruptcy filings among financial institutions. The Safe Harbors seek to accomplish this goal by permitting a party to a derivative trading contract to quickly terminate and liquidate its positions. Thus, these parties are, for the most part, not subject to the normal bankruptcy process that applies to other types of contracts.

Several recent disputes in the Lehman Brothers bankruptcy proceedings raise new issues that illustrate that the precise parameters of the Safe Harbors remain unclear. This lack of clarity adversely affects the ability of market participants to accurately perform credit risk analyses with respect to their derivative trading counterparties and may adversely impact the ability of certain market participants to prepare Living Wills, as required by the recently

* Assistant Professor of Law, Thurgood Marshall School of Law, Texas Southern University. The views and opinions expressed herein are solely those of the author. This Article, inter alia, contains a discussion of the following: (1) the Bench Ruling in the Metavante matter and (2) the dispute between Lehman Bros. Special Finance Inc. and BNY Corporate Trustee Services. Transcript Regarding Hearing Held September 15, 2009 at 101–13, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 17, 2009), ECF No. 5261; *Lehman Bros. Special Fin. Inc. v. BNY Corp. Tr. Servs. Ltd. (In re Lehman Bros. Holdings Inc.)*, 422 B.R. 407, 411 (Bankr. S.D.N.Y. 2010). The author previously discussed those cases while their appeals were pending in the following articles: Peter Marchetti, *The Bankruptcy Court’s Ruling in the Lehman Metavante Matter—Has the Ticking Time Bomb of Enron vs. TXU Exploded or Been Defused?*, FUTURES & DERIVATIVES L. REP., Feb. 2010, at 1; Peter Marchetti, *Trapped Between a Rock and a Hard Place*, FUTURES & DERIVATIVES L. REP., June 2010, at 14. To provide background and context for the topics discussed herein, some of the discussions regarding the facts and holdings of those cases are reproduced herein.

enacted Dodd-Frank Act. Similarly, it adversely affects the ability of a party to reorganize under the Bankruptcy Code. This Article argues that Congress should amend the Safe Harbors to address these issues to mitigate systemic risk.

Several academics have argued that the Safe Harbors should be repealed. Other recent proposals have argued that a short stay should apply before the Safe Harbors could be used against certain large financial institutions that file for bankruptcy protection. Congress, however, has not repealed the Safe Harbors. This Article argues that the Safe Harbors should be amended. Specifically, Congress should amend the Bankruptcy Code so that it is clear that Payment Suspension Clauses, Walkaway Clauses, and Flip Clauses are not enforceable against a debtor that has filed for bankruptcy where a party seeks to enforce such clauses based on that debtor's financial condition or bankruptcy filing or the financial condition or bankruptcy filing of any one of such debtor's affiliates. Furthermore, Congress should amend the Bankruptcy Code and Title II of the Dodd-Frank Act so that it is clear that Triangular Setoff Clauses are enforceable where either affiliated entities both agree to the Triangular Setoff or those affiliated entities guarantee each other's liabilities. Such amendments would both increase efficiency in credit risk analyses and in the drafting of Living Wills and mitigate systemic risk.

INTRODUCTION

During the past decade, the use of derivatives transactions has exploded.¹ According to a recent survey, more than 94% of the world's largest corporations use derivatives for hedging purposes.² Generally, the parties to these transactions are major participants in the financial markets, such as large banks, broker-dealers, commodity traders, large corporations, and hedge funds. The current estimated outstanding amount of such transactions on a worldwide basis is approximately \$693 trillion.³ Certain provisions of derivative trading contracts get special treatment under the Bankruptcy Code (the "Code") and are exempted from some of its very important provisions.⁴ These exemptions

¹ These transactions are "financial product[s] that derive from an underlying market" and allow various types of business entities, or market participants, such as banks, securities firms, and governmental units (asset managers) to hedge different types of risk. PAUL C. HARDING, *MASTERING THE ISDA MASTER AGREEMENTS* (1992 AND 2002) 2 (3d ed. 2010). There are basically two types of derivative markets: exchange traded and over-the-counter ("OTC"). *Id.* In exchange-traded derivative transactions, counterparties do not face each other. *Id.* at 3. Instead, they face an exchange, which stands in the middle of the two parties and effectively is each party's counterparty. *Id.* at 2; *see also* ANDREW M. CHISHOLM, *DERIVATIVES DEMYSTIFIED: A STEP-BY-STEP GUIDE TO FORWARDS, FUTURES, SWAPS & OPTIONS* 1 (2004) (explaining derivatives). Major derivative market participants include dealers, hedgers, speculators, and arbitrageurs. HARDING, *supra*, at 2. Various types of entities such as corporations, financial institutions, and governmental units qualify as hedgers, as they use derivative transactions to hedge against unpredictable market changes in interest rates, currency exchange rates, values of stocks and bonds, and prices of commodities. *Id.* This Article will for the most part address derivatives such as swaps, which fall under an International Swaps and Derivatives Association Master Agreement ("ISDA Master Agreement"). It will not discuss repurchase agreements or "repos," which are typically drafted with the use of a Master Repurchase Agreement.

² *Over 94% of the World's Largest Companies Use Derivatives to Help Manage Their Risks, According to ISDA Survey*, INT'L SWAPS & DERIVATIVES ASS'N (Apr. 23, 2009), www.isda.org/press/press042309der.pdf.

³ *Statistical Release: OTC Derivatives Statistics at End-June 2013*, BANK FOR INT'L SETTLEMENTS 2 (Nov. 2013), http://www.bis.org/publ/otc_hy1311.pdf. This amount is the outstanding notional amount of derivative transactions. *Id.*; *see also* HARDING, *supra* note 1, at 9 (discussing the size of the global derivatives market).

⁴ These provisions are generally part of or inserted into the most widely used form that provides the contractual framework for documentation of these various products—the ISDA Master Agreement. *See* HARDING, *supra* note 1, at 406. The ISDA Master Agreement is published by the International Swaps and Derivatives Association ("ISDA"), a global financial trade association consisting of more than 830 member-institutions from fifty-five different countries. *See id.* (describing ISDA). Indeed, its membership has grown substantially since its formation in 1985, when it had only ten members, most likely due to the increased use of derivative transactions in the global marketplace. *See id.* at 18. Among ISDA's goals are the reduction of "risk in the derivatives and risk management business." *See About ISDA*, INT'L SWAPS & DERIVATIVES ASS'N, www.isda.org/www/wwa_nav.html (last visited May 4, 2015). To address these goals and to create uniformity in the trading markets, ISDA sought to publish a form that market participants could use to document their derivative transactions. *See id.*

In 1987, ISDA published the Interest Rate and Currency Exchange Agreement (the "1987 Agreement"), which at that time was a major development for the derivatives market. *See* HARDING, *supra* note 1, at 18. The 1987 Agreement provided parties with a framework agreement that could be used to

are commonly referred to as the derivative safe harbor provisions of the Code (the “Safe Harbors”).⁵

Congress enacted the Safe Harbors to prevent systemic risk, i.e., to prevent a domino effect of bankruptcy filings among financial institutions.⁶ The Safe Harbors seek to accomplish this goal by permitting a party to a derivative trading contract to quickly terminate and liquidate its positions thereunder.⁷ Thus, parties to derivative trading contracts are, for the most part, not subject to the ordinary bankruptcy process that applies to parties to other types of contracts. Several academics have criticized the Safe Harbors and argue that they should be repealed.⁸ These academics argue that the Safe Harbors do not

document interest rate swaps and currency swaps. *Id.* Also in 1987, in an attempt to provide consistency and standardization among trade confirmations that confirmed the terms of interest rate swaps and currency swaps, ISDA published several booklets that contained ISDA Definitions. *Id.* By 1990, ISDA published addenda that addressed other types of derivatives trades such as interest rate caps, floors, collars, and options. *Id.* As the derivatives market evolved, ISDA, in 1992, published the ISDA Master Agreement, which covered more products than the 1987 Agreement and encouraged netting among different types of derivative products. *Id.*

Furthermore, as discussed in more detail below, the 1992 Agreement provided an alternative method to be used on the early termination or “closing out” of all transactions under the agreement called the “Second Method.” *Id.* at 89. Beginning in 2001, over 100 members of ISDA participated in the revising of the 1992 ISDA Master Agreement. *Id.* at 19. This revision process culminated with the publication of the 2002 ISDA Master Agreement in 2003. *Id.*

⁵ The Safe Harbors are contained in 11 U.S.C. §§ 362(b)(6)–(7), (17); 546(e)–(g); 555–556; and 560–561. Furthermore, the Safe Harbors insulate non-defaulting parties from most avoidance or “clawback” actions brought on behalf of the debtor’s bankruptcy estate. *See, e.g.*, 11 U.S.C. § 546(g) (2012). This Article will not discuss the Safe Harbors regarding “clawback” or avoidance actions as it is beyond the scope of this Article and has been discussed by others. *See* Eleanor Heard Gilbane, *Testing the Bankruptcy Code Safe Harbors in the Current Financial Crisis*, 18 AM. BANKR. INST. L. REV. 241, 270–71 (2010) (discussing § 546(g)); Shmuel Vasser, *Derivatives in Bankruptcy*, 60 BUS. LAW. 1507, 1534–37 (2005) (discussing Safe Harbors regarding avoidance actions). The Safe Harbors allow a non-defaulting party to, inter alia, (1) terminate (or close-out) and value on a net basis all transactions documented under the ISDA Master Agreement and (2) apply collateral to the net terminated (or closed-out) position upon the bankrupt counterparty’s insolvency. Gilbane, *supra*, at 242 (discussing *Interest Swap: Hearing on S. 396 Before the Subcomm. on Courts & Admin. Practice of the S. Comm. on the Judiciary*, 101st Cong. 16 (1989)); *see also* Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1648 (2008).

⁶ *See* Gilbane, *supra* note 5, at 242–46 (detailing evolution of Safe Harbors); Edward R. Morrison & Joerg Riegel, *Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges*, 13 AM. BANKR. INST. L. REV. 641, 642 (2005) (discussing reasons for enacting Safe Harbors); *see also* H.R. REP. NO. 109-31, at 3, 20, 131–32 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 89–90, 105–06, 191–93.

⁷ *See supra* note 5.

⁸ *See generally* Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 YALE J. ON REG. 91 (2005); Bryan G. Faubus, *Narrowing the Bankruptcy Safe Harbor for Derivatives to Combat System Risk*, 59 DUKE L.J. 801 (2010) (arguing that the Safe Harbors should not apply to certain types of derivatives); Stephen Lubben, *Derivatives and Bankruptcy: The Flawed Case for Special Treatment*, 12 U. PA. J. BUS. L. 61 (2009) [hereinafter Lubben, *The Flawed Case*]; Stephen J. Lubben, *Repeal the Safe Harbors*, 18 AM. BANKR. INST. L. REV. 319 (2010) [hereinafter Lubben, *Repeal the Safe*

accomplish their goal of preventing systemic risk.⁹ Similarly, more recently, some academics have proposed that a short stay apply to a party's ability to utilize the Safe Harbors against certain large financial institutions that file for bankruptcy protection.¹⁰ Despite these arguments, and despite significant financial reforms in the recent Dodd-Frank Wall Street Reform and Consumer

Harbors]; Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539 (2011); David A. Skeel, Jr. & Thomas H. Jackson, *Transaction Consistency and the New Finance in Bankruptcy*, 112 COLUM. L. REV. 152 (2012). Others, however, have argued that the Safe Harbors should not be repealed because they encourage derivative transactions and, as a result, increase the supply of capital to the banking system. See generally Nathan Goralnik, Note, *Bankruptcy-Proof Finance and the Supply of Liquidity*, 122 YALE L.J. 460 (2012) (arguing that Congress should not repeal the Safe Harbors). A group comprised of some of these academics that form the Resolution Project subgroup of the Working Group on Economic Policy at the Hoover Institution have proposed the creation of a new chapter of the Code, chapter 14, that would apply to the reorganization or liquidation of large financial institutions. TOM JACKSON, HOOVER INST., BANKRUPTCY CODE CHAPTER 14: A PROPOSAL (2012) [hereinafter HOOVER GROUP CHAPTER 14 PROPOSAL], available at <http://www.hoover.org/sites/default/files/bankruptcy-code-chapter-14-proposal-20120228.pdf>. The Hoover Institution recently revised the *Hoover Group Chapter 14 Proposal*. See TOM JACKSON, BUILDING ON BANKRUPTCY: A REVISED CHAPTER 14 PROPOSAL FOR THE RECAPITALIZATION, REORGANIZATION, OR LIQUIDATION OF LARGE FINANCIAL INSTITUTIONS (2014) [hereinafter REVISED HOOVER GROUP CHAPTER 14 PROPOSAL], available at <http://www.hoover.org/sites/default/files/rp-14-july-9-tom-jackson.pdf>. Part of the proposal that relates to derivative transactions proposes that Congress "freeze" the ability of a non-defaulting party to terminate a derivative trading contract for a 48-hour period following a debtor's bankruptcy filing. See *id.* at 31, 43–45. During that time period, the large financial institution subject to chapter 14 protection would attempt to transfer its derivative transactions to a bridge company that would accept a transfer of those derivative transactions. See *id.* at 21, 42. Based on the work of the Hoover Institution, there is current legislation pending in the U.S. Senate that is aimed creating a chapter 14 of the Code to specifically deal with a bankruptcy filing of a large financial institution. See Taxpayer Protection and Responsible Resolution Act, S. 1861, 113th Cong. (2013), <https://www.congress.gov/bill/113th-congress/senate-bill/1861> (last visited May 4, 2015). Similarly, the House of Representatives passed a related bill on December 1, 2014. See Financial Institution Bankruptcy Act of 2014, H.R. 5421, 113th Cong. (2014); H.R. REP. NO. 113-630 (2014). As of May 2015, the House Bill has been received by the Senate and referred to the Committee on the Judiciary. Instead of creating a new chapter 14 of the Code to deal with large financial institutions that seek bankruptcy protection, the Financial Institution Bankruptcy Act of 2014 seeks to create a new Subchapter V of the Code to deal with such entities. See H.R. 5421. Both the Taxpayer Protection and Responsible Resolution Act and Financial Institution Bankruptcy Act contain similar proposals for a short stay of up to forty-eight hours that would prevent a Non-defaulting Party from terminating a derivatives trading contract with a large, systemically important financial institutions that qualify as a "covered financial institution." See *id.* § 3; S. 1861, § 3. Some have questioned whether a 48-hour stay would be a sufficient time period to effectively transfer a covered financial institution's derivative trading contracts to a bridge company. See, e.g., *Hearing on the "Financial Institution Bankruptcy Act of 2014" Before the Subcomm. on Regulatory Reform, Commercial & Antitrust Law of the H. Comm. on the Judiciary*, 113 Cong. 58 (2014) (statement of Stephen E. Hessler, Partner, Kirkland & Ellis LLP). There are various additional parts of these companion bills that are beyond the scope of this Article and will not be discussed herein.

⁹ See generally Edwards & Morrison, *supra* note 8; Lubben, *Repeal the Safe Harbors*, *supra* note 8; Lubben, *The Flawed Case*, *supra* note 8; Roe, *supra* note 8; Skeel & Jackson, *supra* note 8.

¹⁰ See REVISED HOOVER GROUP CHAPTER 14 PROPOSAL, *supra* note 8, at 21–22. See generally S. 1861; H.R. 5421.

Protection Act (the “Dodd-Frank Act”), Congress refused to repeal the Safe Harbors.¹¹

As Congress has refused to repeal the Safe Harbors, this Article takes a different course than prior scholarship and focuses on clarifying the Safe Harbors. Indeed, several recent disputes that took place during Lehman Brothers’ bankruptcy proceedings regarding issues of first impression illustrate that the precise parameters of the Safe Harbors remain unclear. This lack of clarity adversely affects (1) the ability of financial institutions and other market participants to accurately perform credit risk analyses with respect to their derivative trading counterparties; (2) the ability of a party to a derivative trading contract that files for bankruptcy protection (a “Debtor”) to reorganize its business affairs under the Code;¹² and (3) the ability of certain financial institutions that are required by the Dodd-Frank Act to formulate “Resolution Plans” or “Living Wills.”¹³ The result is an increase in systemic risk and an increase in the lack of stability in our financial system. This Article argues that Congress should amend the Safe Harbors to address these issues so that systemic risk can be mitigated. Specifically, Congress should amend the Code so that it is clear that Payment Suspension Clauses, Walkaway Clauses, and Flip Clauses are not enforceable against a Debtor where a party seeks to enforce such clauses based on the Debtor’s financial condition or bankruptcy filing or the financial condition or bankruptcy filing of any one of the Debtor’s affiliates.¹⁴ Furthermore, Congress should amend the Code and Title II of the Dodd-Frank Act so that it is clear that Triangular Setoff Clauses are enforceable where either (1) affiliated entities agree to the Triangular Setoff or

¹¹ Title II of the Dodd-Frank Act provides an alternative insolvency regime to the Code for certain types of financial institutions and, like the Code, contains safe harbors for derivative trading contracts. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7, 12, and 15 U.S.C.); Douglas G. Baird & Edward R. Morrison, *Dodd-Frank for Bankruptcy Lawyers*, 19 AM. BANKR. INST. L. REV. 287, 308–13 (2011) (discussing Safe Harbors under Title II).

¹² As used herein, “Debtor” means a party that files a bankruptcy petition and becomes a debtor under the Code.

¹³ *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 165, 12 U.S.C. § 5365 (2012); *see also* 12 C.F.R. § 360.10 (2012). *See infra* note 121 for the statutory guidelines on which companies are required to form Resolution Plans.

¹⁴ After this Article was accepted for publication and during the editing process, the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 issued its Final Report and Recommendations (the “ABI Commission Report”) regarding reform of the Code. *See generally* AM. BANKR. INST., AMERICAN BANKRUPTCY INSTITUTE COMMISSION TO STUDY THE REFORM OF CHAPTER 11: FINAL REPORT AND RECOMMENDATIONS (2014), *available at* <https://abiworld.app.box.com/s/vvircv5xv83aav14dp4h>. Similar to one of the proposals made in this Article, a portion of the ABI Commission Report proposed that Walkaway Clauses be rendered unenforceable in chapter 11 cases. *See id.* at 106–07.

(2) those affiliated entities guarantee each other’s liabilities. Such amendments would increase efficiency in credit risk analyses and mitigate systemic risk.¹⁵

First, this Article will present a brief overview of derivative transactions and the players involved in such transactions. That overview will briefly discuss certain contractual provisions commonly contained in the most widely-used derivative trading contract in the world—the International Swaps and Derivatives Association (“ISDA”) Master Agreement.¹⁶ Similarly, that section will discuss the ambiguities surrounding the enforceability of such provisions in the bankruptcy context. Second, this Article will present an overview of the ISDA Master Agreement, focusing on the provisions that are crucial in the bankruptcy or insolvency context. Third, this Article will present a brief overview of the Safe Harbors and certain other provisions of the Code that are vital to an understanding of how the Code intersects with these various provisions of the ISDA Master Agreement.¹⁷ Fourth, this Article will briefly discuss certain provisions of the recently enacted Dodd-Frank Act that relate to

¹⁵ In cases where a large financial institution is a Debtor, consistent with the *Revised Hoover Group Chapter 14 Proposal*, the author agrees that some form of short stay should apply to a Non-defaulting Party’s right to terminate (and set off among) its derivative trading contracts with such a Debtor, which would permit such a Debtor to transfer its derivative trading contracts to another solvent entity. *See, e.g.*, REVISED HOOVER GROUP CHAPTER 14 PROPOSAL, *supra* note 8, at 31–32. Assuming such a stay is implemented through legislation, clarity is still needed with respect to the enforceability of Payments Suspension Clauses, Walkaway Clauses, Flip Clauses, and Triangular Setoff Clauses in derivative trading contracts to which such a Debtor remains a party where (1) such a stay expires and (2) such a Debtor is not successful in transferring or “assuming and assigning” those outstanding derivative trading contracts to a solvent third party. Furthermore, the proposals made in this Article may be subject to some criticism. Generally speaking, although different subsidiaries of a corporation may fall within the same “corporate family,” each such affiliate is generally a separate legal entity with “its own assets and creditors.” *See* Michael Chaisanguanthum, *Charter: The Most Important Recent Bankruptcy Decision for Secured Creditors*, 27 EMORY BANKR. DEV. J. 9, 20–21 (2010) (criticizing holding in *JPMorgan Chase Bank, N.A. v. Charter Commc’ns Operating, LLC (In re Charter Commc’ns)*, 419 B.R. 221 (Bankr. S.D.N.Y. 2009)). In a jointly administered chapter 11 bankruptcy case of a parent and its subsidiaries, the corporate separateness of those entities along with the separateness of their assets and creditors should be respected, unless the bankruptcy court enters an order for substantive consolidation of the various entities. *See id.* at 269–70. Although those general norms of corporate separateness and bankruptcy law should prevail in the vast majority of situations, the nature of the intersection of the ISDA Master Agreement and the Code do present a unique situation. Furthermore, if Congress amends the Code to incorporate the proposals contained herein, parties will know ahead of time what their rights would be in the case of a bankruptcy filing of an entity and its affiliates. Accordingly, the parties will be able to conduct their credit analysis accordingly before entering into the derivative transaction(s).

¹⁶ INT’L SWAPS & DERIVATIVES ASS’N, 2002 ISDA MASTER AGREEMENT § 14 (2002) [hereinafter 2002 ISDA MASTER AGREEMENT]. These clauses are Payment Suspension Clauses, Walkaway Clauses, Flip Clauses, and Triangular Setoff Clauses.

¹⁷ This Article will not present an in-depth discussion of the history of the Safe Harbors, as other prominent practitioners and scholars have thoroughly written on that topic. *See* Vasser, *supra* note 5, at 1507–21; *see also* Gilbane, *supra* note 5, at 270–71 (discussing the history and evolution of Safe Harbors).

the issues discussed in this Article. Next, this Article will discuss and analyze recent litigation that sent reverberations throughout the multi-trillion dollar derivatives markets involving issues of first impression with respect to the intersection of these provisions of the ISDA Master Agreement and the Code.¹⁸

This Article will conclude that Congress should further legislate to resolve some of the ambiguities that continue to exist with regard to the Safe Harbors. Failure to do so will have an adverse effect on the market because absent such legislation, financial institutions and other market participants lack the ability to precisely analyze their credit risk with regard to potential counterparties. Furthermore, for those financial institutions that are required by the Dodd-Frank Act to formulate Living Wills, this lack of clarity may impact their ability to effectively do so. Such a lack of clarity and predictability injects significant uncertainty in any credit risk analysis in the context of derivatives transactions and, as a result, seriously hampers parties' ability to conduct sound credit risk analysis. Clarifying legislation would not only afford market participants increased ability to conduct credit analysis, but also would inject increased certainty regarding such issues into the chapter 11 process, because a chapter 11 debtor would have certainty regarding its rights with respect to its various derivative counterparties.

I. BACKGROUND

A. *Overview of Derivative Transactions and the Players Involved*

Derivatives encompass various types of products including, among others, interest rate swaps, interest rate collars, interest rate caps, forward contracts involving commodities, currency swaps, equity derivatives, options, and credit default swaps.¹⁹ Generally, the value of many derivative transactions such as

¹⁸ This Part will also discuss how courts in other jurisdictions, including the United Kingdom, have reached diametrically opposing conclusions from the U.S. Bankruptcy Court for the Southern District of New York regarding several of the same issues.

¹⁹ HARDING, *supra* note 1, at 4–8; CHRISTIAN A. JOHNSON, A GUIDE TO USING AND NEGOTIATING OTC DERIVATIVES DOCUMENTATION 8–14 (2005). Most of the cases discussed in this Article involved one or more swap agreements, which can generally be described as:

[A] contract between two parties . . . to exchange (“swap”) cash flows at specified intervals, calculated by reference to an index. Parties can swap payments based on a number of indices including interest rates, currency rates and security or commodity prices.

Thrifty Oil Co. v. Bank of Am. Nat'l Trust & Savs. Ass'n, 322 F.3d 1039, 1042 (9th Cir. 2003); *see also* 11 U.S.C. § 101(53B) (2012) (defining swap agreement under the Code).

interest rate swaps and currency swaps change over time so that, on a particular date, the value of a particular derivative transaction may be “in the money” or an asset to one party while simultaneously being “out of the money” or a liability to the counterparty.²⁰ Over time, as markets fluctuate, the status of the parties may shift, such that the party that at one time held the in-the-money position, may, at a different time hold the out-of-the-money position.²¹

Many of the parties that enter into derivative transactions are financial institutions with complex corporate structures.²² Generally, the structures of such entities include a parent holding corporation (“Parent”) and a number of wholly-owned subsidiaries.²³ The subsidiaries may include regulated entities such as a registered broker-dealer, an investment advisor entity, or a regulated bank subsidiary that must be separate as a result of certain regulatory rules.²⁴ Although technically organized as separate business entities within the same corporate enterprise, these entities are generally interconnected, operating out of the same headquarters and often staffed with overlapping employees.²⁵ Likewise, for credit risk management purposes, derivative counterparties to such entities typically deal with the Parent and its different subsidiaries as if they are one entity.²⁶

For a number of different reasons, a party to a derivative transaction, a corporate affiliate or Parent of that party serving as its guarantor (“Guarantor”),²⁷ or one or several of that party’s specific corporate affiliates²⁸

²⁰ See ANTHONY C. GOOCH & LINDA B. KLEIN, DOCUMENTATION FOR DERIVATIVES 219–20 (4th ed. 2002) (discussing parties that are in the money or out of the money). Some exceptions are pre-paid interest rate caps, options, and floors. *Id.* at 221, 439.

²¹ See *id.* at 219–20.

²² Many other types of business entities also enter into derivative transactions. See generally Stephanie Russell-Kraft, *Push for Derivatives Market Clarity Leads to More Confusion*, LAW360 (Oct. 20, 2014, 1:57 PM ET), www.law360.com/articles/585583. Such business entities that are not financial institutions are generally referred to as “end-users.” See *id.*

²³ See Richard J. Herring, Essay, *The Known, the Unknown, and the Unknowable in Financial Policy: An Application to the Subprime Crisis*, 26 YALE J. ON REG. 391, 403 (2009).

²⁴ Some subsidiaries also take the form of Special Purpose Entities. See, e.g., Mark Kronfeld, Vincent Indelicato & Chris Theodoris, *The Murkiness of Corporate Separateness in Chapter 11*, AM. BANKR. INST. J., June 2013, at 46, 47. Applicable tax law may drive the form of such corporate structures but is not discussed herein.

²⁵ See Stephen A. Lumpkin, *Risks in Financial Group Structures*, 2010 OECD J.: FIN. MARKET TRENDS, no. 2, at 105.

²⁶ See generally Daniel P. Winikka & John H. Chase, *When Business Efficiency and Bankruptcy Collide: Resolving Intercompany Claims*, 21 NORTON J. BANKR. L. & PRAC. July 2012, at 4.

²⁷ Such a guarantor is referred to in the ISDA Master Agreement as the “Credit Support Provider.” 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 14. For purposes of simplicity and clarity, this Article uses the

may find itself in financial distress.²⁹ Such financial distress may cause the party, its Guarantor, or one or more of its affiliates to enter into formal restructuring or insolvency proceedings, which may take place under chapter 11 or, for certain types of entities, under the recently-enacted Title II of the Dodd-Frank Act.³⁰

Moreover, for various reasons, the bankruptcy or other insolvency filing of a party to a derivative trading contract may occur on different dates, but in somewhat close temporal proximity with the date on which its Parent-Guarantor or one or more of its affiliates files for bankruptcy.³¹ Because of the constantly shifting values inherent in most derivative transactions, at the time two parties enter into a derivatives transaction, it may be almost impossible to gauge whether (1) one of the parties to such a transaction, its Guarantor, or one or more of its affiliates will file for bankruptcy or other insolvency proceedings and (2) either of the two parties, at the time of such a bankruptcy or insolvency filing, will have an in-the-money position or an out-of-the-money position.³²

term Guarantor when referring to the Credit Support Provider. Furthermore, this Article will use the term “Parent-Guarantor,” when referring to the specific scenario in which a parent corporate entity serves as the Credit Support Provider (or Guarantor) for the liabilities of one or more of its subsidiaries under an ISDA Master Agreement.

²⁸ Such an affiliate is referred to in the ISDA Master Agreement as a “Specified Entity.” *Id.*

²⁹ Under the ISDA Master Agreement, a third party that provides a guarantee or other credit support is called a “Credit Support Provider.” *See id.*; INT’L SWAPS & DERIVATIVES ASS’N, 1992 ISDA MASTER AGREEMENT § 14 (1992) [hereinafter 1992 ISDA MASTER AGREEMENT]. Pursuant to the ISDA Master Agreement, the bankruptcy filing, or similar insolvency event by a Credit Support Provider of a party to an ISDA Master Agreement constitutes an Event of Default. 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 5(a). Furthermore, pursuant to the ISDA Master Agreement, a bankruptcy filing or similar insolvency event by an entity listed in the Schedule to the ISDA Master Agreement as a Specified Entity constitutes an Event of Default. *See id.*

³⁰ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 201–17, 124 Stat. 1376, 1442–1520 (2010) (codified as amended at 12 U.S.C. §§ 5381–94). If the particular entity is a registered broker-dealer, then the entity will be liquidated under the Securities Investors Protection Act of 1970 (“SIPA”). Pub. L. No. 91-598, 84 Stat. 1636 (1970) (codified as amended beginning with 15 U.S.C. § 78aaa (2012)). For purposes of this Article, SIPA proceedings are similar to bankruptcy proceedings. If, however, the particular entity is a bank that takes deposits insured by the FDIC, then that entity will be liquidated under the applicable provisions of Federal Deposit Insurance Act. 12 U.S.C. §§ 1811–35a (2012). Generally speaking, an insurance company cannot file for bankruptcy under the Code. *See* 11 U.S.C. § 109(b)(2). Instead, an insurance company that is insolvent will be liquidated under the insurance insolvency law of the state in which it is organized. 4 WILLIAM L. NORTON, JR. & WILLIAM L. NORTON, III, NORTON BANKRUPTCY LAW AND PRACTICE 3D § 87:10 (2008).

³¹ *See, e.g.,* Lehman Bros. Special Fin. Inc. v. BNY Corp. Tr. Servs. Ltd. (*In re* Lehman Bros. Holdings Inc.), 422 B.R. 407, 418–19 (Bankr. S.D.N.Y. 2010).

³² *See* GOOCH & KLEIN, *supra* note 20, at 219–20 (discussing fluctuating values of derivative transactions).

A bankruptcy filing constitutes an Event of Default under the ISDA Master Agreement.³³ Any Event of Default brings into consideration important provisions of the ISDA Master Agreement or related transaction documents, which, upon a party's default ("Defaulting Party"), permit the non-defaulting party ("Non-defaulting Party")³⁴ to do any of the following: (1) terminate (or close out) and value on a net basis all transactions documented under the ISDA Master Agreement;³⁵ (2) apply collateral to the net terminated (or closed-out) position upon the bankrupt counterparty's insolvency;³⁶ (3) withhold, suspend ("Payment Suspension Clause"),³⁷ or walkaway ("Walkaway Clause") from any payments otherwise due and owing to the bankrupt counterparty under the ISDA Master Agreement;³⁸ (4) elevate, or flip, its position in payment priority provisions ("Flip Clause") contained in structured finance transactions;³⁹ or (5) exercise the right of setoff between or among different affiliates of the bankrupt counterparty ("Triangular Setoff Clause").⁴⁰

³³ See 1992 ISDA MASTER AGREEMENT, *supra* note 29, § 5(a)(vii); 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 5(a)(vii).

³⁴ By Non-defaulting Party, it means a Non-defaulting Party under the ISDA Master Agreement that is not a Debtor under the Code or similar formal insolvency proceedings.

³⁵ See 1992 ISDA MASTER AGREEMENT, *supra* note 29, § 6; 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 6. After this Article was accepted for publication and during its editing process, ISDA announced a new ISDA Resolution Stay Protocol. See Anne E. Beaumont, *Banks Agree to ISDA Resolution Stay Protocol Despite Buy-Side Resistance but Practical Questions Remain*, 46 SEC. REG. & L. REP. (BNA), 46 SRLR 2088 (BL) (Oct. 27, 2014). This protocol only applies to "major global banks" that agree to the protocol. See *id.* A signatory to the protocol agrees to suspend its right to terminate an ISDA Master Agreement for a 48-hour period following the bankruptcy filing of another protocol signatory. See *id.*

³⁶ See INT'L SWAPS & DERIVATIVES ASS'N, 1994 ISDA CREDIT SUPPORT ANNEX ¶ 8 (1994) [hereinafter 1994 ISDA CREDIT SUPPORT ANNEX]; see also GOOCH & KLEIN, *supra* note 20, at 1169–77 (discussing rights of secured parties under the ISDA Master Agreement).

³⁷ See 1992 ISDA MASTER AGREEMENT, *supra* note 29, § 2(a)(iii); 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 2(a)(iii).

³⁸ See discussion of Harrier, *infra* note 104.

³⁹ See, e.g., *Lehman Bros. Special Fin. Inc. v. BNY Corp. Tr. Servs. Ltd. (In re Lehman Bros. Holdings Inc.)*, 422 B.R. 407, 418–19 (Bankr. S.D.N.Y. 2010). A Flip Clause is typically contained in the payment waterfall provision of an indenture connected to a structured finance transaction and is typically not found in an ISDA Master Agreement. See Evan Jones et al., *Lehman Bankruptcy Judge Prevents Trigger of CDO Subordination Provision Based on Credit Support Provider and Swap Counterparty Bankruptcy Filings*, 127 BANKING L.J. 338, 338–39 (2010). A derivative transaction that is documented under an ISDA Master Agreement, however, is generally part of the overall structured financing transaction to which the Flip Clause applies. See *id.* at 341–43.

⁴⁰ See INT'L SWAPS & DERIVATIVES ASS'N, USER'S GUIDE TO THE 2002 ISDA MASTER AGREEMENT, at 68–69 (2003) [hereinafter USER'S GUIDE TO THE 2002 ISDA MASTER AGREEMENT]; INT'L SWAPS & DERIVATIVES ASS'N, USER'S GUIDE TO THE 1992 ISDA MASTER AGREEMENT, at 57 (1993) [hereinafter USER'S GUIDE TO THE 1992 ISDA MASTER AGREEMENT]. Such theoretical language would read as follows:

The predictability of a Non-defaulting Party's ability to enforce its rights under these clauses upon its counterparty's bankruptcy filing is crucial to effective credit risk management. Equally crucial to effective credit risk management is the predictability of a Non-defaulting Party's rights in situations where the Guarantor of its counterparty or an affiliate of its counterparty files for bankruptcy on a date different from its counterparty or simultaneously with its counterparty.⁴¹

The enforceability of the Non-defaulting Party's rights under the ISDA Master Agreement is not only important to the Non-defaulting Party—it is also vitally important to the Debtor, its Guarantor, its affiliates, and, as a corollary, to the creditor body of such a Debtor. This creditor body may be composed of market participants that hold claims against the Debtor, the recovery on which will be diminished if Payment Suspension Clauses, Walkaway Clauses, Flip Clauses, or Triangular Setoff Clauses are deemed to be enforceable by Non-defaulting Parties that have out-of-the-money derivative positions in relation to the Debtor.⁴² The chief underlying policy of chapter 11 is to successfully reorganize a troubled company.⁴³ Likewise, a Debtor has a fiduciary duty to maximize recoveries for all creditor constituencies of the bankruptcy estate.⁴⁴ In a chapter 11 proceeding, the Debtor has a limited exclusive time period to

[U]pon the designation of any Early Termination Date, in addition to and not in limitation of any other right or remedy . . . under applicable law the Non-defaulting Party or Non-affected Party (in either case, "X") may without prior notice to any person set off any sum or obligation (whether or not arising under this Agreement . . .) owed by the Defaulting Party or Affected Party (in either case, "Y") to X or any Affiliate of X against any sum or obligation (whether or not arising under this Agreement . . .) owed by X or any Affiliate of X to Y.

See *In re Lehman Bros. Inc.*, 458 B.R. 134, 138 (Bankr. S.D.N.Y. 2011) (describing a Triangular Setoff Clause).

⁴¹ These different filing dates will generally occur in close temporal proximity to one another.

⁴² The creditor body may also be comprised of claims traders, which may acquire the claims of other market participants at steep discounts so that such claims traders can profit from the chapter 11 process. See generally Sam Roberge, *Maneuvering in the Shadows of the Bankruptcy Code: How to Invest In or Take Over Bankrupt Companies Within the Limits of the Bankruptcy Code*, 30 EMORY BANKR. DEV. J. 73 (2013).

⁴³ *In re Drexel Burnham Lambert Grp. Inc.*, 138 B.R. 723, 759 (Bankr. S.D.N.Y. 1992) (discussing policy of chapter 11). In *Drexel*, the bankruptcy court stated, "Congress has recognized that the continuation of the operations of a debtor's business as a viable entity benefits the national economy through the preservation of jobs and continued production of goods and services." *Id.*

⁴⁴ *In re Reliant Energy Channelview L.P.*, 594 F.3d 200, 210 (3d Cir. 2010) (stating that a debtor in possession has a fiduciary duty to maximize the value of the bankruptcy estate); W. Marion Wilson, Comment, *Trust Me, I'm a Lawyer: Restoring Faith in Fiduciaries by Dumping "Due Diligence" and Tolling the Statute of Limitations for Postpetition Breach of Fiduciary Duty in Chapter 11*, 22 EMORY BANKR. DEV. J. 637, 641–42 (2006) (discussing duties of chapter 11 debtor). A chapter 11 debtor has a fiduciary duty to "protect and maximize the return on estate assets." Wilson, *supra*, at 641 (citations omitted).

propose a plan of reorganization.⁴⁵ Generally, to confirm the plan, at least one class of impaired creditors must vote in favor of the plan.⁴⁶

If major litigation arises regarding ambiguities surrounding the rights of a Non-defaulting Party in relation to a Debtor, its Guarantor, or one of its affiliates, the Debtor's ability to effectively and efficiently monetize any "in-the-money" positions it may have under various derivative contracts will be hampered.⁴⁷ Instead of focusing its time on the chapter 11 plan proposal and confirmation, the Debtor will have to spend time and effort in costly litigation. If the Code is not clear regarding the rights of parties with respect to Payment Suspension Clauses, Walkaway Clauses, Flip Clauses, and Triangular Setoff Clauses, the debtor may be inclined to settle litigation regarding such clauses, which may ultimately lead to smaller recoveries for the Debtor's creditors. Likewise, if any of these clauses are enforceable against a Defaulting Party, they would have an adverse effect on the ability of the Debtor to monetize its in-the-money position, and would adversely affect certain creditors of the Debtor, while favoring certain other creditors of the Debtor. Although the Safe Harbors insulate derivatives from certain provisions of the Code, the extent to which these clauses are enforceable in bankruptcy is unclear.

The recent financial crisis, which involved the chapter 11 bankruptcy filings of Lehman Brothers Holdings Inc. ("LBHI") and many of its affiliates, has demonstrated that major ambiguities continue to exist regarding the outer bounds of the Safe Harbors as they apply to derivative transactions. Several recent court decisions involving issues of first impression in the United States and in the United Kingdom have involved, among other things, the following issues: (1) the extent to which, if any, Payment Suspension Clauses, Walkaway Clauses, Flip Clauses, and Triangular Setoff Clauses contained in the ISDA Master Agreement or related transaction documents are enforceable upon a Defaulting Party's bankruptcy filing and (2) if any of these clauses are enforceable if the Guarantor or affiliate of the Defaulting Party files for bankruptcy or insolvency on a date that is different from, but in close temporal

⁴⁵ 11 U.S.C. § 1121 (2012). Generally, a Debtor may have an exclusive period of up to eighteen months after the petition date to file a chapter 11 plan. *Id.* § 1121(a)–(b), (d).

⁴⁶ *Id.* § 1129(a)(10).

⁴⁷ See GOOCH & KLEIN, *supra* note 20, at 268 (discussing the importance of predictability of enforceability of terms of ISDA Master Agreement).

proximity to, the date of the bankruptcy or insolvency filing of the Defaulting party.⁴⁸

B. *The ISDA Master Agreement*

This Subpart of the Article will present an overview of the ISDA Master Agreement and associated documents that are commonly referred to as the “ISDA documentation architecture.”⁴⁹ In particular, it will focus on the provisions that are crucial in the bankruptcy or insolvency context. Those provisions are the following: Netting, Events of Default, Early Termination (or Close-out), Valuation, Payment Suspension Clauses, Walkaway Clauses, Flip Clauses, and Cross-Affiliate Netting Clauses.⁵⁰

1. *The ISDA Architecture*

Parties to derivative transactions generally use either the 1992 ISDA Master Agreement or the 2002 ISDA Master Agreement and alter the general terms of the ISDA Master Agreement by negotiating a schedule (“Schedule”).⁵¹ Generally, the ISDA Master Agreement, as supplemented by

⁴⁸ See Transcript Regarding Hearing Held September 15, 2009 at 101–13, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 17, 2009) [hereinafter September 15 Transcript], ECF No. 5261; see also *Lehman Bros. Special Fin. Inc. v. BNY Corp. Tr. Servs. Ltd.* (*In re Lehman Bros. Holdings Inc.*), 422 B.R. 407 (Bankr. S.D.N.Y. 2010). The first of these decisions was the bench ruling in the *Metavante* matter, which held that (1) an out-of-the-money Non-defaulting Party to a swap agreement with an in-the-money bankrupt counterparty could not rely on section 2(a)(iii) of the ISDA Master Agreement to withhold payments otherwise due and payable to that bankrupt counterparty based on its (or its credit support provider’s) status as a debtor under the Code and (2) a Non-defaulting Party waives its right to terminate the ISDA Master Agreement if it does not “promptly” terminate following the bankrupt counterparty’s bankruptcy filing. See September 15 Transcript, *supra*. In the second decision, an adversary proceeding brought by Lehman Brothers Special Financing Inc. (“LBSF”), a wholly-owned subsidiary of LBHI, against BNY Corp. Trustee Services Ltd., the court held that a Flip Clause contained in certain transaction documents related to a collateralized debt obligation (“CDO”) transaction was not enforceable in the bankruptcy context. *BNY*, 422 B.R. at 407. Interestingly, in both the *Metavante* and *BNY* matters, the bankruptcy court allowed a debtor to avail itself of the ipso facto protections in §§ 365 and 541 of the Code based on either the debtor’s own bankruptcy filing or the earlier bankruptcy filing of its parent-Credit Support Provider. See *infra* Parts III.A, C.

⁴⁹ See HARDING, *supra* note 1, at 19–27 (discussing ISDA documentation architecture).

⁵⁰ See *id.* at 406–12. Some provisions of the ISDA Master Agreement or documentation architecture are beyond the focus of this Article. For a thorough discussion of the ISDA Master Agreement, see generally GOOCH & KLEIN, *supra* note 20, at 219; HARDING, *supra* note 1; USER’S GUIDE TO THE 1992 ISDA MASTER AGREEMENT, *supra* note 40; USER’S GUIDE TO THE 2002 ISDA MASTER AGREEMENT, *supra* note 40. Instead, this section focuses on the provisions of the ISDA Master Agreement that are of key importance to market participants in the context of chapter 11 bankruptcy proceedings or other insolvency proceedings.

⁵¹ See HARDING, *supra* note 1, at 11; see also JOHNSON, *supra* note 19, at 14, 16; USER’S GUIDE TO THE 1992 ISDA MASTER AGREEMENT, *supra* note 40, at 2; USER’S GUIDE TO THE 2002 ISDA MASTER AGREEMENT, *supra* note 40, at 1. For example, through the Schedule, the parties can elect to apply, disapply,

the Schedule, contains the overarching non-economic terms that will apply to the various trades or transactions (each, a “Transaction”).⁵² Parties often collateralize their positions under the ISDA Master Agreement by negotiating a Credit Support Annex (“CSA”), which forms part of the Schedule.⁵³ The ISDA Master Agreement, as supplemented by the Schedule and the CSA, increases the efficiency with which market participants can enter into derivative transactions, because once the parties negotiate an ISDA Master Agreement, they simply need to set forth the economic terms of each trade in a confirmation (“Confirmation”).⁵⁴

The Confirmation supplements and forms a part of the ISDA Master Agreement.⁵⁵ The Confirmation contains a date on which the transaction or trade begins (“Trade Date”) and the scheduled termination date (“Scheduled Termination Date”), or the date on which the trade will expire.⁵⁶ The Confirmation generally contains payment dates or reset dates (“Reset Date”), which occur on a quarterly or monthly basis. The ISDA Master Agreement, the Schedule, the CSA, and any and all Confirmations are collectively referred to as the “Agreement.”⁵⁷ Thus, if two parties have an interest rate swap and a currency swap, one Confirmation would be used to document the economic terms of the interest rate swap, while another Confirmation would be used to document the terms of the currency swap. Both Confirmations, however, would fall under the ISDA Master Agreement, as modified by the Schedule and collateralized by the CSA. It is not uncommon for larger institutions to have thousands of trades, each documented by its own Confirmation, that fall under one ISDA Master Agreement.

On each Reset Date, the calculation agent (“Calculation Agent”) specified in the ISDA Schedule determines (1) which party is in the money and which party is out of the money with respect to the particular trade and (2) the value

amend, or supplement the standard terms of the ISDA Master Agreement. *See* HARDING, *supra* note 1, at 15–16.

⁵² *See* HARDING, *supra* note 1, at 24–28.

⁵³ *See id.* at 19; *see also* GOOCH & KLEIN, *supra* note 20, at 1088; INT’L SWAPS & DERIVATIVES ASS’N, USER’S GUIDE TO THE 1994 ISDA CREDIT SUPPORT ANNEX 1 (1994).

⁵⁴ *See* 1992 ISDA MASTER AGREEMENT, *supra* note 29, pmb1.; 2002 ISDA MASTER AGREEMENT, *supra* note 16, pmb1.

⁵⁵ *See* GOOCH & KLEIN, *supra* note 20, at 370–71; HARDING, *supra* note 1, at 22–23; JOHNSON, *supra* note 19, at 25.

⁵⁶ In ISDA parlance, the Trade Date is generally referred to as the “Trade Effective Date” and the “Scheduled Termination Date” is generally referred to as the “Termination Date.”

⁵⁷ *See* HARDING, *supra* note 1, at 19–21; *see also* 1992 ISDA MASTER AGREEMENT, *supra* note 29, pmb1.; 2002 ISDA MASTER AGREEMENT, *supra* note 16, pmb1.

of each in-the-money and out-of-the-money position.⁵⁸ Generally, the parties then net or set off their different positions on the applicable Reset Date, and the party that is out of the money on that Reset Date on a net basis makes a net payment to the party that is in the money on a net basis. This is referred to as payment netting (“Payment Netting”).⁵⁹

2. *Important Provisions of the ISDA Master Agreement in the Bankruptcy in Insolvency Context*

a. *Netting*

Netting is a central concept to the ISDA Master Agreement. There are basically two types of netting under the ISDA Master Agreement: Payment Netting and Close-out Netting.⁶⁰ Payment Netting is described above and applies on the scheduled Reset Dates. Payment Netting applies while there are active Transactions under the ISDA Master Agreement. Close-out Netting, however, applies when an Event of Default occurs under an ISDA Master Agreement and the Non-defaulting Party elects to terminate the ISDA Master Agreement.⁶¹ Close-out Netting involves three steps: (1) early termination; (2) valuation of each closed-out position; and (3) netting among the closed-out positions to determine the net balance.

If a Non-defaulting Party could not enforce the Close-out Netting provisions of the ISDA Master Agreement upon its counterparty’s bankruptcy or insolvency filing, the Non-defaulting Party could be subject to “cherry picking” by the Defaulting Party, and its exposure could be substantially

⁵⁸ The ISDA Master Agreement requires this determination to be made in good faith and in a commercially reasonable manner. GOOCH & KLEIN, *supra* note 20, at 754; HARDING, *supra* note 1, at 547; JOHNSON, *supra* note 19, at 44.

⁵⁹ Payment Netting is essentially the same as set-off. The ISDA Master Agreement also contains a feature that allows parties to elect for multiple transaction netting, which allows parties to net among all transactions documented under the ISDA Master Agreement, so that only one payment will be made to the in-the-money party by the out-of-the-money party on the relevant Reset Date. HARDING, *supra* note 1, at 12, 438, 556–59.

⁶⁰ See 1992 ISDA MASTER AGREEMENT, *supra* note 29, § 2(c); 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 2(c).

⁶¹ Close-out netting also applies if an early termination event occurs and a party entitled to do so terminates the ISDA Master Agreement. See HARDING, *supra* note 1, at 397. Early termination events are, for the most part, beyond the scope of this Article and will not be discussed herein in great detail. The ISDA Master Agreement contains eight Events of Default and eight Termination Events. 1992 ISDA MASTER AGREEMENT, *supra* note 29, § 5(a)–(b); 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 5(a)–(b); see also HARDING, *supra* note 1, at 56–85, 200–23.

increased.⁶² For example, such cherry picking would occur if the Defaulting Party could avail itself to certain Code provisions to assume favorable contracts and “reject” unfavorable contracts. If the Non-defaulting Party could not enforce the Close-out Netting provisions of the ISDA Master Agreement, it would risk having to pay the Defaulting Party 100% of the amount owed under transactions that were in the money with respect to the Defaulting Party. Simultaneously, the Non-defaulting Party risks having to wait a substantial amount of time to receive distributions, if any, in a chapter 11 case, on the amounts owed under transactions that were out of the money with respect to the Defaulting Party.

The enforceability of Close-out Netting provisions is not only important to the individual Non-defaulting Party but is also vitally important to the worldwide derivative markets. In the derivative markets, it is very common for market participants to engage in “back-to-back” trades. As a result of these back-to-back trades, market participants are highly interconnected. If the netting provisions of the ISDA Master Agreement are not enforceable upon a counterparty’s bankruptcy, a series of defaults could occur within the financial system, resulting in a “domino effect” of failing institutions, and ultimately, a collapse of the entire financial system. Because market participants are concerned with this systemic risk, ISDA hires leading law firms from fifty-four different countries to obtain opinions regarding the enforceability of the ISDA Master Agreement’s Netting and early termination provisions in the event of a counterparty insolvency.⁶³

b. Events of Default

The ISDA Master Agreement contains eight “Events of Default.”⁶⁴ Included among the Events of Default is a bankruptcy filing or similar insolvency event of a party to the ISDA Master Agreement, its Guarantor, or

⁶² See HARDING, *supra* note 1, at 35, 408; see also GOOCH & KLEIN, *supra* note 20, at 314, 326; JOHNSON, *supra* note 19, at 109; Morrison & Riegel, *supra* note 6, at 642 (discussing cherry picking).

⁶³ HARDING, *supra* note 1, at 71 (discussing ISDA Netting Opinions). These netting opinions are available on the ISDA website; however, ISDA membership is required to view the opinions. See *Opinions*, INT’L SWAPS & DERIVATIVES ASS’N, INC., <http://www2.isda.org/functional-areas/legal-and-documentation/opinions/> (last visited May 31, 2015).

⁶⁴ See 1992 ISDA MASTER AGREEMENT, *supra* note 29, § 5; 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 5; HARDING, *supra* note 1, at 56–73. Unlike Events of Default, however, Termination Events are not “fault” based. HARDING, *supra* note 1, at 225. Termination Events allow a party to terminate upon an event that “substantially alters the [t]ransaction economics or the risk profile” of the counterparty. See GOOCH & KLEIN, *supra* note 20, at 840.

any one of its affiliates.⁶⁵ The other Events of Default are not directly insolvency-related and include events commonly found in commercial lending documents.⁶⁶

Assuming the parties did not elect for Automatic Early Termination, which will be discussed in more detail below, upon the occurrence of an Event of Default, the Non-defaulting Party has the ability to terminate the ISDA Master Agreement by delivering a termination notice to the Defaulting Party.⁶⁷ For the termination notice to be valid, the Event of Default must be continuing at the time the Non-defaulting Party delivers the early termination notice.⁶⁸ Thus, if the Event of Default is cured before the Non-defaulting Party delivers the termination notice, the Non-defaulting Party will lose its right to terminate the ISDA Master Agreement.⁶⁹ Once the Non-defaulting Party delivers the termination notice in accordance with the terms of the ISDA Master Agreement, however, the ISDA Master Agreement will be deemed to have terminated and the Defaulting Party no longer has the right to cure the Event of Default.⁷⁰

c. *Automatic Early Termination*

The Schedule to the ISDA Master Agreement allows the parties to elect for “Automatic Early Termination” to apply if a bankruptcy Event of Default occurs with respect to one of the parties, one of their Guarantors, or one of their affiliates.⁷¹ If the parties select Automatic Early Termination, the ISDA Master Agreement will be deemed to have automatically terminated immediately before or after the occurrence of certain enumerated bankruptcy

⁶⁵ 1992 ISDA MASTER AGREEMENT, *supra* note 29, § 5(a)(vii); 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 5(a)(vii). For a bankruptcy filing of an affiliate to trigger an event of default, the specific affiliate must be listed as a Specified Entity in the ISDA Schedule. 1992 ISDA MASTER AGREEMENT, *supra* note 29, § 5(a)(vii); 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 5(a)(vii); *see also* HARDING, *supra* note 1, at 207, 240, 422–23, 552–53.

⁶⁶ *See* HARDING, *supra* note 1, at 202–23.

⁶⁷ *See id.* at 93, 253. Although the Non-defaulting Party has this ability, it is not obligated to terminate the ISDA Master Agreement if the parties did not elect for Automatic Early Termination. *Id.*

⁶⁸ *See id.* at 59, 205.

⁶⁹ *See id.* at 87, 249–55.

⁷⁰ *Id.* at 88, 249. Upon termination, all outstanding transactions that fall under the ISDA Agreement are terminated and there is “no turning back.” *Id.* at 88, 249, 252–53. To terminate the ISDA Master Agreement in this manner, the Non-defaulting Party gives notice to the Defaulting Party of the Event of Default and designates an early termination date. *See* 1992 ISDA MASTER AGREEMENT, *supra* note 29, § 6(a); 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 6(a); HARDING, *supra* note 1, at 92–93, 252–53.

⁷¹ *See* 1992 ISDA MASTER AGREEMENT, *supra* note 29, § 6(a); 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 6(a).

Events of Default.⁷² In some jurisdictions, parties must select Automatic Early Termination to have the right to terminate.⁷³

In many jurisdictions, including the United States and England, however, parties do not have to select Automatic Early Termination in order to have the right to terminate an ISDA Master Agreement upon an Event of Default by the Defaulting Party, its Guarantor, or one of its affiliates. In these jurisdictions, parties generally do not elect for Automatic Early Termination to apply for several reasons. One reason is the desire by the Non-defaulting Party to maintain control of when and whether to terminate an ISDA Master Agreement upon a bankruptcy filing by the Defaulting Party, its Guarantor, or one of its affiliates.⁷⁴ For example, if the parties selected Automatic Early Termination and one of the parties, its Guarantor, or one of its affiliates files for bankruptcy while it is in the money, the Non-defaulting Party would have to immediately pay the “Early Termination Amount” to the Defaulting Party.⁷⁵

⁷² See 1992 ISDA MASTER AGREEMENT, *supra* note 29, § 6(a); 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 6(a); see also HARDING, *supra* note 1, at 92–93, 252–53. If the parties select Automatic Early Termination to apply, and if a bankruptcy Event of Default occurs under § 5(a)(vii)(4) of the ISDA Master Agreement, which includes the commencement of bankruptcy proceedings that are not dismissed within a certain time period, then the ISDA Master Agreement will be deemed to have automatically terminated immediately before the filing or commencement of such proceedings. See 1992 ISDA MASTER AGREEMENT, *supra* note 29, § 6(a); 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 6(a); HARDING, *supra* note 1, at 92–93, 252–53, 493–96.

⁷³ See HARDING, *supra* note 1, at 495–96. Those jurisdictions are Brazil, Denmark, Germany, Israel, Japan, Netherlands, Netherlands Antilles, and Switzerland. *Id.*

⁷⁴ *Id.* at 402; see also JOHNSON, *supra* note 19, at 115–17; USER’S GUIDE TO THE 2002 ISDA MASTER AGREEMENT, *supra* note 40, at 20–21.

⁷⁵ Likewise, if the parties select Automatic Early Termination, the Non-defaulting Party may not know that a bankruptcy Event of Default occurred with respect to its counterparty, its counterparty’s Guarantor, or one of its counterparty’s affiliates, triggering the Early Termination of the ISDA Master Agreement. HARDING, *supra* note 1, at 89–91, 251. If this is the case, by the time the Non-defaulting Party becomes aware that a bankruptcy Event of Default occurred with respect to its counterparty, its counterparty’s Guarantor, or one of its counterparty’s affiliates, the Non-defaulting Party could be left with un-hedged positions while markets move against it, making it more costly to enter into replacement hedges. See *id.* at 93, 253; see also USER’S GUIDE TO THE 2002 ISDA MASTER AGREEMENT, *supra* note 40, at 21. Furthermore, in such a scenario, the markets may have moved against the Non-defaulting Party by the time it realizes that such an Event of Default occurred. See HARDING, *supra* note 1, at 93, 253. In such a case, if there is a market meltdown in a particular sector and if the Market Quotation valuation methodology applies under a 1992 ISDA Master Agreement, significant valuation disparities between the Non-defaulting Party and a chapter 11 debtor could arise because of the difficulty obtaining quotes in a particular market. See *id.* at 89–91. This, in turn, could lead to litigation between the Non-defaulting Party and the chapter 11 debtor regarding the proper valuation of the Early Termination Amount. *Id.* If, on the other hand, Automatic Early Termination did not apply in such a situation, the Non-defaulting Party could select an Early Termination Date on which it could easily obtain quotes that would be more difficult for a chapter 11 debtor to challenge. *Id.*

If, however, Automatic Early Termination is not selected, the Non-defaulting Party, at least for a short period of time, could perform the cost-benefit analysis to determine whether it is beneficial to terminate the ISDA Master Agreement upon the bankruptcy filing. Alternatively, it could consider projections as to how quickly the market may turn in the Non-defaulting Party's favor while it makes periodic payments that are due on the Reset Dates, which will likely be less than an Early Termination Amount. Similarly, the selection of Automatic Early Termination would prevent the Non-defaulting Party from cooperating with the debtor to enter into some type of mutually beneficial assignment arrangement with a third party, through which the debtor could essentially "sell" its ISDA Master Agreement to a third party.

Following the early termination of the ISDA Master Agreement, the Non-defaulting Party must either, "[o]n or as soon as reasonably practicable following the occurrence of an Early Termination Date," provide a statement calculating its amount of damages ("Calculation Statement"), which essentially is the Non-defaulting Party's net loss or net gain.⁷⁶ Under the 1992 ISDA Master Agreement, this amount is referred to as the "Early Termination Amount." Under the 2002 ISDA Master Agreement, however, it is referred to as the "Close-out Amount."⁷⁷ Indeed, one of the major differences between the 1992 and 2002 ISDA Master Agreements is the process for determining the amount of these damages.

⁷⁶ 1992 ISDA MASTER AGREEMENT, *supra* note 29, § 6(d); 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 6(d). This section raises an ambiguity in the ISDA Master Agreement itself. First, how long is "as soon as reasonably practicable"? See 1992 ISDA MASTER AGREEMENT, *supra* note 29, § 6(d); 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 6(d). Second, what if the Non-defaulting Party fails to deliver the Calculation Statement "as soon as reasonably practicable" after the notice of Early Termination Date and the Non-defaulting Party owes the Defaulting Party the Early Termination (or Close-out) Amount? Will the Non-defaulting Party in that case be deemed to have violated the Agreement by not timely delivering the Calculation Statement and paying the Early Termination (or Close-out) Amount? Will the Non-defaulting Party, in such a scenario, be subject to default interest? This section of the ISDA Master Agreement could be improved by inserting a specified time period within which the Non-defaulting Party must deliver the Calculation Statement. It should be noted that, whether or not ISDA amends this section of the ISDA Master Agreement as suggested, these issues could arise if the parties chose Automatic Early Termination to apply and a bankruptcy Event of Default triggering termination occurs. In such a case, the Non-defaulting Party may not be aware of the termination of the ISDA Master Agreement, and, as a result, fail to deliver the Calculation Statement within the required time, subjecting the Non-defaulting Party to Default Interest.

⁷⁷ 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 14.

i. Calculation of the Early Termination Amount Under the 1992 ISDA Master Agreement, and the First Method and Second Method

The 1992 ISDA Master Agreement provides two alternative means by which the Non-defaulting Party can calculate the Early Termination Amount: Market Quotation or Loss.⁷⁸ Essentially, by selecting Market Quotation, the Non-defaulting Party seeks quotes from four leading dealers in derivative transactions as to how much they would pay (or charge) the Non-defaulting Party to “step into the shoes of” the Defaulting Party.⁷⁹ Next, pursuant to Market Quotation, the Non-defaulting Party adds (1) all “Unpaid Amounts” and (2) the amount representing the net of (a) the aggregate of each Transaction that is out of the money to the Non-defaulting Party and (b) the aggregate of each Transaction that is in the money to the Non-defaulting Party.⁸⁰ The result is the Early Termination Amount.

By contrast, the use of the Loss methodology can apply in two different scenarios under the 1992 ISDA Master Agreement: (1) the parties select for Loss to apply in the Schedule or (2) the parties select Market Quotation to apply in the Schedule but either the Non-defaulting Party, at the time of early termination, cannot obtain at least three quotes from Reference Market Makers or the Market Quotation methodology produces a result that is not “commercially reasonable.”⁸¹ Loss is a general indemnification provision and is defined as “an amount that [the Non-defaulting Party] reasonably determines in good faith to be its total losses and costs.”⁸² The Loss methodology sets forth a nonexclusive list of factors that the Non-defaulting Party may utilize to calculate its Loss, which includes “any loss of bargain, cost of funding or, at the election of such party but without duplication, loss or cost incurred as a result of its terminating, liquidating, obtaining or reestablishing any hedge or related trading position (or any gain resulting from any of them).”⁸³

⁷⁸ 1992 ISDA MASTER AGREEMENT, *supra* note 29, § 6(e)(i). Market Quotation has “the effect of preserving for the [Non-defaulting Party] the economic equivalent of the payments and deliveries that are scheduled to have due dates after the Early Termination Date.” GOOCH & KLEIN, *supra* note 20, at 241.

⁷⁹ The 1992 ISDA Master Agreement defines such dealers as “Reference Market Makers.” See 1992 ISDA MASTER AGREEMENT, *supra* note 29, § 14; see also Phil Weeber et al., *Market Practices for Settling Derivatives in Bankruptcy: Part I*, AM. BANKR. INST. J., Oct. 2009, at 26, 74; GOOCH & KLEIN, *supra* note 20, at 241–43.

⁸⁰ See 1992 ISDA MASTER AGREEMENT, *supra* note 29, § 14.

⁸¹ *Id.* In illiquid markets, it can be virtually impossible to obtain quotes from three Reference Market Makers. See HARDING, *supra* note 1, at 267.

⁸² 1992 ISDA MASTER AGREEMENT, *supra* note 29, § 14.

⁸³ *Id.*; see also GOOCH & KLEIN, *supra* note 20, at 235–38; HARDING, *supra* note 1, at 134–35; JOHNSON, *supra* note 19, at 83–84; USER’S GUIDE TO THE 1992 ISDA MASTER AGREEMENT, *supra* note 40, at 26. Loss

Next, the 1992 ISDA Master Agreement requires the parties to select either of two methods with regard to calculating the Early Termination Amount: “First Method” or “Second Method.”⁸⁴ The First Method is essentially a Walkaway Clause.⁸⁵ Under this method, if the Non-defaulting Party, after using Market Quotation or Loss, owes the Early Termination Amount to the Defaulting Party, the Non-defaulting Party does not have to pay the Defaulting Party.⁸⁶ Under the Second Method, however, if the Non-defaulting Party, after using Market Quotation or Loss, owes the Early Termination Amount to the Defaulting Party, the Non-defaulting Party will have to pay the Early Termination Amount to the Defaulting Party.⁸⁷

ii. Net Loss or Gain Calculation Under the 2002 ISDA Master Agreement

The 2002 ISDA Master Agreement provides a different methodology by which the Non-defaulting Party calculates its net loss or gain, referred to as the Close-out Amount, under which the Non-defaulting Party calculates its gains, losses, and costs involved in replacing or realizing the economic equivalent of the terminated transactions.⁸⁸ The Close-out Amount methodology is more

allows, but does not require, the Non-defaulting Party to determine Loss by receiving quotations from dealers in relevant markets. 1992 ISDA MASTER AGREEMENT, *supra* note 29, § 14; *see also* GOOCH & KLEIN, *supra* note 20, at 235; HARDING, *supra* note 1, at 134–35; USER’S GUIDE TO THE 1992 ISDA MASTER AGREEMENT, *supra* note 40, at 26. Unpaid Amounts are not calculated separately when parties select Loss to apply in the Schedule. *See* USER’S GUIDE TO THE 1992 ISDA MASTER AGREEMENT, *supra* note 40, at 26. If, however, the Non-defaulting Party uses Loss as a fall back to Market Quotation, then Unpaid Amounts can be separately calculated. *See id.* at 26. As with Market Quotation, Loss may be used by the Non-defaulting Party for “one or more Terminated Transactions.” *See* GOOCH & KLEIN, *supra* note 20, at 235. Also under Loss, as under Market Quotation, the Non-defaulting Party nets its in-the-money transaction amounts against out-of-the-money transaction amounts. *See* HARDING, *supra* note 1, at 88–89. If the result is positive, the Non-defaulting Party has a claim against the Defaulting Party. *Id.* If the result is negative, and if the parties chose “Second Method” to apply, the Non-defaulting Party will owe the Close-out Amount to the Defaulting Party. *Id.* at 89–90; *see infra* Part I.B.2.c.iii.

⁸⁴ 1992 ISDA MASTER AGREEMENT, *supra* note 29, § 6(e).

⁸⁵ HARDING, *supra* note 1, at 89; JOHNSON, *supra* note 19, at 83; *see infra* Part I.B.2.e.

⁸⁶ 1992 ISDA MASTER AGREEMENT, *supra* note 29, § 6(e)(i)(1)–(2); *see also* HARDING, *supra* note 1, at 89; JOHNSON, *supra* note 19, at 83. The First Method is not often used anymore because financial regulators do not allow banks to use the First Method if they desire to have derivative contracts recognized for regulatory net capital requirements relating to counterparty risk. *See* HARDING, *supra* note 1, at 89, 250 (suggesting that First Method punishes a Defaulting Party); *see also* USER’S GUIDE TO THE 1992 ISDA MASTER AGREEMENT, *supra* note 40, at 24 (discussing bank regulations requiring the use of Second Method in relation to net capital requirements). That being said, section 2(a)(iii) of the ISDA Master agreement could be interpreted to convert the Second Method into the First Method. *See infra* Part I.B.2.d.

⁸⁷ *See* HARDING, *supra* note 1, at 89; *see also* JOHNSON, *supra* note 19, at 83.

⁸⁸ *See* 1992 ISDA MASTER AGREEMENT, *supra* note 29, § 6(e)(i) (providing for application of Close-out Amount method); *see also* GOOCH & KLEIN, *supra* note 20, at 243; HARDING, *supra* note 1, at 266–71;

flexible than the Market Quotation or Loss methodologies and permits the Non-defaulting Party to consider a wide-range of relevant information in calculating the Close-out Amount.⁸⁹ Then, similar to Market Quotation and Loss methodologies,⁹⁰ after the Non-defaulting Party calculates the Close-out Amount for each transaction, it then nets in-the-money transaction amounts against out-of-the-money transaction amounts.⁹¹ If the result is positive, the Non-defaulting Party has a claim against the Defaulting Party. If the result is negative, the Non-defaulting Party will owe the Close-out Amount to the Defaulting Party.⁹² The 2002 ISDA Master Agreement completely does away with the First Method.⁹³

iii. Calculation of Early Termination Amount or Close-Out Amount

The Market Quotation, Loss, and Close-out Amount methodologies each take into account the life of each terminated derivative transaction as part of the valuation process of arriving at the Early Termination Amount or Close-out Amount.⁹⁴ Thus, if the Non-defaulting Party is out of the money, a significant difference could exist between a payment due to the Defaulting Party on a particular Reset Date and the payment due as the result of an early termination of an ISDA Master Agreement resulting from the bankruptcy filing of the Defaulting Party, its Guarantor, or one of its affiliates. Most likely, in such a case, the payment due by the Non-defaulting Party as a result of an early termination will be a much higher amount than the payment due on a particular Reset Date.

JOHNSON, *supra* note 19, at 55–56. “Close-out Amount” is defined as the amount of losses that the Non-defaulting Party would incur or the amount of gains the Non-defaulting Party would realize “under then prevailing circumstances . . . in replacing, or in providing the [Non-defaulting Party] the economic equivalent of (a) the material terms of [the] Terminated Transaction[s] . . . and (b) the option rights of the parties in respect of [the] Terminated Transaction[s].” 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 14.

⁸⁹ Compare 1992 ISDA MASTER AGREEMENT, *supra* note 29, § 14, with 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 14. Note that, unlike the Market Quotation Methodology, the Close-out Amount Methodology does not require the Non-defaulting Party to seek four quotations from Reference Market Makers. See HARDING, *supra* note 1, at 268; see also JOHNSON, *supra* note 19, at 87–88. But similar to the Loss methodology, the Amount methodology involves elements of good faith and commercial reasonableness by requiring the Non-defaulting Party to use “commercially reasonable procedures” aimed at producing a “commercially reasonable result.” 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 14.

⁹⁰ See *supra* note 83.

⁹¹ 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 6.

⁹² *Id.*

⁹³ HARDING, *supra* note 1, at 251; JOHNSON, *supra* note 19, at 87.

⁹⁴ See USER’S GUIDE TO THE 1992 ISDA MASTER AGREEMENT, *supra* note 40, at 26.

iv. Seizure and Application of Collateral

If an Event of Default is triggered by the bankruptcy or similar insolvency filing by a party, its Guarantor, or one of its affiliates at the time when the Non-defaulting Party is in the money following the early termination of the ISDA Master Agreement, the Non-defaulting Party can apply any collateral it holds under the CSA to the Early Termination Amount or Close-out Amount it is owed.⁹⁵ If such collateral is not sufficient to satisfy the amount owed to the Non-defaulting Party, the Non-defaulting Party will have an unsecured claim against the Debtor's bankruptcy estate. As discussed in more detail below, the Safe Harbors permit the Non-defaulting Party to engage in this activity without seeking to lift the automatic stay that applies in bankruptcy proceedings and irrespective of certain provisions of the Code that invalidate ipso facto clauses in contracts.⁹⁶

d. Payment Suspension Clause

Section 2(a)(iii) of the ISDA Master Agreement ("Payment Suspension Clause") is one of the most controversial provisions of the ISDA Master Agreement in the bankruptcy context. It states that a Non-defaulting Party may withhold payments otherwise due and payable to the Defaulting Party and provides, in pertinent part:

Each obligation of each party [to make each payment or delivery specified in each Confirmation to be made by it, subject to the other provisions of this Agreement] is subject to (1) the condition precedent that no Event of Default or Potential Event of Default with respect to the other party has occurred and is continuing, (2) the condition precedent that no Early Termination Date in respect of the relevant Transaction has occurred or been effectively designated and (3) each other applicable condition precedent specified in this Agreement.⁹⁷

⁹⁵ See 1994 ISDA CREDIT SUPPORT ANNEX, *supra* note 36, ¶ 8; see also GOOCH & KLEIN, *supra* note 20, at 1169–77 (discussing rights of a secured party under an ISDA master agreement). See *supra* note 53 and accompanying text for a discussion of CSAs.

⁹⁶ See 11 U.S.C. §§ 362(b)(17), 560 (2012).

⁹⁷ 1992 ISDA MASTER AGREEMENT, *supra* note 29, § 2(a)(iii). Section 2(a)(iii) of the 2002 ISDA Master Agreement is substantially similar. See 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 2(a)(iii). After this Article was accepted for publication, but during the editorial process, ISDA, in June 2014, published a Form of Amendment to the ISDA Master Agreement for use in relation to section 2(a)(iii). See INT'L SWAPS & DERIVATIVES ASS'N, AMENDMENT TO THE ISDA MASTER AGREEMENT FOR USE IN RELATION TO SECTION 2(A)(III) (2014) [hereinafter ISDA AMENDMENT TO SECTION 2(A)(III)], available at <http://www.isda.org/cgi->

Thus, if a party to an ISDA Master Agreement, its Credit Support Provider, or any Specified Entity listed in a Schedule files for bankruptcy protection under the Code or triggers another Event of Default, section 2(a)(iii) allows the Non-defaulting Party to withhold or suspend payments otherwise due and payable from the Defaulting Party while it is in insolvency proceedings. As a result, section 2(a)(iii) could be interpreted to convert the Second Method to the First Method and allow the Non-defaulting Party to refrain—and in some circumstances “walkaway”—from its payment obligations while its counterparty is in bankruptcy or insolvency proceedings.⁹⁸

Over the past several years, courts have grappled with various issues related to section 2(a)(iii) in the insolvency context.⁹⁹ Those situations generally dealt with a situation where the Non-defaulting Party was out of the money and its counterparty filed for bankruptcy or other insolvency proceedings while at the same time being in the money.¹⁰⁰ If section 2(a)(iii) were enforceable in such a scenario, it would have a devastating impact on the creditors of the Debtor¹⁰¹ because the Non-defaulting Party could simply wait indefinitely while not making any payments to the Debtor, until the market shifts back into the Non-defaulting Party’s favor, to terminate the ISDA Master Agreement.¹⁰²

In the meantime, the Debtor’s bankruptcy estate and its creditors would be deprived of any payments that would have been otherwise due and payable by the Non-defaulting Party to the Debtor on the Reset Dates that elapsed between

bin/_isdadocsdownload/download.asp?DownloadID=1033; INT’L SWAPS & DERIVATIVES ASS’N, GUIDANCE NOTE ON THE FORM OF AMENDMENT TO ISDA MASTER AGREEMENT FOR USE IN RELATION TO SECTION 2(A)(III) (2014), available at http://www.isda.org/publications/pdf/Guidance_Note_amendment_agreement.pdf. The ISDA Section 2(a)(iii) Amendment will apply only if all parties to the ISDA Master Agreement agree to the Amendment. See generally ISDA AMENDMENT TO SECTION 2(A)(III), *supra*. If both parties agree to the ISDA Section 2(a)(iii) Amendment, a Non-defaulting Party will have to terminate the ISDA Master Agreement within a specified time period of the bankruptcy filing of the Debtor (or the bankruptcy filing of any one of its affiliates). *Id.*

⁹⁸ See 1992 ISDA MASTER AGREEMENT, *supra* note 29, § 2(a)(iii); 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 2(a)(iii); Christopher J. Mertens, *Australian Insolvency Law and the 1992 ISDA Master Agreement—Catalyst, Reaction, and Solution*, 15 PAC. RIM L. & POL’Y J. 233, 255 (2006).

⁹⁹ See, e.g., *Enron Austral. Fin. Pty. Ltd v TXU Elec. Ltd.* [2003] NSWSC 1169 (Austl.); *Lomas v. JFB Firth Rixson Inc.*, [2010] EWHC (Ch) 3372, [2011] 2 BCLC 120 (Eng.) (International Swaps and Derivatives Association, Inc. joined as intervenor); September 15 Transcript, *supra* note 48, at 101–13.

¹⁰⁰ See sources cited *supra* note 99.

¹⁰¹ The author uses the term Debtor herein to refer to a Defaulting Party that is a debtor under the Bankruptcy Code.

¹⁰² See Kingsley T.W. Ong, *The ISDA Master Agreement: Insolvency Stalemate and Endgame Solutions for Hong Kong Liquidators*, 40 HONG KONG L.J. 337, 342 (2010).

the date of the bankruptcy filing and the date on which the market shifts back into the Non-defaulting Party’s favor. Likewise, in such a scenario, the Non-defaulting Party would be reluctant to terminate the ISDA Master Agreement, because if it does so it would likely owe the Early Termination Amount, which would likely be much larger than the amount it would owe to the Debtor-counterparty on a particular Reset Date, because the Early Termination Amount takes into account future valuations. For this reason, bankruptcy and insolvency practitioners have referred to section 2(a)(iii) as the “flawed asset clause.”¹⁰³

e. Walkaway Clauses

In certain derivative transactions, market participants may insert into a Confirmation what is commonly referred to as a Walkaway Clause, which excuses a Non-defaulting Party from making a payment otherwise due as a result of an Early Termination originating from the bankruptcy filing of the Debtor, its Guarantor, or any one of its affiliates.¹⁰⁴ If Walkaway Clauses were enforceable in bankruptcy, they would have a devastating impact on the Debtor’s ability to reorganize because they would deprive the Debtor—and in turn, the creditors—the value of the Early Termination Amount or Close-out Amount, even if at the time of the early termination, the Debtor is “in the money.”¹⁰⁵

f. Flip Clauses

A Flip Clause is a clause that usually appears in transaction documents associated with collateralized debt obligation (“CDO”) transactions and other structured finance transactions.¹⁰⁶ Flip Clauses are important in the derivatives

¹⁰³ See *id.* at 339–42.

¹⁰⁴ One example would be the Walkaway Clause in a credit default swap. See, e.g., Complaint at 2–5, Lehman Bros. Special Fin. Inc. v. Harrier Fin. Ltd. (*In re Lehman Bros. Holdings Inc.*), No. 09-01241, 2009 WL 1430616 (Bankr. S.D.N.Y. May 20, 2009) [hereinafter Harrier Complaint] (describing the Walkaway Clause used in credit default swap transaction). Under the Dodd-Frank Act, section 2(a)(iii) would also qualify as a “Walkaway Clause.” See Irene Chapple, *Lehman Bros.’ Swaps Counterparties in Court, Case Could Extend*, DOW JONES DAILY BANKR. REV. (Dec. 7, 2010), <http://bankruptcynews.dowjones.com/article?pid=10&an=DJFDBR0020101207e6c7000b6&ReturnUrl>.

¹⁰⁵ See Schuyler K. Henderson, *Swap Credit Risk: A Multi-Perspective Analysis*, 44 BUS. LAW. 365, 391 (1989) (stating that Walkaway Clauses would have an adverse impact on creditors of an in-the-money defaulting swap party).

¹⁰⁶ See Ong, *supra* note 102, at 351 n.60 (stating that a Flip Clause is a market-standard clause). The Flip Clause is aimed at “disincentivis[ing] default by a swap counterparty and ensur[ing] that the defaulting swap

context because they may affect the rights of the parties to the ISDA Master Agreement.¹⁰⁷ Like the Payment Suspension Clauses and Walkaway Clauses, the predictability of whether a Flip Clause is enforceable in the insolvency context is crucial to sound credit risk management and analysis.

To understand how a Flip Clause works, one must understand the basics of a CDO and other structured finance transactions. In these transactions, a sponsor generally establishes a Special Purpose Vehicle (“SPV”), which sells notes to investors or noteholders under an indenture.¹⁰⁸ These noteholders essentially loan money to the SPV by purchasing notes from the SPV. The SPV generally uses the proceeds generated from these sales to purchase a pool of assets. These assets serve as collateral for the notes.¹⁰⁹ Then, rating agencies, such as Standard & Poor’s, Moody’s, and Fitch, assign ratings to the notes and generally require Flip Clauses.¹¹⁰ The indenture trustee is usually tasked with the holding and administration of the collateral for the various parties to the transactions.¹¹¹

Virtually all CDO and other structured finance transactions use derivative transactions.¹¹² These derivative transactions generally take the form of credit default swaps or interest rate swaps and are documented under an ISDA Master Agreement, executed between a swap provider and the SPV.¹¹³ As there are various different parties to these transactions, such as the indenture trustee, the swap provider, and the noteholders, they generally contain payment waterfall provisions that establish a payment priority.¹¹⁴ The payment waterfall generally provides two different payment priorities: (1) the payment priority that applies while there is no Event of Default under the transaction documents associated with the structure; and (2) the payment waterfall that applies if an

counterparty does not benefit from its own default by continuing to be paid at a senior position in the waterfall.” *Id.*

¹⁰⁷ See Jones et al., *supra* note 39, at 344–45.

¹⁰⁸ See *CDO Primer*, DUFF & PHELPS (Nov. 20, 2008), http://www.duffandphelps.com/SiteCollectionDocuments/DP_CDO_Primer.pdf. Generally speaking, the sponsor of a CDO will be a financial institution such as a bank. *Id.*

¹⁰⁹ The notes may be issued in different classes or tranches. See generally Richard D. Cudahy, *The Coming Demise of Deregulation II*, 61 ADMIN. L. REV. 543, 548–49 (2009).

¹¹⁰ See Jones et al., *supra* note 39, at 343–45.

¹¹¹ See generally Position Paper, Am. Bankers Ass’n, Corporate Trust Comm., *The Trustee’s Role in Asset-Backed Securities* (Nov. 9, 2010), <http://www.aba.com/ABA/Documents/press/roleoftheTrusteeinasset-backedsecuritiesJuly2010.pdf>.

¹¹² See generally GOOCH & KLEIN, *supra* note 20, at 646, 655; Jones et al., *supra* note 39.

¹¹³ GOOCH & KLEIN, *supra* note 20, at 646, 655

¹¹⁴ See Jones et al., *supra* note 39, at 339; see also *CDO Primer*, *supra* note 108.

Event of Default is declared under the transaction documents causing the collateral to be liquidated.¹¹⁵

Here is where the Flip Clause steps in. It reorders the payment priorities set forth in the payment waterfall provision following the declaration of an Event of Default.¹¹⁶ The goal of the Flip Clause is to prevent a swap provider that has caused an Event of Default under its agreement with an SPV from being paid an Early Termination Amount until after the SPV fully satisfies its obligations owed to the noteholders that loaned money or invested in the SPV.¹¹⁷

g. Triangular Setoff Clauses

Parties will often agree to add language to the ISDA Schedule that permits the out-of-the-money party or any of its affiliates, in the case of an Event of Default, to reduce its Early Termination Amount payable to the in-the-money party or any of its affiliates. This is done through a Triangular Setoff Clause, which allows setoff of the Early Termination Amount against amounts payable under any other agreements between the out-of-the-money party or its affiliates and the in-the-money party or its affiliates.¹¹⁸

h. The Dodd-Frank Act and Clearing

In response to the financial crisis, Congress enacted the Dodd-Frank Act, which introduced sweeping reforms to the derivatives markets.¹¹⁹ Other than Title II, which established the Orderly Liquidation Authority,¹²⁰ several reforms introduced by the Dodd-Frank Act relate to the issues discussed in this Article: (1) a requirement that certain entities defined as “Covered Companies” periodically submit “Resolution Plans” or “Living Wills” to the FDIC and the Board of Governors of the Federal Reserve System (“FRB”) setting forth a plan for the Covered Company’s resolution under the Code in the event the Covered Company becomes insolvent;¹²¹ (2) a requirement that certain types

¹¹⁵ See Jones et al., *supra* note 39, at 339.

¹¹⁶ See *id.*

¹¹⁷ See Peter Marchetti, *Trapped Between a Rock and a Hard Place*, FUTURES & DERIVATIVES L. REP., June 2010, at 14, 15.

¹¹⁸ See sources cited and quoted text *supra* note 40.

¹¹⁹ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7, 12, and 15 U.S.C.); see John Carney, *Too Big Not to Fail*, N.Y. TIMES, Aug. 12, 2010, at A31.

¹²⁰ See *infra* Part II.E.

¹²¹ See Dodd-Frank Wall Street Reform and Consumer Protection Act § 165, 12 U.S.C. § 5365 (2012); see also 12 C.F.R. § 360.10 (2012). Covered Companies that are required to submit Living Wills are (1)

of swaps be cleared by a Derivatives Clearing Organization (“Clearinghouse”);¹²² and (3) a requirement that certain financial institutions “push out” certain swap transactions to affiliates that are not eligible for either deposit insurance or access to the Federal Reserve’s discount window (the “Swaps Push Out Rule”).¹²³

Under the second noted reform, the Clearinghouse, swaps will now be categorized as “cleared swaps” and “uncleared swaps.”¹²⁴ Most likely, uncleared swaps will be documented under the ISDA Master Agreement as described above.¹²⁵ Cleared swaps, however, will involve the use of a Clearing Member that stands between a party that is not a Clearing Member, i.e., an End-User, and the Clearinghouse.¹²⁶ Although the ISDA Master Agreement might still be used to document cleared swaps, such transactions will most likely involve a Clearing Agreement either along with the ISDA Master Agreement or instead of it.¹²⁷ In contrast to the ISDA architecture, there is not

nonbank financial companies supervised by the FRB; (2) U.S. bank holding companies with assets of \$50 billion or more; and (3) certain foreign banks or companies that have assets of \$50 billion or more on a global basis and are considered bank holding companies under section 8(a) of the International Banking Act of 1978. See Dodd-Frank Wall Street Reform and Consumer Protection Act § 165; see also 12 C.F.R. § 360.10.

¹²² See Dodd-Frank Wall Street Reform and Consumer Protection Act § 723, 7 U.S.C. § 2 (requiring “clearing” for certain types of swap transactions).

¹²³ See Dodd-Frank Wall Street Reform and Consumer Protection Act § 716, 15 U.S.C. § 3805 (requiring “swaps push-out” for certain entities). The Living Wills requirement and the Swaps Push Out Rule are important with respect to the issue of Triangular Setoff discussed below. After this Article was accepted for publication and during the editorial process, the President of the United States, on December 16, 2014, signed an omnibus spending bill that amended and significantly reduced the scope of the Swaps Push Out Rule. See *Swaps Pushout Provision Amended: Pushout Requirement in Section 716 Now Limited to Certain ABS Swaps*, DAVIS POLK & WARDWELL LLP (Dec. 17, 2014), http://www.davispolk.com/sites/default/files/2014-12-17_Swaps_Pushout_Provision_Amended.pdf; Julian Hammar, *New Law Limits the Swaps Pushout Requirement to Apply Only to Certain ABS Swaps*, MORRISON & FOERSTER (Dec. 22, 2014), available at <http://www.mofo.com/~media/Files/ClientAlert/2014/12/141222SwapsPushoutRequirements.pdf>. Under this amendment to the Swaps Push Out Rule, certain financial institutions only have to transfer specified structured finance swaps to an affiliate. See *id.*

¹²⁴ See generally Sherri Venokur, *What Customers Should Look Out For in FCM Clearing Agreements*, FUTURES & DERIVATIVES L. REP., June 2013, at 1.

¹²⁵ See *id.*

¹²⁶ See generally Adam J. Levitin, *Response: The Tenuous Case for Derivatives Clearinghouses*, 101 GEO. L.J. 445, 449–53 (2013) (describing structure of the Clearinghouse). Mandatory clearing of swap transactions will add a level of complexity (and additional parties) to what were, for approximately the past thirty years, bilateral transactions under the ISDA architecture. See Robert Pickel, *The Bilateral World vs. The Cleared World*, DERIVATIVEVIEWS (Apr. 24, 2012), <http://isda.derivatviews.org/2012/04/24/the-bilateral-world-vs-the-cleared-world/>.

¹²⁷ See generally Venokur, *supra* note 124 (discussing Clearing Agreements); *Preparing for OTC Derivatives Clearing*, SIDLEY AUSTIN, L.L.P. (Mar. 24, 2011), http://www.sidley.com/InvestmentProducts_Update_032411/.

an “industry standard form” of Clearing Agreement.¹²⁸ The issues discussed in this Article, however, are also applicable to Clearing Agreements, especially because such agreements are likely to contain Triangular Setoff Clauses.¹²⁹

II. IMPORTANT PROVISIONS OF THE BANKRUPTCY CODE AND THE DODD-FRANK ACT IN RELATION TO THE RIGHTS UNDER ISDA MASTER AGREEMENT

A. *Property of the Bankruptcy Estate and the Automatic Stay*

The underlying policy of chapter 11 bankruptcy is to foster the reorganization of a distressed business entity.¹³⁰ There is a strong policy that favors giving the Debtor a reprieve so that it can continue operating its business.¹³¹ This policy does not favor the immediate liquidation of the Debtor.¹³² Instead, it is based on the idea that the Debtor’s ability to reorganize preserves its employees’ jobs and preserves that Debtor’s ability to continue to provide services, thus benefitting the U.S. economy.¹³³

Several events simultaneously occur under the Code immediately when an entity files a chapter 11 bankruptcy petition (the “Petition Date”). The entity becomes a Debtor and a bankruptcy estate is created.¹³⁴ All of that Debtor’s property rights become property of that bankruptcy estate.¹³⁵ Included in such property rights are all of the Debtor’s rights in its contracts that exist as of the Petition Date.¹³⁶ To protect the property of the Debtor’s bankruptcy estate, and to give the Debtor a “breathing spell,” an automatic stay is imposed and automatically halts any efforts by creditors of the Debtor to commence or

¹²⁸ See Venokur, *supra* note 124, at 2 (indicating lack of standard clearing documentation).

¹²⁹ See *id.* at 5 (discussing the use of Triangular Setoff Clauses in Clearing Agreements.) But as a Clearinghouse stands between the various parties to a particular derivatives trade, Payment Suspension Clauses or Walkaway Clauses are not likely to be part of Clearing Agreements.

¹³⁰ *In re Drexel Burnham Lambert Grp. Inc.*, 138 B.R. 723, 759–60 (Bankr. S.D.N.Y. 1992).

¹³¹ *In re Talladega Steaks, Inc.*, 50 B.R. 42, 44 (N.D. Ala. 1985).

¹³² *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 528 (1984). A chapter 11 debtor can also liquidate its assets through a chapter 11 plan. See 11 U.S.C. § 1129(a)(9)(C)(11) (2012). In such situations, a Debtor will sell substantially all of its assets through a § 363 sale and then distribute the proceeds of that sale to the various creditors through a chapter 11 plan. See Deborah Thorne, *Pay to Play: Liquidation of Assets Using Chapter 11 Should Provide Unsecured Creditors with a Share of the Proceeds*, BUS. CREDIT, June 2009, available at http://www.btlaw.com/files/BC-June09_Thorne.pdf.

¹³³ See *NLRB*, 465 U.S. at 528.

¹³⁴ 11 U.S.C. § 541.

¹³⁵ See *id.*

¹³⁶ See *id.*

continue any litigation against the Debtor or its property or to enforce any liens against the Debtor or its property.¹³⁷

Generally, secured creditors must seek permission of the bankruptcy court to lift the automatic stay to seize their collateral.¹³⁸ A Debtor, however, generally may continue to use the collateral to operate its business and to facilitate the reorganization process, though there are special limitations on the use of cash collateral.¹³⁹ When a Debtor uses a secured creditor's collateral, it typically agrees to give the secured creditor adequate protection, which is a remedy designed to protect the secured creditor against any diminution in the value of its collateral.¹⁴⁰

B. Executory Contracts

The Code gives a Debtor extensive powers with respect to executory contracts, which are contracts under “which performance remains due to some extent on both sides.”¹⁴¹ Under the Code, with court approval, a Debtor can assume any executory contract that is of value to the bankruptcy estate or can reject any executory contract that is not of value to the bankruptcy estate.¹⁴² A Debtor uses its business judgment in deciding whether to assume or reject an executory contract¹⁴³ and may make this decision until the date on which a bankruptcy court confirms a chapter 11 plan.¹⁴⁴

¹³⁷ See *id.* § 362. Thus the automatic stay is extensive. See *id.*

¹³⁸ See *id.* § 362(d).

¹³⁹ See *id.* §§ 363(b)–(c), 1108.

¹⁴⁰ See *id.* § 362(e); see also *id.* § 361.

¹⁴¹ See *In re Teligent, Inc.*, 268 B.R. 723, 730 (Bankr. S.D.N.Y. 2001) (citing to the Countryman Test for determining whether a contract qualifies as an executory contract). Under the Countryman Test, an executory contract is “a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other.” *Id.*; see 11 U.S.C. § 365; see also Vern Countryman, *Executory Contracts in Bankruptcy: Part 1*, 57 MINN. L. REV. 439, 460 (1973) (discussing the definition of an executory contract).

¹⁴² See 11 U.S.C. § 365.

¹⁴³ *In re MF Global Holdings Ltd.*, 466 B.R. 239, 242 (Bankr. S.D.N.Y. 2012).

¹⁴⁴ See 4 COLLIER ON BANKRUPTCY ¶ 365.02 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2011). A substantial time period can exist between the petition date and the date on which the bankruptcy court confirms a chapter 11 plan. See 11 U.S.C. § 1121. Generally, a Debtor may have an exclusive period of eighteen months after the petition date to file a chapter 11 plan. See *id.* A counterparty to an executory contract can file a motion requesting bankruptcy court approval to force a Debtor to assume or reject an executory contract within a shorter time period. See *id.* § 365(d)(2); *In re Enron Corp.*, 279 B.R. 695, 702–03 (Bankr. S.D.N.Y. 2002) (discussing ability of counterparty to compel Debtor's assumption or rejection of executory contract). In making a decision on such a motion, a bankruptcy court, using its discretion, will decide whether the debtor had reasonable time to decide on assumption or rejection of the particular contract. *Enron*, 279 B.R. at 702–03. In making this decision, the court examines several factors, including: (1) the damage the non-

If a Debtor decides to assume an executory contract, it will have the obligation to cure all monetary defaults under that contract and provide adequate assurance of future performance.¹⁴⁵ If, however, the Debtor rejects an executory contract, the contract is treated as if the Debtor breached it, and the counterparty will have a claim for rejection damages.¹⁴⁶ The Debtor's rejection of an executory contract does not terminate the executory contract.¹⁴⁷ Instead, it renders the contract breached.¹⁴⁸

The calculation of rejection damages related to terminated derivative transactions are governed by § 562 of the Code.¹⁴⁹ Section 562 requires such rejection damages to be calculated as of the earlier of the rejection date or the termination date of the derivative transaction.¹⁵⁰ If no reasonable determinants of value exist on the appropriate date, damages are to be measured on the next date that such determinants exist.¹⁵¹ Although § 562 requires calculation of rejection damages of a rejected ISDA Master Agreement during the postpetition period, the Code only allows the Non-defaulting Party to file a prepetition unsecured claim, which most likely precludes asserting a claim for a postpetition administrative expense.¹⁵²

debtor counterparty will suffer beyond the compensation available under the Code; (2) the importance of the executory contract to the debtor's business and reorganization; (3) whether the debtor has had adequate time to evaluate its financial situation and potential value of its assets in formulating a plan; and (4) whether the exclusive time within which the debtor may propose a plan has terminated. The court will also consider the complexity of the case, including the number of contracts to be evaluated, and the need for a court to determine the validity of such contracts. *Id.*

¹⁴⁵ See 11 U.S.C. § 365(b)(1)(A).

¹⁴⁶ See *id.* §§ 365(g), 502(g).

¹⁴⁷ See 4 COLLIER ON BANKRUPTCY, *supra* note 144, ¶ 365.02.

¹⁴⁸ *Id.*

¹⁴⁹ See 11 U.S.C. § 562(a).

¹⁵⁰ See *id.* § 562(b).

¹⁵¹ See *id.*; see also *In re Am. Home Mortg. Holdings, Inc.*, 411 B.R. 181, 189–93 (Bankr. D. Del. 2009) (discussing § 562).

¹⁵² See 11 U.S.C. § 502(g)(2). The Code normally allows an administrative expense for postpetition value from an executory contract received by the debtor between the Petition Date and the date of the rejection of the contract. Section 502(g)(2) provides in pertinent part: "A claim for damages calculated in accordance with section 562 shall be allowed . . . or disallowed . . . as if such claim had arisen before the date of the filing of the petition." *Id.* To successfully assert a claim for an administrative expense under § 503, the claimant must demonstrate (1) that the claim arose out of a transaction between the claimant and the debtor during the postpetition period and (2) that the transaction conferred a benefit on the estate in a demonstrable way. See, e.g., *In re Bayou Group, L.L.C.*, 431 B.R. 549, 557–58 (Bankr. S.D.N.Y. 2010); see also 11 U.S.C. § 503; Douglas J. Bordewick, *The Postpetition, Pre-Rejection, Pre-Assumption Status of an Executory Contract*, 59 AM. BANKR. L.J. 197, 221–26 (1985) (discussing the ability of a non-debtor party to an executory contract with a chapter 11 debtor to assert a claim for an administrative claim).

C. *Ipso Facto Clauses and §§ 365 and 541 of the Code*

The Code prohibits a Debtor's counterparty to an executory contract from withholding performance due to the Debtor while the Debtor decides to assume or reject the executory contract.¹⁵³ Generally speaking, during this time period, the counterparty has an obligation to perform its obligations due to the Debtor under the executory contract.¹⁵⁴ Likewise, in most situations, the Code renders unenforceable any contractual clause that permits a non-debtor party to an executory contract to modify or terminate (or enforce a provision that automatically modifies or terminates) the executory contract based on the Debtor's bankruptcy filing.¹⁵⁵ Such contractual clauses are referred to as "ipso facto" clauses.¹⁵⁶ Section 365(e)(1) provides in pertinent part:

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.¹⁵⁷

Similarly, § 541(c)(1) also invalidates ipso facto clauses and provides, in pertinent part:

[A]n interest of the debtor in property becomes property of the estate . . . notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law . . . that is conditioned on . . . the commencement of a case under this title . . . and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.¹⁵⁸

¹⁵³ See 11 U.S.C. § 365(e)(1).

¹⁵⁴ See *id.*

¹⁵⁵ See *id.*

¹⁵⁶ See *id.*

¹⁵⁷ *Id.* (emphasis added).

¹⁵⁸ *Id.* § 541(c)(1). Similarly, § 363(l) provides in pertinent part:

In summary, under the Code, a contractual clause is generally unenforceable if it (1) allows a party to unilaterally terminate, modify, or suspend a Debtor's interest in property or (2) functions as a forfeiture, modification, or termination of a Debtor's interest in property.

D. The Safe Harbors

Aimed at protecting the financial industry,¹⁵⁹ Congress enacted the Safe Harbors to address various types of derivative transactions in bankruptcy.¹⁶⁰ The Safe Harbors allow the Non-defaulting Party to a derivative transaction with a Debtor to terminate, liquidate, accelerate, net out, and set off among such derivative transactions upon the bankruptcy filing of the Debtor.¹⁶¹ Sections 560 and 561 partly annul § 365(e)(1) because they allow a Non-defaulting Party to specified derivative transactions to terminate, liquidate, and accelerate such contracts, or to set off or net out termination values or payment amounts owed thereunder, notwithstanding the counterparties' bankruptcy filing.¹⁶² The Safe Harbors contained in § 362 also override some of the general provisions of § 362, as they allow a Non-defaulting Party to automatically seize any collateral it holds and to apply such collateral to any amounts owed to it as a result of the termination of a swap agreement.¹⁶³ The financial crisis of 2008 tested the outer bounds of the Safe Harbors, especially with respect to Payment Suspension Clauses, Walkaway Clauses, Flip Clauses, and Triangular Setoff Clauses.¹⁶⁴

Subject to the provisions of section 365, [a debtor] may use, sell or lease property under subsection (b) or (c) of this section, . . . notwithstanding any provision in a contract, a lease, or applicable law that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title concerning the debtor, or on the appointment of or the taking possession by a trustee in a case under this title or a custodian, and that effects, or gives an option to effect, a forfeiture, modification, or termination of the debtor's interest in such property.

Id. § 363(l) (emphasis added).

¹⁵⁹ See Morrison & Riegel, *supra* note 6, at 642 (discussing reason for enacting safe harbors); see also H.R. REP. NO. 109-31 at 3, 20, 131, 132 (2005).

¹⁶⁰ See 11 U.S.C. §§ 362(b)(6)–(7), (17); 546(e)–(g); 555–556; 560–561.

¹⁶¹ See *id.*

¹⁶² See *id.* §§ 365(e)(1), 560–561.

¹⁶³ See *id.* § 362(b)(6)–(7), (17); see also Lubben, *Repeal the Safe Harbors*, *supra* note 8, at 323.

¹⁶⁴ See, e.g., *In re Lehman Bros. Inc.* (UBS Decision), 458 B.R. 134 (Bankr. S.D.N.Y. 2011); *Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007–1 Ltd.* (*In re Lehman Bros. Holdings Inc.*), 452 B.R. 31 (Bankr. S.D.N.Y. 2011); *In re Lehman Bros. Holdings Inc.*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010); September 15 Transcript, *supra* note 48; Harrier Complaint, *supra* note 104.

E. The Safe Harbors in Title II of the Dodd-Frank Act

While parts of the Dodd-Frank Act are aimed at regulating derivative transactions (e.g., through Clearinghouses),¹⁶⁵ Title II of the Act provides an alternative insolvency regime to the Code called the Orderly Liquidation Authority, which applies to certain types of financial institutions called Significantly Important Financial Institutions (“SIFI’s”).¹⁶⁶ Congress intended that Title II would be used only as a “last resort” in very limited situations where, inter alia, the applicable regulatory authorities deem that a bankruptcy case would not be appropriate.¹⁶⁷ Title II contains safe harbors for derivative trading contracts.¹⁶⁸

The safe harbors contained in Title II, however, are slightly different in two respects from the Safe Harbors in the Code. First, under Title II, the Non-defaulting Party cannot exercise its right to terminate, liquidate, and net out its derivative transactions with the SIFI that is subject to a Title II proceeding for a period of one business day after the day on which the SIFI enters into a Title II proceeding.¹⁶⁹ Secondly, it seems quite clear that in a Title II proceeding, no Payment Suspension Clause or Walkaway Clause would be enforceable under any circumstances.¹⁷⁰ But issues surrounding Triangular Setoff Clauses could arise in a Title II proceeding, as the language regarding setoff in Title II is essentially the same as the language contained in § 553 of the Code.¹⁷¹

¹⁶⁵ *Supra* Part I.B.2.h.

¹⁶⁶ *See* Baird & Morrison, *supra* note 11, at 308–13 (discussing Title II). The Taxpayer Protection and Responsible Resolution Act, which is currently pending in the U.S. Senate, proposes to repeal Title II and to replace it with a new Chapter 14 of the Code. *See* Taxpayer Protection and Responsible Resolution Act, S. 1861, 113th Cong. §§ 2(a), 4 (2013).

¹⁶⁷ *See* 12 U.S.C. §§ 5381(a)(8), 5383(a)(1)(A); Bruce Grohsgal, *Case in Brief Against “Chapter 14,”* AM. BANKR. INST. J., May 2014, at 44. Indeed, for a SIFI to file for orderly liquidation under Title II, strict criteria must be met, including, but not limited to, a finding by the Secretary of the U.S. Treasury (after consulting with the President of the U.S.) that “the failure [of the SIFI] and its resolution under [the Code] would have serious adverse effects on financial stability in the United States.” 12 U.S.C. § 5383(b).

¹⁶⁸ *See* 12 U.S.C. § 5390(c)(8)(A)(i).

¹⁶⁹ *Id.* § 5390(c)(10)(B).

¹⁷⁰ *See id.* § 5390(c)(8)(F) (invalidating Walkaway Clauses). Title II broadly defines “Walkaway Clauses” as:

[A]ny provision in a [Safe-Harbored contract or ISDA Master Agreement] that suspends, conditions, or extinguishes a payment obligation of a party, in whole or in part, or does not create a payment obligation of a party that would otherwise exist, solely because of the status of such party as a [Non-defaulting] [P]arty in connection with [its formal insolvency proceedings under Title II]

Id.

¹⁷¹ *Compare id.* § 5390(a)(12), with 11 U.S.C. § 553.

III. LITIGATION INVOLVING THE INTERSECTION OF THE ISDA MASTER
AGREEMENT AND THE BANKRUPTCY CODE

During the financial crisis of 2008, several storied investment banking institutions were on the verge of failure. JP Morgan Chase purchased Bear Stearns in a distressed sale.¹⁷² Around the same time, Bank of America acquired Merrill Lynch, which was also in financial distress.¹⁷³ Unable to receive government assistance in the form of a “bailout” and unable to structure a sale to a third party, on September 15, 2008 (the “LBHI Petition Date”), LBHI, filed for chapter 11 protection in the U.S. Bankruptcy Court for the Southern District of New York.¹⁷⁴ LBHI was the fourth-largest investment banking firm in the United States.¹⁷⁵ On the same day, Lehman Brothers International (Europe) (“LBIE”), based in London, filed for administration in the United Kingdom.¹⁷⁶ On October 8, 2009 (the “LBSF Petition Date”), Lehman Brothers Special Financing Inc. (“LBSF”), a wholly-owned subsidiary of LBHI, also filed for chapter 11 protection.¹⁷⁷

LBSF conducted a large number of derivative trades.¹⁷⁸ It had open derivative trades with thousands of counterparties as of the LBHI Petition Date.¹⁷⁹ Most, if not all, of these trades were documented under ISDA Master

¹⁷² Robin Sidel et al., *J.P. Morgan Buys Bear in Fire Sale, as Fed Widens Credit to Avert Crisis: Ailing Firm Sold for Just \$2 a Share in U.S.-Backed Deal*, WALL ST. J., March 17, 2008, www.online.wsj.com/news/articles/SB120569598608739825.

¹⁷³ Charlie Gasparino, *Bank of America to Buy Merrill Lynch for \$50 Billion*, CNBC (Sept. 14, 2008, 7:42 PM), <http://www.cnbc.com/id/26708319>.

¹⁷⁴ Yalman Onaran & Christopher Scinta, *Lehman Files Biggest Bankruptcy Case as Suitors Balk*, BLOOMBERG (Sept. 15, 2008, 9:43 AM), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=awh5hRyXkvs4>.

¹⁷⁵ *Id.* At that time, Goldman Sachs, Morgan Stanley, and Merrill Lynch were the three largest investment banking firms in the United States. See Katy Marquardt, *FAQ on Investment Banks*, U.S. NEWS & WORLD REP. (March 17, 2008, 4:01 PM), <http://money.usnews.com/money/business-economy/articles/2008/03/17/faq-on-investment-banks>.

¹⁷⁶ *Lehman Brothers Files for Bankruptcy*, FIN. TIMES (Sept. 16, 2008, 10:07 AM), <http://www.ft.com/cms/s/0/52098fa2-82e3-11dd-907e-000077b07658.html#axzz2ZlmP9K3F>. Administration is a formal insolvency proceeding in the United Kingdom that is similar to a bankruptcy filing in the United States. See John Armour et al., Symposium, *Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom*, 55 VAND. L. REV. 1699, 1742–50 (2002).

¹⁷⁷ The chapter 11 bankruptcy filings of LBHI and its affiliates were the largest chapter 11 bankruptcy filings in history. Onaran & Scinta, *supra* note 174.

¹⁷⁸ See Report of Anton R. Valukas, Examiner, Vol. 2, at 569, 572, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Mar. 11, 2010), ECF No. 7531-2, available at <https://jenner.com/lehman> (last visited June 20, 2015).

¹⁷⁹ See *id.*

Agreements.¹⁸⁰ LBHI acted as Guarantor for virtually all of LBSF's ISDA Master Agreements with its counterparties.¹⁸¹

The Lehman Brothers bankruptcy proceedings have given rise to several decisions of first impression and produced important decisions regarding the relationship between the ISDA Master Agreement and the statutory Safe Harbors in the Code. Some of those decisions are discussed below (along with some unrelated, earlier decisions) to highlight the need for amending the Safe Harbors as this Article proposes. Specifically, the decisions address the issues in enforcement of the following provisions in bankruptcy proceedings: Payment Suspension Clauses, Walkaway Clauses, Flip Clauses, and Triangular Setoff Clauses.

A. *Payment Suspension Clauses: The Metavante Matter, "First Method," and Section 2(a)(iii)*¹⁸²

1. *Facts and Arguments of Metavante and LBSF*

The Metavante matter involved the following set of facts: Metavante and LBSF entered into an interest rate swap document under an ISDA Master Agreement.¹⁸³ LBHI guaranteed LBSF's obligations thereunder.¹⁸⁴ Under the terms of the interest rate swap, the parties agreed to pay whichever of them was in the money on a net basis on agreed upon quarterly Reset Dates.¹⁸⁵

Recall that LBSF filed for chapter 11 protection twenty-two days after LBHI.¹⁸⁶ Both of those bankruptcy filings qualified as an Event of Default

¹⁸⁰ See Solomon Noh, *Lesson from Lehman Brothers for Hedge Fund Managers: The Effect of a Bankruptcy Filing on the Value of the Debtor's Derivative Book*, HEDGE FUND L. REP., July 12, 2012, available at <http://www.shearman.com/en/> (search "Lesson from Lehman"; then follow hyperlink to article) (last visited June 20, 2015) (stating that most of Lehman's derivative transactions were documents under the ISDA Master Agreement).

¹⁸¹ Thus, LBHI was LBSF's Credit Support Provider. See *Lehman Bros. Special Fin. Inc. v. BNY Corp. Tr. Servs. Ltd. (In re Lehman Bros. Holdings Inc.)*, 422 B.R. 407, 411 (Bankr. S.D.N.Y. 2010).

¹⁸² The author previously published an article that presented a detailed discussion of the Metavante Matter. See generally Peter Marchetti, *The Ruling in the Lehman Metavante Matter—Has the Ticking Time Bomb of Enron vs. TXU Exploded or Been Defused?*, FUTURES & DERIVATIVES L. REP., Feb. 2010, at 1. Portions of the discussion contained in that article have been included herein as relevant.

¹⁸³ September 15 Transcript, *supra* note 48, at 102–03.

¹⁸⁴ LBHI was listed as LBSF's "Credit Support Provider" in the ISDA Schedule. *Id.* at 103.

¹⁸⁵ Under this interest rate swap, LBSF was the "floating rate payer" and Metavante was the "fixed rate payer." See Marchetti, *supra* note 182, at 6 (describing the facts of the Metavante matter); see also INT'L SWAPS & DERIVATIVES ASS'N, 2006 ISDA DEFINITIONS 6 (2006).

¹⁸⁶ *Supra* text accompanying notes 174 & 177.

under the ISDA Master Agreement and would have allowed Metavante to terminate the interest rate swap.¹⁸⁷ If Metavante did terminate at that time, it would have owed LBSF a large termination payment, because Metavante was out of the money.¹⁸⁸ Metavante refused to terminate the swap.¹⁸⁹ Instead, Metavante relied on the Payment Suspension Clause, refusing to make the quarterly payments that it owed to LBSF.¹⁹⁰ Metavante believed that it could withhold the payments that were otherwise due and payable to LBSF and that it could wait for the value of the swap to swing back to a point where Metavante would be in the money.¹⁹¹

LBSF sought to compel Metavante to make those scheduled payments and made the following three arguments. First, the interest rate swap was an executory contract under the Code, and even though LBSF committed an Event of Default under the ISDA Master Agreement by filing for bankruptcy, Metavante still had to perform its payment obligations thereunder until LBSF decided whether to assume or reject the ISDA Master Agreement. Second, the Safe Harbors did not permit Metavante to withhold payments that were otherwise due and owing to LBSF. It would, however, have allowed Metavante to terminate, liquidate, and accelerate the interest rate swap and to set-off or to net out amounts owed under those terminated transactions upon the bankruptcy filing of LBSF or LBHI. Finally, the Safe Harbors did not allow Metavante to “ride the market” by withholding the payments that were otherwise due and payable to LBSF and by waiting for the value of the swap to swing back to a point where Metavante would be in the money.¹⁹²

Metavante, however, first argued that LBSF and LBHI’s chapter 11 bankruptcy filings were two different and distinct Events of Default under the ISDA Master Agreement, and Metavante could withhold payments under the Payment Suspension Clause based on LBHI’s bankruptcy filing, not LBSF’s

¹⁸⁷ Metavante could have terminated the ISDA Master Agreement along with any transactions falling thereunder (including the interest rate swap) pursuant to section 6(a) of the ISDA Master Agreement and pursuant to 11 U.S.C. § 560 (2012). September 15 Transcript, *supra* note 48, at 108–09.

¹⁸⁸ See Marchetti, *supra* note 182, at 6.

¹⁸⁹ See September 15 Transcript, *supra* note 48, at 106.

¹⁹⁰ See *id.* at 103–04, 109. Metavante refused to make three quarterly payments to LBSF that totaled approximately \$6.6 million. *Id.* at 103.

¹⁹¹ See *id.* at 110. Metavante was “riding the market” waiting for the value of the swap to swing back to a value favorable to Metavante. See *id.*

¹⁹² See *id.* at 101–13; Debtor’s Motion Pursuant to Sections 105(a), 362 and 365 of the Bankruptcy Code to Compel Performance of Metavante Corp.’s Obligations Under an Executory Contract and to Enforce the Automatic Stay at 7–12, *In re Lehman Bros., Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 17, 2009), ECF No. 3691; Marchetti, *supra* note 182, at 6–7 (detailing arguments made by LBSF).

bankruptcy filing.¹⁹³ Second, Metavante argued that under the Safe Harbors, Metavante could terminate the ISDA Master Agreement at any time it desired to do so.¹⁹⁴

2. *The Bankruptcy Court's Decision*

The bankruptcy court, ruling on this issue of first impression under U.S. law, ultimately sided with LBSF and held the following: (1) Section 2(a)(iii) was a non-enforceable ipso facto clause under § 365(e)(1) and would not permit an out-of-the-money Non-defaulting Party to withhold payments otherwise due and payable to a Debtor under a swap agreement based on the Debtor's (or its Guarantor's) status as a debtor under the Code; and (2) a Non-defaulting Party waives its right to terminate the ISDA Master Agreement if it does not promptly terminate following the bankrupt counterparty's (or its Guarantor's) bankruptcy filing.¹⁹⁵ Likewise, the court held that Metavante violated the automatic stay by relying on section 2(a)(iii) to withhold payments that were otherwise due and payable to LBSF under a swap agreement on the quarterly Reset Dates.¹⁹⁶

Metavante later appealed the ruling, but before the U.S. District Court for the Southern District of New York decided the appeal, Metavante and LBSF entered into a settlement.¹⁹⁷

¹⁹³ See Objection of Metavante Corp. to Debtor's Motion, Pursuant to Sections 105(a) and 365 of the Bankruptcy Code, to Compel Performance of Obligations Under an Executory Contract and to Enforce the Automatic Stay at 5–11, *In re Lehman Bros. Holdings Inc.*, No. 08-13555, ECF No. 3951.

¹⁹⁴ See *id.* at 5–6. Metavante also made other arguments in support of its position. See Marchetti, *supra* note 182, at 6–7 (detailing arguments advanced by LBSF and Metavante).

¹⁹⁵ September 15 Transcript, *supra* note 48, at 101, 113. The court did note that the Safe Harbors allow certain parties to derivative contracts to “exercise certain limited contractual rights triggered by a chapter 11 bankruptcy filing.” *Id.* at 107. The court said, however, that the Code provides such parties those rights “only to the extent that the non-debtor party seeks to liquidate, terminate, or accelerate its contracts or net out its positions.” *Id.* (emphasis added). See Marchetti, *supra* note 182, at 7–8 (providing a detailed description of the bankruptcy court's ruling in the Metavante matter).

¹⁹⁶ September 15 Transcript, *supra* note 48, at 112–13. The bankruptcy court stated that “Metavante's attempts to control LBSF's right to receive payment under the [ISDA Master] Agreement constitute, in effect, an attempt to control property of the estate.” *Id.* at 112. The bankruptcy court further stated that “contract rights are property of the estate . . .” *Id.*

¹⁹⁷ See Order Granting Debtors' Motion for Approval of a Settlement Agreement with Metavante Corp., *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. April 15, 2010), ECF No. 8336; Debtors' Motion for Approval of a Settlement Agreement with Metavante Corp., *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Mar. 24, 2010), ECF No. 7780; Declaration of Daniel Ehrmann in Support of Debtors' Motion for Approval of a Settlement Agreement with Metavante Corp., *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Mar. 24, 2010), ECF No. 7781; Order Remanding Appeal of Metavante Corp., *Metavante Corp. v. Lehman Bros. Holdings, Inc.* (*In re Lehman Bros. Holdings Inc.*), No. 09-09839 (S.D.N.Y. March 17, 2010).

3. *Implications of the Metavante Matter*

Although the Metavante matter provided some clarity on the enforceability of section 2(a)(iii),¹⁹⁸ a lack of clarity remains in the bankruptcy context with respect to several issues, which the author discussed in a previous work.¹⁹⁹ Other than those issues, the ruling does not provide an in-depth analysis of whether a Non-defaulting Party like Metavante could withhold payments to a chapter 11 Debtor based not on that debtor's bankruptcy filing, but on the bankruptcy filing of its Guarantor or one of its affiliates. Although the court addressed this issue in two later cases involving Flip Clauses, it glossed over the issue here.²⁰⁰

B. *Walkaway Clauses*

Recall that, notwithstanding section 2(a)(iii) of the ISDA Master Agreement, parties sometimes insert a Walkaway Clause into the Schedule or a Confirmation, and it completely excuses a Non-defaulting Party from making a payment that would be otherwise due and payable to a Defaulting Party, regardless of whether the Event of Default resulted from the Debtor's bankruptcy filing or the bankruptcy filing of one of its affiliates.²⁰¹ While there are no reported decisions that expressly hold whether a Walkaway Clause is enforceable in the derivatives context against a chapter 11 debtor, two notable cases have addressed this issue.

¹⁹⁸ See Marchetti, *supra* note 182, at 15–17.

¹⁹⁹ See *id.* (discussing issues remaining after the ruling in the Metavante matter). One of the major unresolved issues following the ruling in the Metavante matter is the exact time period within which a Non-defaulting Party must terminate an ISDA Master Agreement to be deemed to have acted “promptly.” *Id.* at 17. To remedy that uncertainty, Congress should amend the Code so that market participants know the exact window of time within which they must act to be deemed to have terminated an ISDA Master Agreement “promptly.” *Id.* Indeed, one bankruptcy court noted that a Non-defaulting Party properly exercised its right to terminate when it did so within a seven-week time frame. See *In re Mirant Corp.*, 314 B.R. 347, 349–53 (Bankr. N.D. Tex. 2004).

²⁰⁰ See *infra* Part III.C. (discussing *BNY*).

²⁰¹ See *supra* Part I.B.2.e. Depending on how a court interprets section 2(a)(iii), a court could interpret section 2(a)(iii) as a Walkaway Clause in addition to interpreting it as a Payment Suspension Clause. See Mertens, *supra* note 98, at 234–35, 253, 263; Jeremy D. Weinstein et al., *Escape from the Island of One-Way Termination: Expectations and Enron v. TXU*, FUTURES & DERIVATIVES L. REP., Nov. 2004, at 1, 4–5. One such interpretation is that under section 2(a)(iii), a Non-defaulting Party's obligation is indefinitely suspended for so long as an Event of Default exists. See Mertens, *supra* note 98, at 252–53. Under section 5(a)(vii)(4)(B) of the ISDA Master Agreement, any bankruptcy case that lasts more than thirty days may not be a “curable” event of default. See Weinstein et al., *supra*, at 4–5.

I. Drexel

In 1991, the case of *Drexel Burnham Lambert Products Corp. v. Midland Bank P.L.C.*, arose from the chapter 11 filing of Drexel Burnham Lambert Group Inc. and many of its affiliates.²⁰² *Drexel* involved the following facts: Midland Bank P.L.C. (“Midland”) and Drexel Burnham Lambert Products (“Drexel Products”) entered into an interest rate swap.²⁰³ Drexel Burnham Lambert Group (“Drexel Group”) guaranteed Drexel Products’ obligations to Midland under the interest rate swap agreement.²⁰⁴ The interest rate swap agreement contained a Walkaway Clause.²⁰⁵

Drexel Group filed a chapter 11 bankruptcy petition, which triggered an Event of Default under the swap agreement.²⁰⁶ As a result, the interest rate swap terminated.²⁰⁷ Drexel Group alleged that it was owed \$373,000 upon the swap’s termination.²⁰⁸ Midland refused to pay.²⁰⁹ A dispute then arose between Drexel Group and Midland as to whether the Walkaway Clause was enforceable.²¹⁰ Drexel Group argued that it was not enforceable and sought to recover the \$373,000 termination payment on the grounds of unjust enrichment.²¹¹

Midland, on the other hand, argued that the Walkaway Clause was enforceable because it did not qualify as a penalty clause. It further noted that an equitable remedy such as unjust enrichment was not available to a

²⁰² No. 92-3098, 1992 WL 12633422, at *1 (S.D.N.Y. Nov. 10, 1992). Aside from certain fraud issues involved in Drexel’s downfall, Drexel’s business model, in many ways, could be compared to the investment banks involved in the financial crisis. See Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts?*, 35 J. CORP. L. 469, 477–81 (2010) (discussing *Drexel*).

²⁰³ *Drexel*, 1992 WL 12633422, at *1–2. This agreement was not documented under an ISDA Master Agreement. Midland and Drexel Burnham Government Securities, Inc. (“Drexel GSI”) were the initial parties to this interest rate swap agreement. *Id.* Midland and Drexel GSI executed the interest rate swap agreement on April 17, 1986. *Id.* About sixteen months later, on August 14, 1987, Drexel GSI assigned the swap agreement to Drexel Products. *Id.*

²⁰⁴ *Id.* Thus, Drexel Group would qualify as Drexel GSI’s Guarantor if this swap agreement was drafted under an ISDA Master Agreement. See 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 14.

²⁰⁵ See *Drexel*, 1992 WL 12633422, at *3–4. The Walkaway Clause took the form of a “Limited Two-Way Payment Clause,” which is similar to the First Method contained in the 1987 ISDA Agreement and in the 1992 ISDA Master Agreement. *Id.* at *2.

²⁰⁶ *Id.* at *3.

²⁰⁷ See *id.* at *3–4; see also Complaint at 4–5, *Drexel*, 1992 WL 12633422 (No. 92-3098) [hereinafter Drexel Complaint].

²⁰⁸ See Drexel Complaint, *supra* note 207, at 5.

²⁰⁹ See *id.*

²¹⁰ See generally *id.*

²¹¹ *Id.*

sophisticated party like Drexel Group, which drafted the contract containing the Walkaway Clause, the consequences of which Drexel Group was attempting to avoid after its own breach.²¹²

In an unpublished decision, the *Drexel* court held in favor of Midland.²¹³ The court upheld the Walkaway Clause on the grounds that, among other things, it qualified as a valid liquidated damages clause, was not contrary to public policy, and did not constitute forfeiture or result in unjust enrichment to Midland.²¹⁴

It is important to note that in *Drexel*, it seemed that Drexel Products, like its Guarantor, Drexel Group, was in bankruptcy proceedings around the time Midland attempted to enforce the Walkaway Clause. However, neither the Drexel complaint nor any of the pleadings in the *Drexel* case made any reference to § 365 or § 541, which invalidate ipso facto clauses such as the Walkaway Clause at issue in that case, when a party seeks to enforce such a clause against a Debtor.²¹⁵ Likewise, the *Drexel* opinion failed to even mention, let alone analyze, ipso facto clauses or § 365 or § 541 of the Code.²¹⁶

If this analysis were applied to a Non-defaulting Party seeking to enforce a Walkaway Clause against a chapter 11 debtor based solely upon that Debtor's bankruptcy filing, a bankruptcy court would most likely hold that such a clause is an unenforceable ipso facto clause because it would operate to deprive a chapter 11 debtor of a valuable asset—its contractual right to payment.²¹⁷

²¹² See generally Answer to Complaint and Counterclaim by Midland Bank, P.L.C., *Drexel*, 1992 WL 12633422 (No. 92-3098) [hereinafter Midland Answer]. Midland was essentially saying that Drexel was estopped from arguing that the Walkaway Clause was unenforceable, because Drexel drafted the swap agreement and imposed its terms on Midland. *Id.* at 4.

²¹³ *Drexel*, 1992 WL 12633422, at *4.

²¹⁴ See *id.* at *3–4.

²¹⁵ See *In re Drexel Burnham Lambert Group Inc.*, 138 B.R. 723, 743–44 (Bankr. S.D.N.Y. 1992) (discussing Drexel affiliates that filed for chapter 11 protection). See generally Drexel Complaint, *supra* note 207; Midland Answer, *supra* note 212; Defendant's Memorandum of Law in Support of Summary Judgment, *Drexel*, 1992 WL 12633422; Plaintiff's Memorandum of Law in Support of Cross Motion for Summary Judgment on Its Complaint, *Drexel*, 1992 WL 12633422 (No. 92-3098).

²¹⁶ See generally *Drexel*, 1992 WL 12633422.

²¹⁷ Indeed, as some commentators have noted, the *Drexel* decision did not cite any supporting precedent, did not contain an extensive analysis of the conclusion it reached, and is of "dubious precedential value." Craig R. Enochs et al., *Early Termination and Liquidation Provisions as Risk Tools in Master Energy Agreements*, JACKSON WALKER L.L.P. 9 n.25 (Nov. 2, 2004), <http://images.jw.com/com/publications/419.pdf>. Depending on the facts involved, outside of formal bankruptcy proceedings where the Code's prohibitions on ipso facto clauses do not apply, a Payment Suspension Clause or Walkaway Clause may be enforceable under state contract law. See *Brookfield Asset Mgmt. v. AIG Fin. Prod. Corp.*, No. 09-cv-8285(PGG), 2010 WL 3910590

2. Harrier Dispute

A recent dispute in the Lehman chapter 11 proceedings between LBSF and Harrier Finance Limited (“Harrier”) also centered on the enforceability of a Walkaway Clause in the context of chapter 11 bankruptcy filing.²¹⁸ That dispute involved the following facts.²¹⁹ In July 2005, LBSF entered into a credit default swap documented under an ISDA Master Agreement with a structured investment vehicle called the Racers Trust.²²⁰ The sole beneficiary of the Racers Trust was Harrier.²²¹ According to the terms of the credit default swap transaction, the Racers Trust acted as a “protection seller,” and LBSF acted as a “protection buyer” with respect to twelve financial institutions.²²²

If certain events occurred with respect to any one of those twelve financial institutions that would adversely affect the financial condition of one or more of them, the Racers Trust, as protection seller, would have to pay LBSF, as protection buyer, a large sum of money.²²³ In 2005, LBSF paid the Racers Trust approximately \$4.5 million to purchase this credit protection.²²⁴ Thus, these payments were analogous to the payment of an insurance premium

at *15–17 (S.D.N.Y. Sept. 29, 2010) (declining to dismiss suit based on assertion that Walkaway Clause constituted an unenforceable penalty clause under applicable state contract law).

²¹⁸ See Harrier Complaint, *supra* note 104, ¶ 21 (describing the Walkaway Clause used in credit default swap transaction).

²¹⁹ These are the allegations contained in the Complaint. See *generally id.* An answer was not filed in this dispute.

²²⁰ See *id.* ¶¶ 1–2. The name of the Racers Trust was the Restructured Asset Certificates with Enhanced Returns, Series 2005-13-C Trust.

²²¹ See *id.* ¶ 1. The Racers Trust was a Structured Investment Vehicle (“SIV”). Basically, Harrier gave money to Racers Trust in exchange for beneficial interests therein. See *id.* ¶ 19. In turn, the Racers Trust invested that money in AAA rated assets with “a par amount of \$300 million.” *Id.* If a “credit event” did not occur before the scheduled termination date of the credit default swap, September 20, 2010, the Racers Trust would turn over any “cash from the matured AAA-rated assets and the upfront payment” of approximately \$4.5 million LBSF made to the Racers Trust in 2005. *Id.* Harrier, however, could lose the money it invested in the SIV if one or more credit events took place with respect to one of the twelve financial institutions referenced in the credit default swap. *Id.*

²²² See *id.* ¶ 2. These were all large institutions, such as American Express, Citigroup, Inc., The Goldman Sachs Group, JP Morgan Chase & Co., and Merrill Lynch & Co. *Id.* ¶ 19. Under the ISDA Credit Derivative Definitions, these entities that are subject to the credit default swap are referred to as “Reference Entities.” See INT’L SWAPS & DERIVATIVES ASS’N, 2003 ISDA CREDIT DERIVATIVE DEFINITIONS § 2.1 (2003).

²²³ Harrier Complaint, *supra* note 104, ¶ 2. These events are generally referred to as “Credit Events.” See Harrier Complaint, *supra* note 104, ¶ 19; 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 5(b)(v). According to the Harrier Complaint, the sum the Racers Trust owed to LBSF was “up to \$25 million . . . (for a total potential payment obligation of \$300 million).” Harrier Complaint, *supra* note 104, ¶ 2.

²²⁴ See Harrier Complaint, *supra* note 104, ¶ 3.

because, after making these payments, LBSF did not have any more payment obligations to the Racers Trust under the credit default swap.²²⁵

On October 1, 2008—two days before the LBSF Petition Date—the Racers Trust terminated the credit default swap based on LBHI’s bankruptcy filing.²²⁶ Like the derivative transaction in the *Metavante* matter, both the LBHI Petition Date and the LBSF Petition Date qualified as Events of Default under the ISDA Master Agreement.²²⁷ Approximately four months after the Racers Trust terminated the credit default swap, the trustee of the Racers Trust “distributed substantially all of the Racers Trust’s assets” to Harrier and did not pay any amounts to LBSF.²²⁸

LBSF claimed that Harrier, which received all of the assets of the Racers Trust, owed it a termination amount of approximately \$55 million as a result of the Racers Trust’s election to terminate the credit default swap.²²⁹ Harrier, on the other hand, refused to pay LBSF any amount based on a Walkaway Clause contained in the ISDA Schedule.²³⁰ In support of its argument, Harrier cited to *Drexel*.²³¹ Harrier argued that the Walkaway Clause did not qualify as an ipso facto clause because Harrier terminated the credit default swap based on LBHI’s bankruptcy filing, not LBSF’s bankruptcy filing, and Harrier sent the termination to LBSF *before* LBSF filed for bankruptcy.²³²

²²⁵ See *id.* ¶¶ 4–5, 20.

²²⁶ See *id.* ¶¶ 4, 26. According to the Harrier Complaint, the Racers Trust “terminated the credit default swap . . . based solely on the prior Chapter 11 filing of LBHI.” *Id.* at ¶ 4. The Racers Trust designated October 6, 2008, as the early termination date of the credit default swap. *Id.* at ¶ 26.

²²⁷ See *id.* ¶ 21. LBHI was listed as LBSF’s “credit support provider” in the ISDA Master Agreement between the parties, even though LBSF already fully paid all amounts it owed to the Racers Trust under the credit default swap. See *id.*

²²⁸ See *id.* ¶ 4. According to the Harrier Complaint, those assets consisted of approximately \$145 million in cash and approximately \$155 million worth of AAA-rated securities. *Id.*

²²⁹ See *id.* LBSF alleged that even though a credit event did not occur with respect to any of the Reference Entities, “the risk of one or more” of them experiencing a credit event increased the value of the credit default swap to LBSF. *Id.* ¶¶ 4, 22.

²³⁰ See *id.* ¶ 24. The Walkaway Clause provided as follows: “[I]n the event [LBSF] is the Defaulting Party or Affected Party under the terms of this Agreement, no termination payments shall be paid by either party and [the Trustee] shall deliver to the holders of each Series of Certificates, *pro rata*, the Underlying Securities held by [the Trustee].” *Id.*

²³¹ See Memorandum in Support of Defendant’s Motion to Dismiss the Complaint at 9–10, *Lehman Bros. Special Fin. Inc. v. Harrier Fin. Ltd. (In re Lehman Bros Holdings Inc.)*, No. 09-01241 (Bankr. S.D.N.Y. June 22, 2009), ECF No. 9.

²³² See Reply Memorandum in Support of Defendant’s Motion to Dismiss the Complaint at 10, *Harrier Fin. Ltd.*, No. 09-01241 (Sept. 16, 2009), ECF No. 19. Although the termination notice was sent before LBSF’s bankruptcy, it designated a termination date that fell on a day approximately three days after LBSF’s bankruptcy. *Id.* at 9–10.

LBSF argued that the Walkaway Clause was not enforceable, because it qualified as an ipso facto clause.²³³ LBSF claimed that it did not matter whether the bankruptcy filing of LBHI or LBSF triggered the Walkaway Clause because §§ 541 and 365 invalidate ipso facto clauses that are triggered by “the commencement of a [bankruptcy] case,” not the debtor’s bankruptcy case.²³⁴ Similar to its argument in the *Metavante* matter, LBSF also argued that the Safe Harbors did not permit the Racers Trust to completely “walkaway” from its payment obligations that, absent the Walkaway Clause, would have been due and owing to LBSF.²³⁵

Before the bankruptcy court issued a decision, LBSF agreed to dismiss the case, most likely as a result of a settlement between the parties.²³⁶ For the reasons discussed above, it seems somewhat clear a Walkaway Clause would not be enforceable where a non-defaulting, non-debtor party sought to enforce such a clause against a chapter 11 debtor based solely upon that chapter 11 debtor’s bankruptcy filing.²³⁷ *Harrier*, however, presented a situation where a non-debtor, Non-defaulting Party sought to enforce such a clause against a chapter 11 debtor based not only on that debtor’s bankruptcy filing, but on the previous filing of its parent company, and on the fact that the termination notice was sent to the debtor-subsiary prior to its filing.

²³³ See *Harrier* Complaint, *supra* note 104, ¶¶ 33–34. LBSF also argued that the Walkaway Clause: (1) qualified as an unenforceable penalty clause that would cause it to suffer a forfeiture and allow *Harrier* to be unjustly enriched; and (2) the Walkaway Clause effectuated a fraudulent conveyance to *Harrier*. *Id.* See generally Plaintiff Lehman Bros. Special Fin. Inc.’s Opposition to Defendant’s Motion to Dismiss, *Harrier Fin. Ltd.*, No. 09-01241 (July 22, 2009), ECF No. 15. In that Motion, LBSF argued that the *Drexel* decision was “an unpublished opinion devoid of any substantive analysis.” *Id.* at 12. With respect to the issue as to whether the Walkaway Clause qualified as an unenforceable penalty clause, LBSF argued that *Drexel* was distinguishable from LBSF’s dispute with *Harrier* because the amount in dispute in *Drexel* was approximately \$373,000, while the amount in dispute with *Harrier* was significantly larger—approximately \$55 million. *Id.*

²³⁴ See Plaintiff Lehman Bros. Special Fin. Inc.’s Opposition to Defendant’s Motion to Dismiss, *supra* note 233, at 13–15 (emphasis added).

²³⁵ See *id.* at 15. Instead, LBSF argued that the Safe Harbors would have simply allowed the Racers Trust to terminate, liquidate, and accelerate derivative transactions and to set off or net out amounts owed under those terminated transactions upon the bankruptcy filing of LBSF or LBHI. *Id.* at 15–16.

²³⁶ The court issued an order requiring *Harrier* and other similarly-situated parties to submit to mandatory, non-binding alternative dispute resolution. See Alternative Dispute Resolution Procedures Order for Affirmative Claims of the Debtors Under Derivatives Transactions with Special Purpose Vehicle Counterparties, *In re* Lehman Bros. Holdings Inc., No. 08-13555 (Bankr. S.D.N.Y. Mar. 3, 2011), ECF No. 14789. The court ordered that the amounts of any payments and any other economic terms resulting from any of the settlements reached pursuant to the procedures prescribed in the ADR Order be kept strictly confidential. *Id.* at 22–23. Therefore, whether *Harrier* paid LBSF any sums of money to settle the matter is not public knowledge. See *id.*

²³⁷ See *supra* note 217 and accompanying text.

C. Flip Clauses: BNY

Perhaps the most controversial decision arising from the Lehman Brothers bankruptcy proceedings was the bankruptcy court's decision involving a matter of first impression in *Lehman Bros. Special Financing Inc. v. BNY Corporate Trustee Services (In re Lehman Bros. Holdings Inc.)* ("BNY").²³⁸ In *BNY*, the bankruptcy court held that a Flip Clause contained in certain transaction documents associated with a CDO transaction was not enforceable because it qualified as an unenforceable ipso facto clause.²³⁹ This case is significant because the court did not allow a non-debtor, Non-defaulting Party to enforce an ipso facto clause against a Debtor where enforcement was based on the bankruptcy filing of an entity affiliated with the Debtor, and not based on the Debtor's own bankruptcy filing.²⁴⁰ The case is also significant because the bankruptcy court reached a conclusion completely opposite of an English court's reading of the same facts.²⁴¹ Accordingly, the English court's decision could be persuasive authority for a U.S. bankruptcy court in a district other than the Southern District of New York, or for any higher court in the U.S., that confronts the issue of whether an ipso facto clause is enforceable against a Debtor where the enforcement is based on the bankruptcy filing of an entity affiliated with the Debtor, and not based on the Debtor's own filing.

BNY involved the following facts. In a transaction governed by English law, BNY was a party to a Principal Trust Deed (which is similar to an indenture in the United States) with Dante Finance Public Limited Company associated with the Dante Programme, a multi-issuer secured obligation program.²⁴² As part of the structure of the transaction, Lehman Brothers International (Europe) established an SPV named Saphir that sold secured

²³⁸ *Lehman Bros. Special Fin. Inc. v. BNY Corp. Tr. Servs. Ltd. (In re Lehman Bros. Holdings Inc.)*, 422 B.R. 407, 418–19 (Bankr. S.D.N.Y. 2010). See generally Jones et al., *supra* note 39 (discussing decision as controversial); David B. Stratton & Michael J. Custer, *Shot Heard Around the CDO World: Flip Clauses Found to Be Unenforceable Ipso Facto Provisions*, AM. BANKR. INST. J., Apr. 2010, at 30; Nicole Bullock & Anousha Sakoui, *Lehman SPV Ruling Sparks Controversy*, FIN. TIMES (Jan. 27, 2010, 2:00 AM), <http://www.ft.com> (click in the box to the right of "Subscribe" then search "Lehman SPV Ruling Sparks Controversy") ("It is a controversial ruling which will be closely scrutinized for its implications for the structured products and derivatives markets."). Previously, the author published a short article regarding implications of *BNY* that are not set forth herein. See Marchetti, *supra* note 117, at 14. Portions of that article regarding the facts and background of *BNY* appear herein as they are important to the proposals made in this Article.

²³⁹ *BNY*, 422 B.R. at 418–19.

²⁴⁰ See *id.* at 420. Later, the bankruptcy court reached the same conclusion in a dispute between LBSF and Ballyrock ABS CDO 2007—1 Limited. See *Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007—1 Ltd. (In re Lehman Bros. Holdings Inc.)*, 452 B.R. 31 (Bankr. S.D.N.Y. 2011).

²⁴¹ See *infra* Part III.C.1.

²⁴² *BNY*, 422 B.R. at 413.

notes to various investors.²⁴³ Perpetual Trustee Company Limited bought two series of the notes.²⁴⁴ Various transaction documents governed the notes.²⁴⁵

As part of the overall transaction, LBSF entered into swap agreements with Dante.²⁴⁶ Those swaps fell under an ISDA Master Agreement between the parties.²⁴⁷ In its role as trustee, BNY held collateral for Saphir's creditors.²⁴⁸ Both Perpetual and LBSF were creditors of Saphir.²⁴⁹ The transaction documents contained a waterfall provision that provided that Saphir would pay any and all amounts owed to LBSF, as its swap counterparty, before making any payments owed to Perpetual, as noteholder.²⁵⁰ The waterfall provision contained a Flip Clause that provided that this priority of payment scheme would be flipped if LBSF triggered an Event of Default under the ISDA Master Agreement.²⁵¹ Under the Flip Clause, if an Event of Default occurred under the ISDA Master Agreement between LBSF and Saphir, Saphir would have to pay any and all amount it owed to Perpetual before paying any amounts Saphir owed to LBSF.²⁵²

After its bankruptcy filing, LBSF contacted BNY and stated that the Flip Clause contained in the transaction documents was not enforceable.²⁵³ Shortly thereafter, Saphir sent LBSF a termination notice that terminated the parties' ISDA Master.²⁵⁴ Under the transaction documents, the termination of the ISDA Master Agreement triggered Saphir's obligation to redeem the notes.²⁵⁵

1. The English Court Proceeding and Decision

Concerned that there was not sufficient collateral to fully pay the amounts Saphir owed to Perpetual and LBSF, Perpetual commenced an action in the High Court of Justice, Chancery Division ("High Court") seeking clarity as to

²⁴³ *Id.*

²⁴⁴ *Id.*

²⁴⁵ *Id.*

²⁴⁶ *Id.*

²⁴⁷ *Id.*

²⁴⁸ *Id.*

²⁴⁹ *Id.*

²⁵⁰ *Id.*

²⁵¹ *Id.*

²⁵² *Id.*

²⁵³ *Id.*

²⁵⁴ *Id.* at 413–14.

²⁵⁵ *Id.*

the enforceability of the Flip Clause.²⁵⁶ Shortly thereafter, while the English litigation was occurring, LBSF commenced an adversary proceeding in the U.S. Bankruptcy Court for the Southern District of New York against BNY (the “New York Litigation”).²⁵⁷ LBSF sought, *inter alia*, a declaration that the Flip Clause qualified as an unenforceable *ipso facto* clause under §§ 365 and 541.²⁵⁸ LBSF filed a summary judgment motion in support of the arguments advanced in its complaint in the New York Litigation.²⁵⁹ Later, BNY filed a cross-motion for summary judgment in the New York Litigation.²⁶⁰

The High Court held in favor of Perpetual and held that the Flip Clause was enforceable.²⁶¹ Specifically, it held that the Flip Clause did not violate the “anti-deprivation principle” under English law because the Flip Clause took effect on September 15, 2008—the LBHI Petition Date, which occurred before the LBSF Petition Date.²⁶² In support of this holding, the High Court stated that the LBHI Petition Date triggered the Flip Clause, not the LBSF Petition Date, because LBHI was LBSF’s Guarantor, and a Guarantor’s bankruptcy filing is an Event of Default under the ISDA Master Agreement.²⁶³

2. *The Bankruptcy Court’s Decision*

In diametric opposition to the English Court, the U.S. Bankruptcy Court for the Southern District of New York in the New York Litigation held that the Flip Clause was not enforceable because it was an unenforceable *ipso facto*

²⁵⁶ See *id.* at 410–11; see also Complaint at 7, *Lehman Bros. Special Fin. Inc. v. BNY Corp. Tr. Servs. Ltd.* (*In re Lehman Bros. Holdings Inc.*), 422 B.R. 407 (Bankr. S.D.N.Y. 2010) (No. 1:09-AP-01242).

²⁵⁷ *BNY*, 422 B.R. at 411.

²⁵⁸ *Id.*

²⁵⁹ *Id.*

²⁶⁰ *Id.* at 412.

²⁶¹ *Id.* at 411.

²⁶² *Id.* The anti-deprivation principle provides that “there cannot be a valid contract that a man’s property shall remain his until bankruptcy, and on the happening of that event go over to someone else, and be taken from his creditors.” *Perpetual Tr. Co. v. BNY Corp. Tr. Servs. Ltd.*, [2009] EWHC (Ch) 1912, [2009] 2 BCLC 400 (Eng.). The *ipso facto* provisions of the Code seem to provide broader protections to a chapter 11 debtor because they prevent, *inter alia*, any modification of any rights of a debtor in an executory contract or a debtor’s interest in property, based on the commencement of a bankruptcy case or based on the financial condition of the debtor. See 11 U.S.C. §§ 365(e)(1), 541(c)(1)(B) (2012).

²⁶³ *Perpetual Tr. Co.*, [2009] EWHC (Ch) 1912. LBSF filed an appeal of the High Court’s decision to the Court of Appeal, Civil Division (the “Court of Appeal” and, together with the High Court, the “UK Courts”). *Id.* at 412. Before summary judgment briefing concluded in the New York Litigation, the Court of Appeal issued a decision upholding the High Court’s decision. *Id.* See generally *Perpetual Tr. Co. v. BNY Corp. Tr. Servs. Ltd.*, [2009] EWCA (Civ) 1160, [2010] Ch 347 (Eng.).

clause.²⁶⁴ Furthermore, again, in diametric opposition to the English Court, the bankruptcy court stated that the LBSF Petition Date, and not the LBHI Petition Date, triggered the Flip Clause.²⁶⁵

a. The Case or “a Case”

Moreover, the Bankruptcy Court stated that, under the Code, it did not matter whether the LBHI Petition Date or the LBSF Petition Date triggered the Flip Clause, because it was an unenforceable ipso facto clause.²⁶⁶ The court further stated that the Lehman debtors’ different corporate entities comprised an “integrated enterprise” and that “the financial condition of one [Lehman] affiliate affects the others.”²⁶⁷ The court acknowledged that it took a novel approach in concluding that the separate bankruptcy filings of LBSF and LBHI, which occurred on different dates, but in close proximity to each other, constituted a singular event for purposes of §§ 365(e)(1) and 541(c)(1)(B).²⁶⁸ The bankruptcy court stated that the plain language of §§ 365(e)(1) and

²⁶⁴ *BNY*, 422 B.R. at 414–15. Furthermore, the bankruptcy court stated that §§ 365 and 541 of the Code nullify ipso facto clauses. *Id.*

²⁶⁵ *Id.* at 418. Through the court’s interpretation of those documents, it reasoned that although an Event of Default may have occurred under the Swap Agreements as a result of LBHI’s bankruptcy filing, that Event of Default, under the Transaction Documents, was not sufficient by itself to effectuate the Flip Clause. *Id.* Instead, the court found that pursuant to the terms of the Transaction Documents, Noteholder Priority would be triggered only when amounts were paid “in connection with the realization or enforcement of the [Collateral].” *Id.* The court noted that, as of the LBSF Petition Date, the Collateral had not been sold. *Id.*

²⁶⁶ *Id.* The court pointed to §§ 365(e)(1) and 541(c)(1)(B). *Id.*

²⁶⁷ *Id.* at 419. In an different bankruptcy decision that did not involve derivatives, Judge Peck, the bankruptcy judge that issued the Bench Ruling in the *Metavante* matter and also wrote the *BNY* decision, made a similar holding regarding a cross default clause triggered by the bankruptcy filing of a Debtor’s affiliate. *See In re Charter Commc’ns*, 419 B.R. 221, 250–51 (Bankr. S.D.N.Y. 2009). There, the court stated that: “[The Debtor] is an integrated enterprise, and the financial condition of one affiliate affects the others.” *Id.* at 251.

²⁶⁸ *BNY*, 422 B.R. at 422. The court stated: “No case has ever declared that the operative bankruptcy filing is not limited to the commencement of a bankruptcy case by the debtor-counterparty itself but may be a case filed by a related entity.” *Id.* The court also acknowledged:

[T]here is an element of commercial expectation that underlies the subordination argument. LBSF was instrumental in the development and marketing of the complex financial structures that are now being reviewed from a bankruptcy perspective. The Court assumes that a bankruptcy affecting any of the Lehman Entities was viewed a highly remote contingency at the time that the Transaction Documents were being prepared. At that time, LBSF agreed to a subordination of its Swap Counterparty Priority in the hard-to-imagine event that it should be in default at some time in the future. Capital was committed with this concept embedded in the transaction. But the ipso facto protections of sections 365 and 541 of the Bankruptcy Code apply uniformly, regardless of market expectations. They exist and should be enforced to preserve property interests for the benefit of all creditor constituencies.

Id. at 422 n.9.

541(c)(1)(B) forbids any modification of a debtor's contractual right in an executory contract based on an *ipso facto* clause triggered by the filing of "a case under this title."²⁶⁹ The court reasoned that it was "convinced that the chapter 11 cases of LBHI and its affiliates is a single event for purposes of interpreting the *ipso facto* language" contained in §§ 365(e)(1) and 541(c)(1)(B).²⁷⁰

The bankruptcy court noted that the plain meaning of §§ 365(e)(1) and 541(c)(1)(B) presumably applies to the commencement of any bankruptcy case "that is related in some appropriate manner to the contracting parties"²⁷¹ and stated:

If the words are not tied to the case filed by the particular debtor that is a party to a specified executory contract, under what circumstances is the bankruptcy case of another debtor sufficiently related to rights of the parties to such an executory contract that is reasonable to trigger the *ipso facto* protections of these sections? Opening up the subject to cases filed by debtors other than the counterparty itself has the potential of opening up a proverbial "can of worms" that may lead to speculation as to the nature and degree of the relationship between debtors that is needed in order to properly apply the provision.²⁷²

²⁶⁹ *Id.* at 419.

²⁷⁰ *Id.* at 420. The court then analyzed the legislative history of §§ 365(e)(1) and 541(c)(1)(B) and noted that the early versions of those sections contained language that proscribed modification of a debtor's contractual right in an executory contract based on a contractual provision in an agreement conditioned upon *the debtor's* bankruptcy filing, but that Congress later rejected that language in favor of the broader language, currently found in the Code, which proscribes any modification of a debtor's contractual right in an executory contract based on a provision in an agreement conditioned upon *a bankruptcy filing*. *Id.* at 418–19. The court stated:

The legislative history of section 365(e)(1) and section 541(c)(1)(B) provides helpful guidance in understanding the meaning of these sections and in analyzing how to interpret the words "a case" used in these sections. An early version of what eventually became section 365(e)(1) referred to the "commencement of a case under this Act *by or against the debtor*." Similarly, a draft of the language that became section 541(c)(1) at one time referred to "the commencement of a case under this title *concerning the debtor*." This initial use and later rejection of limiting language demonstrates that Congress considered, but ultimately rejected, drafting sections 365(e)(1) and 541(c)(1)(B) in a manner that would have expressly restricted their application to the bankruptcy case of the debtor counterparty.

Id. at 419 (citations omitted). The court stated that although the language "commencement of a case under this title" seems straightforward at first blush, "what has been left out raises a number of questions." *Id.*

²⁷¹ *Id.*

²⁷² *Id.*

The bankruptcy court stated that this language could be construed in a manner that renders “multiple subsidiaries under common control sufficiently related” to each other as to trigger the ipso facto protections set forth in §§ 365(e)(1) and 541(c)(1)(B).²⁷³ The bankruptcy court further stated that an additional possibility is that a court might deem a Debtor and its Guarantor “as sufficiently related to impose ipso facto protections [contained in §§ 365(e)(1) and 541(c)(1)(B)] if either the principal or the guarantor were to file for bankruptcy relief.”²⁷⁴

The court then held that the Flip Clause was an unenforceable ipso facto clause, and that any enforcement of it would violate the automatic stay.²⁷⁵ In reaching this conclusion, the court did not give market participants an extensive explanation as to when and in what circumstances the different bankruptcy filings of a Debtor and an affiliated Guarantor would qualify as a singular event for purposes of §§ 365(e)(1) and 541(c)(1)(B).²⁷⁶

b. Safe Harbors

In its cross-motion for summary judgment, BNY argued that the Flip Clause was enforceable under the Safe Harbors.²⁷⁷ Construing the Safe Harbors narrowly, the bankruptcy court rejected this argument and stated that the Safe Harbors only allow a Non-defaulting Party to a swap agreement with a bankruptcy counterparty to enforce its

²⁷³ *Id.* at 419 n.6.

²⁷⁴ *Id.* The court continued, stating: “This opinion identifies these possibilities, but makes no ruling as to whether any of these relationships is sufficiently close the mandate that the bankruptcy of one debtor entity necessarily would lead to the protection of property interests of any other entity.” *Id.* The court acknowledged that there could be a “potential for future disputes over the interpretation” of the language contained in §§ 365(e)(1) and 541(c)(1)(B), but “decline[d] . . . to make any broad pronouncements, interpret the language in the abstract or to expand on the various relationships between or among debtor entities that would make it appropriate for one debtor to invoke [ipso facto] protection due to the filing of another affiliated member of a corporate family.” *Id.* at 419. The court continued to state that the “description of the kind of relationship that is sufficient to trigger [ipso facto] protections affecting the rights of contracting parties is best left to a case-by-case determination” and with that “principal of restraint in mind” it applied the “a case” language to the LBSF and LBHI chapter 11 filings. *Id.* In reaching this conclusion, the court acknowledged that: (1) the issues before it were “unprecedented;” (2) it “was not aware of any other case that . . . construed the ipso facto provisions of the Bankruptcy Code under [similar] circumstances;” and (3) its decision “may be a controversial one.” *Id.* at 422.

²⁷⁵ *Id.* at 419–20.

²⁷⁶ See Stratton & Custer, *supra* note 238, at 66 (discussing lack of guidance provided by court’s decision as creating “significant uncertainty with respect to the enforceability in bankruptcy of flip clauses or similar market-standard subordination provisions in CDO transactions”).

²⁷⁷ *BNY*, 422 B.R. at 421–22.

contractual rights to (i) liquidate, terminate or accelerate “one or more swap agreements because of condition [sic] of the kind specified in [§] 365(e)(1)” or (ii) “offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of one or more swap agreements.”²⁷⁸

The bankruptcy court went on to state that the Flip Clause set forth the process to be used in paying the proceeds flowing from the termination of the ISDA Master Agreement, but did not “comprise [a] part of [the] swap agreements themselves.”²⁷⁹ Furthermore, the bankruptcy court stated that § 560 did not apply to the Flip Clause because § 560 is expressly limited to the “liquidation, termination or acceleration (not the alteration of rights as they then exist) and refer[s] specifically to swap agreements.”²⁸⁰

BNY was granted permission to file an interlocutory appeal of the bankruptcy court’s decision to the U.S. District Court for the Southern District of New York.²⁸¹ The parties settled the matter before the U.S. District Court adjudicated the appeal.²⁸²

D. Decisions from Non-U.S. Jurisdictions Dealing with Section 2(a)(iii)

Courts in other countries have addressed section 2(a)(iii). The clause seems to be enforceable in Australia and in the U.K.²⁸³ One of the first cases that

²⁷⁸ *Id.* at 421–22 (quoting 11 U.S.C. § 560 (2012)). The court analyzed the Swap Agreements and noted that they did not at all reference the Flip Clause. *Id.*

²⁷⁹ *Id.* at 421.

²⁸⁰ *Id.* BNY also argued that the Flip Clause was an enforceable subordination agreement. *Id.* The bankruptcy court rejected this argument. *Id.* at 421–22. *Collier on Bankruptcy* questions the reasoning of this decision stating that:

[T]he decision is questionable because (a) the priority-shifting provisions were contained in the security arrangement for the subject swap agreements and thus, were a swap agreement under the Bankruptcy Code section 101 (53B)(A)(vi) and (b) the priority-shifting provision were arguably a liquidation or termination right.

⁵ COLLIER ON BANKRUPTCY, *supra* note 144, ¶ 560.02.

²⁸¹ See *Lehman Bros. Special Fin. Inc. v. BNY Corp. Tr. Servs. Ltd. (In re Lehman Bros. Holdings Inc.)*, No. 09–01242, 2010 WL 10078354 (Bankr. S.D.N.Y. Sept. 20, 2010) (granting BNY leave to appeal).

²⁸² See Order Pursuant to Rule 9019 of the Federal Rules of Bankruptcy Procedure for Approval of a Settlement Among Lehman Bros. Special Financing Inc., BNY Corp. Trustee Services Ltd., Perpetual Trustee Co. Ltd., & Others, Relating to Certain Swap Transactions with Saphir Finance Public Ltd. Co., *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Dec. 16, 2010), ECF No. 13511.

²⁸³ See, e.g., *Enron Austral. Fin. Pty. Ltd v TXU Elec. Ltd.* [2003] NSWSC 1169 (Austl.); *Lomas v. JFB Firth Rixson Inc.*, [2010] EWHC (Ch) 3372, [2011] 2 BCLC 120 (Eng.) (International Swaps and Derivatives Association, Inc. joined as intervenor).

seemed to address section 2(a)(iii) was *Enron Australia Finance Party Ltd. v. TXU Electricity Ltd.* (the “TXU Case”).²⁸⁴ The TXU Case, however, did not involve litigation as to whether section 2(a)(iii) was enforceable; rather, in that case the parties expressly stipulated that section 2(a)(iii) was enforceable under applicable Australian insolvency law.²⁸⁵

On December 21, 2010, the High Court of Justice in London (the “High Court”), held in *Lomas et al. Together the Joint Administrators of Lehman Brothers International (Europe) v. JFB Firth Rixson Inc.* (“*Lomas*”) that a Non-defaulting Party may, in certain circumstances, rely on section 2(a)(iii) of the ISDA Master Agreement to withhold payments to a defaulting counterparty that triggered an Event of Default under an ISDA Master Agreement by entering into formal insolvency proceedings under U.K. law.²⁸⁶ The holding in *Lomas* is diametrically opposed to the U.S. bankruptcy courts’ rulings in the *Metavante* matter and *BNY*.

Specifically, the *Lomas* court held: (1) Section 2(a)(iii) suspends, but does not extinguish, a Non-defaulting Party’s payment obligation(s) to a Defaulting Party; (2) this suspended payment obligation lapses on the scheduled termination date of the relevant swap transaction if at that time an Event of Default continues to exist; (3) section 2(a)(iii) does not, under certain circumstances, violate the anti-deprivation principle, which under English law is similar to, but not as broad as, §§ 365 and 541; (4) section 2(a)(iii) does not constitute a penalty when a Non-defaulting Party seeks to invoke it upon an Event of Default with respect to the Defaulting Counterparty; (5) a Non-defaulting Party does not have to decide within a reasonable time period, whether or when to designate an Early Termination Date with respect to the bankrupt defaulting counterparty; and (6) a Defaulting Party’s loss of the right to receive a contingent payment as a result of an Event of Default does not

²⁸⁴ See *TXU*, [2003] NSWSC 1169.

²⁸⁵ *Id.* Instead, the main issues in the *TXU* case were whether Enron Australia, which caused an Event of Default under its ISDA Master Agreement with TXU by commencing formal insolvency proceedings under Australian law and was in the money under that ISDA Master Agreement at that time, could: (1) terminate the ISDA Master Agreement early, before the scheduled termination date of the last trade documented thereunder; and (2) force TXU to then pay Enron Australia the Early Termination Amount. *Id.* TXU prevailed in that matter. *Id.* For a more detailed discussion of the TXU case, see Marchetti, *supra* note 182, at 14–15; Weinstein, et al., *supra* note 201, at 6.

²⁸⁶ See *Lomas*, [2010] EWHC (Ch) 3372. Like the *Metavante* matter, the *Lomas* case involved a matter of first impression regarding the enforceability of section 2(a)(iii) of the ISDA Master Agreement in the context of formal U.K. insolvency proceedings. *Id.*

qualify as a forfeiture or a penalty under U.K. law.²⁸⁷ Moreover, in dicta, the *Lomas* court stated that even if section 2(a)(iii) did violate the anti-deprivation principal, which it did not, section 2(a)(iii) would be enforceable if either: (1) LBHI filed for bankruptcy before LBIE filed for administration; or (2) LBHI filed for bankruptcy at the same time LBIE filed for administration.²⁸⁸

These decisions raise several issues. First, the *BNY* decision is important because when read together with the decision in the *Metavante* matter, it seems to indicate that a Payment Suspension Clause or Walkaway Clause would not be enforceable if the Non-defaulting Party seeking to enforce such a clause seeks to do so based not on the Debtor's bankruptcy filing, but based on the bankruptcy filing of the Debtor's Parent-Guarantor or based on any one of the Debtor's affiliates.²⁸⁹ Indeed, as mentioned above, market participants that enter into derivative transactions under an ISDA Master Agreement are generally large corporations comprised of various affiliates within the same corporate enterprise.

It is common to have a situation like the one in the *Lehman Brothers* bankruptcy where the Parent-Guarantor guarantees the obligations of its subsidiaries under an ISDA Master Agreement.²⁹⁰ Likewise, it is not uncommon for a parent company to file for chapter 11 protection first, and gradually place its subsidiaries into chapter 11 protection over a time period spanning approximately one or more months.²⁹¹ If the precedent were otherwise, the creditors of both the parent and of any of its affiliates could be deprived of valuable payment rights falling under an ISDA Master Agreement if a scenario like the one in the *Metavante* matter or *BNY* arose.²⁹²

²⁸⁷ *Id.*; see Jeannette K. Boot & Michael T. Nguyen, *A Transatlantic Tangle: U.S. and U.K. Take Opposite Positions on Section 2(a)(iii)*, FUTURES & DERIVATIVES L. REP., Aug. 2012, at 1 (discussing *Lomas* and similar UK cases).

²⁸⁸ See *Lomas*, [2010] EWHC (Ch) 3372 [114]–[117].

²⁸⁹ See, e.g., September 15 Transcript, *supra* note 48, at 103–12; *Lehman Bros. Special Fin. Inc. v. BNY Corp. Tr. Servs. Ltd. (In re Lehman Bros. Holdings Inc.)*, 422 B.R. 407, 418–20 (Bankr. S.D.N.Y. 2010).

²⁹⁰ See Howard T. Spilko & Cesar Bello, *What Every Hedge Fund Should Know in Structuring Its ISDA Derivatives Facilities*, HEDGEWORLD DAILY NEWS, 2005 WLNR 18137166 (Nov. 9, 2005), available at http://www.kramerlevin.com/files/Publication/a6807aff-0e34-4502-96b5-03828bfca537/Presentation/PublicationAttachment/6a617048-0673-4924-857b-0357d9a551fb/3989_KLNews_Spilko_v2.pdf.

²⁹¹ See, e.g., *Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007—1 Ltd. (In re Lehman Bros. Holdings Inc.)*, 452 B.R. 31 (Bankr. S.D.N.Y. 2011); *BNY*, 422 B.R. at 418–19. This also occurred in other large chapter 11 cases such as *Enron* and *WorldCom*. See, e.g., *In re Enron Corp.*, 357 B.R. 32, 35 (Bankr. S.D.N.Y. 2006) (noting different bankruptcy petition dates of parent company and subsidiaries); *In re WorldCom, Inc.*, 2005 WL 3832065 (Bankr. S.D.N.Y. 2005) (noting different bankruptcy petition dates of parent company and subsidiaries).

²⁹² See, e.g., *Ballyrock*, 452 B.R. at 34–35, 39–40.

Secondly, the *BNY* decision is important because it may provide a modicum of clarity as to what would occur if Congress repealed the Safe Harbors, as several academics have urged.²⁹³ Consider the following scenario. The Safe Harbors are repealed. A Debtor that is a party to an ISDA Master Agreement and its Parent-Guarantor both file for bankruptcy, either on the same date or on different dates. Now the Non-defaulting Party seeks to either terminate the ISDA Master Agreement or enforce a Payment Suspension Clause, a Walkaway Clause (if applicable), or a Flip Clause (if applicable). In such a scenario, the Debtor would argue that such clauses are unenforceable ipso facto clauses under §§ 365 and 541. The Non-defaulting Party, however, could argue that, even though the Safe Harbors were repealed, it sought to exercise its contractual rights to terminate the ISDA Master Agreement, or its contractual rights under a Payment Suspension Clause, a Walkaway Clause, or a Flip Clause, based not on the Debtor's bankruptcy filing, but on the filing of its Parent-Guarantor or one of its affiliates, which, as a completely separate corporate entity, could arguably qualify as a separate bankruptcy filing.

Furthermore, clarity regarding this situation is not just important to the Non-defaulting Party to an ISDA Master Agreement and a Debtor (and one or more of the Debtor's affiliates). As mentioned above, many parties in structured financing transactions (including CDO transactions) and similar type of structured transactions are SPVs.²⁹⁴ In these types of structured transactions, an asset manager generally "manages" the assets of the SPV, including any derivative transactions to which the SPV may be a party.²⁹⁵ When the Lehman entities filed for chapter 11 protection, asset managers found themselves terminating derivative transactions on behalf of the SPVs they managed.²⁹⁶ These asset managers most likely thought that Payment Suspension Clauses, Walkaway Clauses, and Flip Clauses were enforceable under the Safe Harbors or were enforceable because such clauses were triggered by LBHI's bankruptcy filing, not LBSF's.²⁹⁷ Disputes also arose as to the Early Termination Amounts owed as the result of such early terminations.²⁹⁸ Depending on the exculpatory language contained in the

²⁹³ See generally Lubben, *Repeal the Safe Harbors*, *supra* note 8.

²⁹⁴ See *supra* text accompanying note 108.

²⁹⁵ See, e.g., IFTIKHAR U. HYDER, *THE BARCLAYS CAPITAL GUIDE TO CASH FLOW COLLATERAL DEBT OBLIGATIONS 21* (2002), available at http://people.stern.nyu.edu/igiddy/ABS/barclays_cdguide.pdf.

²⁹⁶ See, e.g., Harrier Complaint, *supra* note 104.

²⁹⁷ See, e.g., *id.*

²⁹⁸ See generally Adversary Complaint and Objection, *Lehman Bros. Holdings, Inc. v. Nomura Sec. Co.*, No. 10-03229 (Bankr. S.D.N.Y. Apr. 23, 2010) [hereinafter *Nomura Complaint*].

relevant asset management agreements, such asset managers could be liable to the note holders of the SPVs for terminating swap transactions that, had they been left in place, may not have triggered such high Early Termination Amount liabilities.²⁹⁹

Although the *BNY* decision has provided some clarity, it, like the decision in the *Metavante* matter, is merely a bankruptcy court decision from one circuit. There are no other decisions from other circuits or any higher level courts in the U.S. that have ruled on the same issues. This lack of precedent is further complicated by the holdings in the U.K. courts, which reached conclusions opposite to those reached by the Bankruptcy Court for the Southern District of New York.³⁰⁰ Indeed, the decisions of the U.K. courts could be persuasive authority to different U.S. courts regarding the same issues.

To remedy this issue, Congress should amend the Code to so that it is clear that Payment Suspension Clauses, Walkaway Clauses, and Flip Clauses³⁰¹ are

²⁹⁹ Later, issues arose as to whether these Asset Managers had authority to enter into settlements with the Lehman Entities in certain mandatory, non-binding alternative dispute resolution proceedings. See Andrew J. Olejnik, *Lehman Brothers' ADR Procedures for Resolving Its Derivative Contracts in Bankruptcy*, BANKR. STRATEGIST, June 2012, available at http://jenner.com/system/assets/publications/9813/original/081061201_Jenner.pdf; see also Debtors' Motion Pursuant to Section 105(a) of the Bankruptcy Code & General Order M-390 for Authorization to Implement Alternative Dispute Resolution Procedures for Affirmative Claims of the Debtors Under Derivatives Transactions with Special Purpose Vehicle Counterparties at 6-7, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Nov. 24, 2010), ECF No. 13009. Some Asset Management Agreements were not clear as to whether the Asset Manager had such authority. See *id.*; see also Ltd. Objection of Bank of America, N.A. Successor by Merger to Lasalle Bank, N.A., Solely in Its Capacity as Trustee Under Certain Pooling and Servicing Agreements to Debtors' Motion Pursuant to Section 105(a) of the Bankruptcy Code & General Order M-390 for Authorization to Implement Alternative Dispute Resolution Procedures for Affirmative Claims of the Debtors Under Derivatives Transactions with Special Purpose Vehicle Counterparties at 4-7, *Lehman Bros. Holdings Inc.*, No. 08-13555 (Dec. 9, 2010), ECF No. 13343; Joinder of HSBC Bank USA, N.A., as Trustee, in Objection of the Bank of N.Y. Mellon, the Bank of N.Y. Mellon Trust Co., N.A. and BNY Corp. Trustee Services. Ltd. to Debtors' Motion Pursuant to Section 105(a) of the Bankruptcy Code & General Order M-390 for Authorization to Implement Alternative Dispute Resolution Procedures for Affirmative Claims of the Debtors Under Derivatives Transactions with Special Purpose Vehicle Counterparties, *Lehman Bros. Holdings Inc.*, No. 08-13555 (Dec. 8, 2010), ECF No. 13315.

³⁰⁰ See generally Boot & Nguyen, *supra* note 287 (discussing *Lomas* and similar UK cases).

³⁰¹ Some commentators have suggested that the unenforceability of Flip Clauses in the bankruptcy context could adversely affect the credit ratings of the notes issued in connection with certain structured finance transactions. See Jones, et al., *supra* note 39, at 344-45. To address this situation, such transactions could be structured in a different fashion. For example, the payment waterfall provision used in structured financing transactions could be drafted so that the swap provider is paid after the noteholders both where: (1) the swap provider has not experienced an Event of Default and (2) the swap provider has experienced an Event of Default. Of course, a sponsor may not favor this approach because it may delay payment of part of the administrative costs of such a structured financing transaction until the various noteholders are paid in full. Such a structure may also result in increased swap pricing.

not enforceable against a Debtor where the Non-defaulting Party seeks to enforce such clauses based on (1) that Debtor's financial condition or bankruptcy filing or (2) the financial condition or bankruptcy filing of any one of the Debtor's affiliates.³⁰² Such an amendment to the Code would clarify the enforceability of the Payment Suspension Clauses, Flip Clauses, and Walkaway Clauses in the bankruptcy context and would lead to easier risk management for Non-defaulting Parties on the one hand, and make the Code more workable for the reorganization of financial institutions on the other hand.³⁰³ Likewise, such clarity would likely make the task of drafting Living Wills easier. Entities that are required to draft Living Wills are large "integrated enterprises" consisting of numerous subsidiaries within one corporate enterprise that would likely face the same issues the Lehman entities faced regarding the enforceability of Payment Suspension Clauses, Flip Clauses, and Walkaway Clauses if such entities were to file for bankruptcy protection.

E. Triangular Setoff Clauses

1. Cross-Affiliate Netting and Triangular Setoff

As mentioned above, market participants frequently insert Triangular Setoff Clauses into the Schedule to the ISDA Master Agreement as a credit risk management device so that they can net out credit exposures among multiple subsidiaries and affiliates that fall within the same corporate

³⁰² Such an amendment could read something similar to the following language:

Any provision in any agreement whatsoever, whether or not such agreement qualifies as a swap agreement, repurchase agreement, forward contract, master netting agreement or any other agreement related thereto or protected under §§ 362(b)(6), (7), (17); 546(e), (f), (g); 555; 556; 560 and 561 of this Title that suspends, conditions, or extinguishes a payment obligation of a party, in whole or in part, or does not create a payment obligation of a party that would otherwise exist, or elevates the payment priority of a party in a payment priority provision related to any of the aforementioned agreements, shall not be enforceable if such provision is based on (i) the insolvency or financial condition of the debtor or any one of its affiliates; or (ii) the commencement of a case by the debtor or any one of the debtor's affiliates under this title.

Alternatively, such language could include a time restriction (i.e. thirty to sixty-days) within which the separate bankruptcy filings of a Debtor and its particular affiliate(s) must occur in order for a Walkaway Clause, Payment Suspension Clause, or Flip Clause to be rendered ineffective against both the Debtor and its particular affiliate(s).

³⁰³ It seems that there is more clarity regarding such clauses under Title II of the Dodd-Frank Act than there is under the Code. See Mark A. McDermott & David M. Turetsky, *Restructuring Large, Systemically-Important, Financial Companies*, 19 AM. BANKR. INST. L. REV. 401, 431–32 (2011) (discussing Walkaway Clauses and the *Lehman* decisions).

enterprise of a counterparty to an ISDA Master Agreement.³⁰⁴ Until recently, there was a widely held belief among market participants that these Triangular Setoff Clauses were enforceable in the bankruptcy context.³⁰⁵ Several recent court decisions have caused anxiety among market participants regarding this belief.³⁰⁶ Two of these decisions came out of the Bankruptcy Court for the District of Delaware. One of these decisions was the *SemCrude* case.³⁰⁷ The other was a recent decision in the *American Home Mortgage* chapter 11 proceedings.³⁰⁸ The other decision is a Bankruptcy Court Decision arising from a dispute between Lehman Brothers, Inc. and UBS AG (the “UBS Decision”).

a. *SemCrude and American Home Mortgage*

In *SemCrude*,³⁰⁹ the bankruptcy court held that Chevron Products Company could not enforce a Triangular Setoff agreement against SemCrude and two of its affiliates, all of which filed for chapter 11 protection.³¹⁰ The bankruptcy court in *SemCrude* stated that “mutuality” as set forth in § 553, could not be created by contract and that there was not a “contractual exception” to the mutuality requirement set forth in § 553.³¹¹

As the Triangular Setoff agreement was associated with three separate agreements for the purchase and sale of commodities with the *SemCrude* debtors, Chevron moved for reconsideration on January 20, 2009, arguing that the contracts at issue qualified as forward contracts or swap agreements, and thus fell under the Safe Harbors.³¹² The *SemCrude* court denied Chevron’s Motion for Reconsideration on procedural grounds.³¹³ In November 2013, the

³⁰⁴ See Fabien Carruzzo, *Managing Credit Risk of Derivatives Counterparties—A Practical Approach*, FUTURES & DERIVATIVES L. REP., Sept. 2010, at 10, 14–15 (discussing Triangular Setoff).

³⁰⁵ See generally Lauren Teigland-Hunt, *Chevron’s Bermuda Triangle: Delaware Bankruptcy Court Refuses To Enforce Contractual Cross-Affiliate Setoff Rights*, FUTURES & DERIVATIVES L. REP., Apr. 2009, at 1.

³⁰⁶ See, e.g., *Sass v. Barclays Bank P.L.C. (In re Am. Home Mortg., Holdings, Inc.)*, 501 B.R. 44 (Bankr. D. Del. 2013); *In re Lehman Bros. Inc. (UBS Decision)*, 458 B.R. 134 (Bankr. S.D.N.Y. 2011).

³⁰⁷ See generally Teigland-Hunt, *supra* note 305, at 29 (stating that *SemCrude* caused much concern among market participants).

³⁰⁸ *Am. Home Mortg., Holdings, Inc.*, 501 B.R. 44.

³⁰⁹ *In re SemCrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2010).

³¹⁰ *Chevron Prods. Co. v. SemCrude, L.P. (In re SemCrude, L.P.)*, 428 B.R. 590, 592 (D. Del. 2010).

³¹¹ See *id.* at 594.

³¹² See Chevron Products Co.’s Motion for Reconsideration at 2, *SemCrude, L.P.*, 428 B.R. 590 (No. 08-11525), ECF No. 2853. Those agreements were related to the purchase and sale of crude oil, gasoline, butane, isobutene, and propane. See *id.*

³¹³ See *SemCrude, L.P.*, 428 B.R. at 595. The bankruptcy court denied Chevron’s Motion for Reconsideration because, inter alia, Chevron failed to argue that the Triangular Setoff agreement at issue

Bankruptcy Court for the District of Delaware applied the ruling in *SemCrude* to derivative transactions and held that Triangular Setoff Clauses are not enforceable under the Safe Harbors.³¹⁴

b. The UBS Decision

The Bankruptcy Court for the Southern District of New York, ruling on a dispute between UBS, AG (“UBS”), and Lehman Brothers, Inc. (“LBI”), held that a Triangular Setoff clause contained in an ISDA Master Agreement is not enforceable in the bankruptcy context because “mutuality,” as required by § 553, cannot be created by contract.³¹⁵ The bankruptcy court further held that the Safe Harbors do not validate Triangular Setoff Clauses.³¹⁶

The UBS Decision involved the following facts: UBS and LBI entered into an ISDA Master Agreement, Schedule, and CSA.³¹⁷ The Schedule contained a Triangular Setoff Clause.³¹⁸ UBS and LBI then entered into various currency swaps that fell under their ISDA Master Agreement.³¹⁹ UBS terminated the ISDA Master Agreement with LBI on September 16, 2008.³²⁰ At that time, UBS held approximately \$170 million worth of collateral.³²¹ A short time later, LBI filed for SIPA liquidation.³²² Later, UBS sent a calculation notice to LBI claiming a setoff right against LBI regarding a portion of the collateral.³²³ UBS and LBI agreed that UBS had a right to set-off a portion of the collateral.³²⁴

qualified as a safe harbored contract prior to the bankruptcy court’s earlier decision. *See id.* The United States District Court for the District of Delaware recently affirmed the *SemCrude* decision. *Id.* at 595. Chevron appealed the District Court’s decision to the United States Court of Appeals for the Third Circuit. *Samson Energy Res. v. Luke Oil Co. (In re SemCrude L.P.)*, 728 F.3d 314 (3d Cir. 2013) (reversing district court’s dismissal and remanding for hearing on the merits).

³¹⁴ *Sass v. Barclays Bank P.L.C. (In re Am. Home Mortg., Holdings, Inc.)*, 501 B.R. 44, 57–60 (Bankr. D. Del. 2013) (holding that Triangular Setoff Clauses are not enforceable under the Safe Harbors). The bankruptcy court in the *American Home Mortgage* decision found the UBS Decision to be very persuasive. *See id.*

³¹⁵ *In re Lehman Bros. Inc. (“UBS Decision”)*, 458 B.R. 134 (Bankr. S.D.N.Y. 2011).

³¹⁶ *Id.* at 143–44.

³¹⁷ *Id.* at 137.

³¹⁸ *Id.* at 138.

³¹⁹ *Id.* at 137.

³²⁰ *Id.* UBS terminated the ISDA Master Agreement based on a cross-default stemming from swap agreements between UBS and some of LBI’s affiliates and the lowering of LBI’s credit rating. *Id.*

³²¹ *Id.*

³²² *Id.* LBI was a licensed-broker dealer and wholly-owned subsidiary of LBHI. *Id.* at 138. Broker dealers cannot file for chapter 11 bankruptcy protection, but instead file for SIPA liquidation. *See Securities Investor Protection Act of 1970*, 15 U.S.C. §§ 78aaa–78lll (2012).

³²³ *UBS Decision*, 458 B.R. at 137.

³²⁴ *Id.* at 137–38.

The parties, however, disagreed on UBS's right to retain approximately \$23 million of collateral based on the Triangular Setoff Clause contained in the schedule to the ISDA.³²⁵ UBS argued, *inter alia*, that the Triangular Setoff Clause was enforceable and allowed it to hold the \$23 million in collateral based on amounts that LBI owed to two UBS affiliates: UBS Securities L.L.C. and UBS Financial Services.³²⁶

As mentioned above, the bankruptcy court rejected UBS's arguments and held that the Triangular Setoff Clause was not enforceable in the bankruptcy context.³²⁷ First, the bankruptcy court looked to the express language of § 553 and stated that a party must demonstrate the following factors to exercise a right of setoff in the bankruptcy (or SIPA) context: (1) the amount owed by the debtor must be a debt that arose before the date of the debtor's bankruptcy (or SIPA) filing; (2) the amount owed by the debtor to the creditor must also be a debt that arose before the debtor's bankruptcy (or SIPA filing); and (3) mutuality must exist between the "debtor's claim against the creditor and the debt owed the creditor."³²⁸ The bankruptcy court then stated that, in the bankruptcy (or SIPA) context, Triangular Setoff Clauses violate the mutuality requirement of § 553 because "courts consistently find debts to be mutual only when they are in the same right and between the same parties, standing in the same capacity."³²⁹

³²⁵ *Id.* at 138–39 (discussing dispute over collateral). Of the approximate \$23 million at issue in the UBS Decision, approximately \$1.7 million resulted from a mistaken wire transfer from LBI to UBS Securities L.L.C., a UBS Subsidiary. *Id.* at 136. The mistaken wire transfer issue is not relevant to the issues discussed in this Article.

³²⁶ *Id.* at 138–39.

³²⁷ *Id.* at 139.

³²⁸ *Id.* at 139–40 (citations omitted). The bankruptcy court cited to its prior decision in *Swedbank. In re Lehman Bros. Holdings Inc. (Swedbank)*, 433 B.R. 101, 107 (Bankr. S.D.N.Y. 2010). In that case, LBHI had a bank account at Swedbank. *Id.* at 104. After LBHI's bankruptcy filing, the funds in the account grew substantially based on postpetition deposits and wire transfers. *Id.* at 105–06. Swedbank sought to set off this postpetition amount against a prepetition debt LBHI owed to Swedbank based on the termination of several ISDA Master Agreements LBHI guaranteed. *Id.* The bankruptcy court held that Swedbank could not set off a prepetition debt against the amounts that were placed into LBHI's bank account during the postpetition period, because those debts were not "mutual." *Id.* at 110–12. The U.S. District Court for the Southern District of New York upheld the bankruptcy court's decision. *Swedbank AB (PUBL) v. Lehman Bros. Holdings Inc. (In re Lehman Bros. Holdings Inc.)*, 445 B.R. 130 (S.D.N.Y. 2011), *aff'g Swedbank*, 433 B.R. 101; *see also* Peter Marchetti, *Lehman Decision Holds that Mutuality Must Exist to Exercise a Right of Setoff*, AM. BANKR. INST. J., July 2010, at 30 (discussing *Swedbank* in detail).

³²⁹ *UBS Decision*, 458 B.R. at 140 (internal quotation marks and citations omitted). The bankruptcy court further stated:

The clarity of [§ 553] is conclusive—mutuality quite literally is tied to the identity of a particular creditor that owes an offsetting debt. The right is personal, and there simply is no ability to get

In reaching this conclusion, the bankruptcy court analyzed prior decisions that seemed to recognize a contract exception that would allow a party to enforce a Triangular Setoff Clause in the bankruptcy context.³³⁰ The bankruptcy court pointed to the Seventh Circuit Court of Appeal's decision in *Inland Steel Co. v. Berger Steel Co.* ("Berger Steel").³³¹ The bankruptcy court noted that although *Berger Steel*, in dicta, discussed the ability of parties to contract for Triangular Setoff, the Seventh Circuit did not expressly state that such an agreement would be enforceable in the bankruptcy context.³³² The bankruptcy court concluded that *Berger Steel* was misquoted by several later courts for the proposition that a Triangular Setoff Clause would be enforceable in the bankruptcy context.³³³

The bankruptcy court went on to hold that although the Safe Harbors allow a Non-defaulting, non-debtor Party to exercise any contractual right regardless of the automatic stay, they do not permit such a party to enforce a Triangular

around this language. Parties may freely contract for Triangular Setoff rights, but not in derogation of these mandates of the Bankruptcy Code.

Id. at 141.

³³⁰ *Id.* at 141–42. The bankruptcy court in *SemCrude* engaged in a similar analysis regarding cases that had discussed Triangular Setoff agreements. See *In re SemCrude, L.P.*, 399 B.R. 388, 394 (Bankr. D. Del. 2009).

³³¹ *UBS Decision*, 458 B.R. at 141–42; see also *Inland Steel Co. v. Berger Steel Co. (In re Berger Steel Co.)*, 327 F.2d 401 (7th Cir. 1964).

³³² *UBS Decision*, 458 B.R. at 142–43. The bankruptcy court in *SemCrude* engaged in a similar analysis. See *SemCrude*, 399 B.R. at 394; Pamela Foohey, *In re SemCrude LP: Reigning in Triangular Setoff and Preserving Creditor Equality*, AM. BANKR. INST. J., Mar. 2009, at 44 (discussing *SemCrude* in detail). Although case law exists that seems to state that Triangular Setoff Clauses are enforceable, support for that proposition is not very strong and each case's statement to that effect "was essentially dicta." *Id.* at 44.

³³³ *UBS Decision*, 458 B.R. at 141–42. The bankruptcy court stated:

An examination of the decisions [following *Berger Steel*] that are thought to imply that the courts would have enforced a Triangular Setoff right [in the bankruptcy context] if there had been such an agreement lends support to the finding in *SemCrude* that the so-called contract exception cited in these cases actually was created by a game of 'whisper down the lane' from decision to decision.

....

Conceivably, the courts in these cases might have mistakenly enforced a triangular setoff right simply on the basis of string citations if presented with an enforceable agreement for Triangular setoff, but that does not establish a legitimate basis for a contractual exception to the requirement of mutuality. These cases assume the existence of a contract exception but fail to engage in any analysis demonstrating that the exception actually fits within the statutory scheme. . . . There simply is no contract exception [allowing a party to enforce a Triangular Setoff Clause in the bankruptcy context].

Id. at 142.

Setoff Clause.³³⁴ The bankruptcy court reasoned any rights that a Non-defaulting, non-debtor party to an ISDA Master Agreement seeks to exercise under the Safe Harbors “must exist in the first place.”³³⁵ The bankruptcy court did note, however, that a Triangular Setoff Clause may be enforceable outside of the bankruptcy (or SIPA) context.³³⁶

Indeed, there seems to be some tension between the UBS Decision and the *BNY* decision. Recall that, in the *BNY* decision, the court stated (1) that it did not matter whether the LBHI Petition Date or the LBSF Petition Date triggered an ipso facto clause; and (2) that the Lehman debtors’ different corporate enterprises comprised an “integrated enterprise” and that “the financial condition of one [Lehman] affiliate affects the others.”³³⁷ In the UBS Decision, however, the same bankruptcy court held that mutuality for purposes of § 553 could not be created by contract, even though UBS sought to set off amounts owed to it by two Debtors in the same “integrated enterprise.”³³⁸ Therefore, it seems as if the bankruptcy court allowed two different Debtors that were affiliates in the same corporate enterprise to use §§ 365 and 541 as a “sword” against a Non-defaulting Party to an ISDA Master Agreement to invalidate an ipso facto clause, while simultaneously, in a different case, allowing two different Debtors that were affiliates in the same corporate enterprise to use § 553 as a “shield” to prevent a Non-defaulting Party to an ISDA Master Agreement containing a triangular setoff clause to enforce that clause.³³⁹

Despite the decisions in *American Home Mortgage* and *UBS*, issues remain regarding the certainty of the enforceability of Triangular Setoff Clauses contained in an ISDA Master Agreement or a Clearing Agreement in the bankruptcy context. First, although criticized by the UBS Decision, several decisions have stated in dicta that an agreement providing for Triangular Setoff

³³⁴ *Id.* at 143.

³³⁵ *Id.* The bankruptcy court also pointed to the district court’s decision affirming *Swedbank*. *See id.* In that decision, the district court stated it was important that “there is no mention in the legislative history that the Safe Harbor Provisions were intended to eliminate the mutuality requirement [contained in § 553].” *Swedbank AB (PUBL) v. Lehman Bros. Holdings Inc. (In re Lehman Bros. Holdings Inc.)*, 445 B.R. 130, 137 (S.D.N.Y. 2011), *aff’g In re Lehman Bros. Holdings Inc. (Swedbank)*, 433 B.R. 101, 107 (Bankr. S.D.N.Y. 2010).

³³⁶ *UBS Decision*, 458 B.R. at 144.

³³⁷ *See Lehman Bros. Special Fin. Inc. v. BNY Corp. Tr. Servs. Ltd. (In re Lehman Bros. Holdings Inc.)*, 422 B.R. 407, 418 (Bankr. S.D.N.Y. 2010) (quoting *JPMorgan Chase Bank N.A. v. Charter Commc’ns Operating LLC (In re Charter Commc’ns)*, 419 B.R. 221, 251 (Bankr. S.D.N.Y. 2009)).

³³⁸ *See UBS Decision*, 458 B.R. at 139–41.

³³⁹ *See BNY*, 422 B.R. at 418; *UBS Decision*, 458 B.R. at 139–41.

is enforceable in the bankruptcy context.³⁴⁰ Likewise, the *American Home Mortgage* and UBS decisions are decisions of bankruptcy courts, not a circuit court of appeals, which could reach a different conclusion. Therefore, bankruptcy courts in different circuits could reach a different decision on the same issue.

Secondly, neither the *American Home* decision nor the UBS Decision address a situation where one (or both) of the bankrupt parties to the Triangular Setoff agreement served as a guarantor of the other's obligations under the ISDA Master Agreement. Those facts were not before the bankruptcy courts that rendered those decisions.³⁴¹ In such a situation, an argument could be made that such a guarantee arrangement would create mutuality for purposes of § 553.³⁴²

2. *Dodd-Frank Act and Triangular Setoff*

As mentioned above, if certain stringent conditions are met, the recently-enacted Title II of the Dodd-Frank Act sets forth an alternative insolvency

³⁴⁰ See, e.g., *In re Garden Ridge Corp.*, 338 B.R. 627, 634 (Bankr. D. Del. 2006); *U.S. Nat'l Bank v. Custom Coals Laurel (In re Custom Coals Laurel)*, 258 B.R. 597, 607 (Bankr. W.D. Pa. 2001); *Equibank v. Hildebrand Mach. Co. (In re Lang Mach. Corp.)*, No. 86-00415, 1988 WL 110429 at *5 (Bankr. W.D. Pa. Oct. 19, 1988); *Eckles v. Petco Inc., Interstate (In re Balducci Oil Co.)*, 33 B.R. 847, 853 (Bankr. D. Colo. 1983); see also *Bloor v. Shapiro*, 32 B.R. 993, 1001-02 (S.D.N.Y. 1983).

³⁴¹ This guarantee issue would be relevant to a situation like the one in *SemCrude*, where a Non-defaulting, non-debtor party sought to set off an amount it owed to one bankrupt debtor against an amount owed to it from an affiliate of such a debtor. The situation in the UBS Decision, however, was different, because there UBS attempted to use the Triangular Setoff Clause to set-off an amount it owed to LBI against amounts LBI owed to other UBS affiliates.

³⁴² See *In re SemCrude, L.P.*, 399 B.R. 388, 397 n.7 (Bankr. D. Del. 2009) (stating that courts are divided on whether a guarantee can create mutuality for enforceable Triangular Setoff agreement). Compare *Bloor*, 32 B.R. at 1001-02 (stating that mutuality existed in context of guarantee), with *In re Ingersoll*, 90 B.R. 168, 171-72 (Bankr. W.D.N.C. 1987) (stating that guarantee did not create mutuality); see also Ian Cuillerier & Yvette Valdez, *Lehman Bankruptcy Court Denies Contractual Right to Triangular Setoff*, FUTURES & DERIVATIVES L. REP., Feb. 2012, at 1, 6-7 (stating that courts are divided on guarantee issue). A Triangular Setoff agreement may be enforceable if an ISDA Master Agreement is executed among parties on a "joint and several basis." *Id.* at 7; see Martin J. Bienenstock et al., *Are Triangular Setoff Agreements Enforceable in Bankruptcy?*, 83 AM. BANKR. L.J. 325 (2009) (discussing *SemCrude* and arguing that Triangular Setoff agreements should be enforceable). Parties may be able to mitigate the risk that a court will deem a right of setoff in a Triangular Setoff arrangement as lacking mutuality by entering "into mutual guarantees of their respective affiliates' debts at the inception of trading, and the guarantees should provide that they shall be enforced by setoffs on settlement dates if the parties desire to replicate the rights and remedies of the Triangular Setoff agreement." *Id.* at 343. Furthermore, "[t]he master agreements and their termination provisions should expressly provide that affiliates assume their affiliates' debt for purposes of enabling the parties to set off on settlement dates." *Id.*

regime to the Code for SIFIs.³⁴³ Other than placing a 24-hour stay on the ability of a Non-defaulting Party to exercise its termination and liquidation rights against a SIFI liquidating under Title II, for the most part, Title II contains certain safe harbors very similar to the Safe Harbors contained in the Code.³⁴⁴

One major difference between the Code and Title II, however, is that under Title II there seems to be clarity regarding the unenforceability of Payment Suspension Clauses, Walkaway Clauses, and Flip Clauses.³⁴⁵ The ability of a Non-defaulting Party to enforce a Triangular Setoff Clause, under the Dodd-Frank Act, however, is not so clear. Indeed, the Set-Off provision contained in Title II is virtually identical to § 553.³⁴⁶ Therefore it seems that much of the uncertainty discussed above regarding Triangular Setoff Clauses in the bankruptcy context could also arise under a Title II proceeding.

Compounding this situation is that, as mentioned above, the Dodd-Frank Act, through the Swaps Push Out Rule, may require certain financial institutions to conduct certain derivative transactions through certain affiliates.³⁴⁷ Likewise, many of these same financial institutions may be required to periodically submit Living Wills to the FDIC and FRB.³⁴⁸ Furthermore, as mentioned above, because many of these swaps may be required to be cleared, the Clearing Agreements or the associated ISDA Master Agreements entered into in connection with many of those swaps may contain Triangular Setoff Clauses aimed at favoring the Clearinghouse.

Will a Triangular Setoff Clause be enforceable in such a situation if one of those financial institutions along with its affiliates ends up filing for chapter 11? Should cross-guarantees be involved under which the Parent and subsidiary or affiliates guarantee each other's obligations? What would result in a Title II proceeding? What did the Living Wills say about Triangular Setoff? Were those predictions accurate?

³⁴³ Generally speaking, only the largest financial institutions would qualify as a SIFI under Title II of the Dodd-Frank Act, making that insolvency scheme unavailable for many entities. *See supra* note 167–168 and accompanying text.

³⁴⁴ *See supra* Part II.D.

³⁴⁵ *See supra* Part II.E.

³⁴⁶ Compare Dodd-Frank Wall Street Reform and Consumer Protection Act § 210(a)(12)(A), 12 U.S.C. § 5390(a)(12)(A) (2012), with 11 U.S.C. § 553.

³⁴⁷ *See supra* note 123.

³⁴⁸ *See supra* note 121.

It seems that the answers to these questions are not 100% clear. To provide more clarity regarding the enforceability of Triangular Setoff Clauses in this situation, both the Code and the Dodd-Frank Act should be amended. A sensible amendment would clarify that Triangular Setoff Clauses are enforceable where there are either (1) mutual guarantees between the Parent and subsidiaries' or affiliates' derivatives obligations or (2) where such derivative transactions are entered into on a joint and several basis among the different corporate affiliates.³⁴⁹

IV. VALUATION

Valuation issues pervade bankruptcy proceedings. Most likely, the agreed upon valuation methodology contained in an ISDA Master Agreement will be enforceable.³⁵⁰ The Bankruptcy Court for the Southern District of New York, in a recent decision involving a dispute between LBSF and the Michigan State Housing Development Authority ("MSHDA"), held that the Safe Harbors, specifically § 560, protected MSHDA's right to use a liquidation and valuation methodology clause contained in an ISDA Master Agreement, even though the agreed upon market quotation methodology resulted in a termination value that was less favorable to LBSF than the methodology that would have applied (Mid Market or Mid-Point methodology) had LBSF not filed for chapter 11 protection.³⁵¹

³⁴⁹ Another alternative is simply to permit triangular setoff if each entity within the corporate structure signs an agreement (including an ISDA Master Agreement) that permits the Non-defaulting Party to conduct triangular setoff. Indeed, the difference between having the various entities guarantee each other's liability versus signing agreements permitting triangular setoff seems to involve an element of "form over substance." See, e.g., Bienenstock et al., *supra* note 342 (discussing *SemCrude* and arguing that Triangular Setoff agreements should be enforceable).

³⁵⁰ See generally *Mich. State Hous. Dev. Auth. v. Lehman Bros. Derivative Prods. (In re Lehman Bros. Holdings Inc.)*, 502 B.R. 383 (Bankr. S.D.N.Y. 2013).

³⁵¹ *Id.* at 392–94. MSHDA had entered into an interest rate swap documented under an ISDA Master Agreement (the "MSHDA Swap Agreement") with Lehman Brothers Derivative Products ("LBDP") to hedge interest rate risk associated with variable rate municipal bonds it issued. *Id.* at 387. If LBHI filed for bankruptcy, the terms of the MSHDA Swap Agreement compelled LBDP to terminate the swap agreement within five days of LBHI's bankruptcy filing and to calculate damages at a "mid-market" price, *id.* at 388, which "effectively splits the 'bid-ask spread' between the parties, rather than relying only on the prices on the Non-defaulting Party's side of the transaction." Memorandum of Law in Support of Michigan State Housing Development Authority's Partial Motion for Summary Judgment at 7, *Mich. State Hous. Dev. Auth.*, 502 B.R. 383 (No. 09-01728), ECF No. 31-2. The "spread" or difference between these two prices may vary in different markets. Noh, *supra* note 180, at 5. According to MSHDA, LBHI, following its bankruptcy filing, requested that MSHDA assign the MSHDA Swap Agreement to LBSF. *Mich. State Hous. Dev. Auth.*, 502 B.R. at 389. In the assignment transaction, the parties agreed that if LBSF committed an Event of Default by filing for bankruptcy or by failing to pay any amount due to MSHDA, then MSHDA, as the Non-defaulting Party,

This decision, however, does not impact a chapter 11 debtor's ability to challenge, in good faith, the Close-out Amount claimed by the Non-defaulting Party.³⁵² Valuation is not an exact science. It becomes much more complex when dealing with derivative transactions, especially OTC derivatives that are not traded over an exchange.³⁵³

An ongoing dispute between LBSF and Nomura International PLC ("Nomura") highlights this issue.³⁵⁴ In this dispute (the "Nomura Dispute") Nomura entered into an ISDA Master Agreement with LBSF.³⁵⁵ More than 2,000 derivative transactions fell thereunder.³⁵⁶ Following the termination of that ISDA Master Agreement, Nomura claimed that LBHI and LBSF owed Nomura \$443,978,774.³⁵⁷ LBHI and LBSF, on the other hand, objected to Nomura's claim. Instead, LBHI and LBSF argued that Nomura improperly followed the valuation methodology contained in the ISDA Master Agreement,

would be able to terminate the MSHDA Swap Agreement and use the Market Quotation methodology instead of the "mid-market" methodology to value the Early Termination Amount. *Id.* at 388. Market Quotation was more favorable to MSHDA than the "mid-market" methodology if MSHDA was the Non-defaulting Party. *Id.*; see also, Noh, *supra* note 180 (discussing valuation issues associated with derivative transactions).

LBSF later filed for chapter 11 protection and, at that time, was in the money under the swap agreement. *Mich. State Hous. Dev. Auth.*, 502 B.R. at 389. MSHDA terminated the swap agreement using the Market Quotation methodology, which resulted in MSHDA owing less money to LBSF than it would have if the "mid-market" valuation methodology had applied. *Id.* The court held in favor of MSHDA. *Id.* at 395–96.

Of course, if a valuation methodology includes a Payment Suspension Clause, a Walkaway Clause, or a Flip Clause, such clauses would most likely not be enforceable in the bankruptcy context. See *id.* at 386 (distinguishing rulings regarding such clauses from ruling regarding pure valuation methodology clauses). Indeed, at first blush, this decision seems to conflict with the holding of *BNY* regarding Flip Clauses. Compare *id.* at 389, with *Lehman Bros. Special Fin. Inc. v. BNY Corp. Tr. Servs. Ltd. (In re Lehman Bros. Holdings Inc.)*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010). With respect to this issue, the *Michigan State Housing Development Authority* court noted:

There is a significant difference between the reordering of priorities within a hierarchy of distributions (an *ipso facto* contractual term that is not mentioned in Section 560) and selecting which method to use when disposing and valuing collateral in connection with liquidating a terminated swap agreement. The choice of an accepted and contractually specified method to liquidate, even if it produces a less desirable result from the point of view of the debtor, is consistent with full implementation of the exemption that is codified in Section 560.

Mich. State Hous. Dev. Auth., 502 B.R. at 387; see 11 U.S.C. § 560.

³⁵² See 11 U.S.C. § 502 (providing debtor with ability to object to claims filed against debtor).

³⁵³ See generally Sarah Sharer Curley & Elizabeth Fella, *Where to Hide? How Valuation of Derivatives Haunts the Courts Even After BAPCPA*, 83 AM. BANKR. L.J. 297 (2009) (discussing complexity of valuing derivatives in bankruptcy).

³⁵⁴ See Nomura Complaint, *supra* note 298.

³⁵⁵ See *id.* at 2.

³⁵⁶ *Id.* at 7.

³⁵⁷ *Id.* at 5. Unlike many ISDA Master Agreements in the U.S., the one between Nomura and LBSF provided Automatic Early Termination, which termination occurred on the LBHI Petition Date. See *id.* at 3.

vastly inflated its claims in a commercially unreasonable manner, and owed LBSF “tens of millions of dollars.”³⁵⁸ LBHI and LBSF have raised claims similar to those raised in the Nomura Dispute against many other Non-defaulting Parties to ISDA Master Agreements with LBSF.³⁵⁹

As mentioned above, the 1992 ISDA Master Agreement contains two alternative valuation methodologies: Market Quotation and Loss. The 2002 ISDA Master Agreement, however, uses the Close-out Amount methodology.³⁶⁰ At the time LBHI filed for bankruptcy, the Lehman entities had hundreds of thousands of trades documented under ISDA Master Agreements with a large number of Non-defaulting Parties.³⁶¹ During the frenzy that followed LBHI’s bankruptcy filing, many of these Non-defaulting Parties that had terminated ISDA Master Agreements with the Lehman entities could not obtain quotes.³⁶² During that time period, many of the leading derivative dealers themselves were too occupied with evaluating their own exposure to the Lehman entities and did not provide quotes when requested to do so by other market participants.³⁶³ As a result, many Non-defaulting Parties, like Nomura, reverted to the Loss Methodology and used internal valuation models and other sources to value their terminated derivative transactions.³⁶⁴

Of course, as those valuation methods did not involve quotes from leading dealers, those methods could involve factual issues that could be subject to dispute. For example, a chapter 11 debtor, such as LBSF, could argue that the valuation methods used by a Non-defaulting Party do not qualify as “reasonable determinants of value” as required by § 562. Likewise, under § 562, a chapter 11 debtor could argue that even if such valuation methods do so qualify, they were not measured on the next date following the termination date on which such valuation determinants exist. Such litigation could involve

³⁵⁸ *Id.* LBHI and LBSF also argued that, approximately one week before the LBHI Petition Date, Nomura conceded that it owed LBSF approximately \$200 million. *Id.* at 16.

³⁵⁹ See Noh, *supra* note 180; Patrick Fitzgerald, *Lehman Sues J.P. Morgan Over Claims*, WALL ST. J., Sept. 19, 2012, at C3.

³⁶⁰ 2002 ISDA MASTER AGREEMENT, *supra* note 16, § 6(d). Although the Close-out methodology does not require a Non-defaulting Party to obtain quotes from parties that deal in derivatives, such quotes are generally considered stronger valuation evidence because it is derived from quotes of what other leading dealers in derivative transactions would pay to step into the shoes of the Defaulting Party.

³⁶¹ See Report of Anton R. Valukas, *supra* note 178, at 569, 572–73 (stating that Lehman had more than 900,000 derivative trades at the time of its bankruptcy filing).

³⁶² See Noh, *supra* note 180.

³⁶³ See *id.*

³⁶⁴ See *id.*

disputes of hundreds of millions of dollars³⁶⁵ and would likely require expert witnesses, which in the case of valuation of derivatives could be quite costly.³⁶⁶

This Article proposes that Congress should amend the Code so that it is clear that Payment Suspension Clauses, Walkaway Clauses, and Flip Clauses are not enforceable against a Debtor where a party seeks to enforce such clauses based on (1) that Debtor's financial condition or bankruptcy filing; or (2) the financial condition or bankruptcy filing of any one of such a Debtor's affiliates. Furthermore, Congress should amend the Code and Title II of the Dodd-Frank Act so that it is clear that Triangular Setoff Clauses are enforceable where either affiliated entities both agree to the triangular setoff or those affiliated entities guarantee each other's liabilities.

Such clarity may also have a favorable impact on litigation involving the valuation of terminated swap transactions, especially where the Non-defaulting Party is out of the money on the day on which a particular Debtor files for chapter 11. For example, if a Non-defaulting Party knew ahead of time that it could not suspend payment or otherwise "walkaway" from the termination amount it owed a debtor upon the debtor's bankruptcy filing and also was aware that a chapter 11 debtor could challenge any valuation methodology the Non-defaulting Party used, the Non-defaulting Party may be incentivized to work with the chapter 11 debtor so that the debtor could sell the derivative transactions to a solvent third party. The 48-hour stay on a Non-defaulting Party's ability to exercise its termination rights proposed in the *Revised Hoover Group Chapter 14 Proposal* would, combined with the reforms proposed in this Article, strengthen this approach.³⁶⁷

Such a situation would benefit the Non-defaulting Party, who could retain the derivative transactions with a more solvent assignee. Likewise, the Debtor would receive a payment for its in-the-money position. Moreover, the valuation methodology in such a situation would be one of the best

³⁶⁵ See *Crédit Agricole Corporate & Inv. Bank N.Y. Branch v. Am. Home Mortg. Holdings, Inc.* (*In re Am. Home Morg. Holdings, Inc.*), 637 F.3d 246, 247 (3d Cir. 2011) (stating that parties asserted valuations were approximately \$500 million apart).

³⁶⁶ See *Sass v. Barclays Bank P.L.C.* (*In re Am. Home Mortg., Holdings, Inc.*), 501 B.R. 44, 64 (Bankr. D. Del. 2013) (discussing use of expert witnesses).

³⁶⁷ See REVISED HOOVER GROUP CHAPTER 14 PROPOSAL, *supra* note 8, at 31–32. Of course, a 48-hour stay may not be sufficient time period to untangle a large portfolio of derivative transactions. The same may be true even if a clearinghouse is involved. See generally Julia Lees Allen, Note, *Derivatives Clearinghouses and Systemic Risk: A Bankruptcy and Dodd-Frank Analysis*, 64 STAN. L. REV. 1079 (2012).

methodologies—the price a party is willing to pay for an asset in an arm’s-length transaction.³⁶⁸ Indeed, shortly following its bankruptcy filing, LBSF sought to “sell” many of its ISDA Master Agreements to solvent third parties, but many Non-defaulting Parties heavily objected to that procedure, possibly because they mistakenly believed that Payment Suspension Clauses would be enforceable based on LBHI’s bankruptcy filing, which occurred on a different date than LBSF’s bankruptcy filing.³⁶⁹

Of course, regulatory measures that are beyond the scope of this Article could have more of an effect of minimizing valuation disputes over terminated derivative transactions. For example, if derivatives are traded over exchanges, there will be more price transparency.³⁷⁰ Therefore, if regulatory reforms require more derivatives to be exchange-traded, parties could look to the values of such transactions as they are traded on a particular exchange to determine value as of a particular date.

CONCLUSION

As evidenced by the recent disputes regarding the ISDA Master Agreement, uncertainty continues to exist regarding the enforceability of Payment Suspension Clauses, Walkaway Clauses, Flip Clauses, and Triangular Setoff Clauses in the bankruptcy context. Likewise, the enforceability of a Triangular Setoff Clause under Title II of the Dodd-Frank Act is also not clear. Congress should amend the Code so that it is clear that Payment Suspension Clauses, Flip Clauses, and Walkaway Clauses are not enforceable against a Debtor where a party seeks to enforce such as clause based on (1) that Debtor’s financial condition or bankruptcy filing; or (2) the financial condition or bankruptcy filing of any one of that Debtor’s affiliates. Furthermore, Congress

³⁶⁸ See, e.g., *Friedman v. Beway Realty Corp.*, 661 N.E.2d 972, 976 (N.Y. 1995).

³⁶⁹ See *Legal Alert: Lehman Bankruptcy Developments that Affect Trading Counterparties*, SUTHERLAND (Jan. 5, 2009), <http://www.sutherland.com/Search> (search for “Lehman Bankruptcy Developments”). LBSF sought to do this by using the assumption and assignment procedure set forth in § 365. *Id.* Objections to LBSF’s attempt to assume and assign these ISDA Master Agreements cited other reasons. *Id.* As mentioned above, under a Title II proceeding, Payment Suspension Clauses and Walkaway Clauses are not enforceable under any circumstances. See 12 U.S.C. § 5390(c)(8)(F) (2012) (invalidating Walkaway Clauses). Likewise, a Non-defaulting Party’s ability to terminate its derivative transactions with a counterparty subject to a Title II proceeding is stayed for one business day following the commencement of the Title II proceeding. See 12 U.S.C. §5390(c)(10)(B). The aim of these provisions is to transfer derivative transactions of a party subject to the Title II proceedings to a third party purchaser. See Noh, *supra* note 180. If such a third party purchaser cannot be found or if the derivative transactions at issue could not be transferred to a bridge financial company within that time period, the Non-defaulting Party could terminate its derivative transactions. See *id.*

³⁷⁰ See Skeel & Jackson, *supra* note 8, at 154–55.

should amend the Code and Title II of the Dodd-Frank Act so that it is clear that Triangular Setoff Clauses are enforceable where either affiliated entities both agree to the triangular setoff or those affiliated entities guarantee each other's liabilities.

Furthermore, such clarity would be one step in making the Code more favorable to financial institutions seeking to reorganize their operations. Even if Congress, pursuant to the *Revised Hoover Group Chapter 14 Proposal*, adopts some form of short stay that would apply to a Non-defaulting Party's right to terminate (and set off among) its derivative trading contracts with a large financial institution that is a Debtor, clarity is still needed with respect to the enforceability of Payments Suspension Clauses, Walkaway Clauses, Flip Clauses, and Triangular Setoff Clauses in such a scenario if (1) such a stay expires and (2) such a Debtor is not successful in transferring those outstanding derivative trading contracts to a solvent party.³⁷¹

Clarity on these issues would substantially reduce costly and complex litigation, allowing a Debtor to better focus its time and energy on formulating a chapter 11 plan of reorganization or liquidation, instead of spending such time on complex litigation of the Debtor's rights that are crucial to the formulation of such a plan. Undoubtedly, such legislation would speed up the chapter 11 process for debtors involved in derivatives transactions and could result in greater recoveries to the creditors of a Debtor. Likewise, further clarity would help mitigate systemic risk in the financial markets by obviating litigation regarding such rights.

³⁷¹ See *supra* note 15.