

Case

Decision of the US Bankruptcy Court

Synopsis

Held that the provisions of the ISDA Master Agreement do not allow a swap counterparty to a bankrupt Lehman entity to suspend indefinitely its own performance to Lehman without taking steps to terminate the ISDA Master Agreement.

Topics covered: [Case Law](#), [Chapter 11 US Bankruptcy Code](#)

The Facts

The decision arose in a chapter 11 hearing of Lehman debtor companies in September but the decision will be of interest to other jurisdictions given the widespread use of the ISDA Master Agreement. Metavante Corporation and the relevant bankrupt Lehman entity ("LBSF") entered into an interest rate swap under the 1992 ISDA Master Agreement. Under the terms of the swap agreement, the filing of the bankruptcy petition by LBSF constituted an event of default. Metavante refused to make any payments to LBSF. It asserted that it could rely upon section 2(a)(iii) of the ISDA Master Agreement which provided that payment obligations were subject to the condition precedent that "no event of default has occurred and is continuing", so as to withhold its own performance from LBSF without exercising its discretionary right to terminate the ISDA Master Agreement. LBSF petitioned the court to compel Metavante to perform the contract as an executory contract, subject to LBSF's right to assume or reject it.

Judge Peck held that the condition precedent provision in section 2(a)(iii) was unenforceable because it was a 'ipso facto' provision that was triggered by the bankruptcy. An "ipso facto" provision is a contractual term that purports to allow one party to terminate or enforce rights against security purely as a result of the bankruptcy of the other party; such provisions are generally unenforceable under the US Bankruptcy Code. The Bankruptcy Code contains special exemptions that protect the right to exercise liquidation, termination and netting provisions of swap agreements, but 'other uses of ipso facto provisions are unenforceable'. As such, the court held that Metavante's right to withhold performance was not protected by the safe harbour provisions.

Moreover, the court indicated that while Metavante's right to terminate the swap agreement would have been protected by the safe harbour provisions had it been exercised promptly, it had been waived by Metavante by waiting a year to do so. The court indicated that the non-defaulting counterparty should act 'fairly contemporaneously' with the bankruptcy filing in order to take advantage of the safe harbour provisions. Metavante's conduct of delaying a year before taking any action was regarded by the court as simply unacceptable and contrary to the spirit of the provisions of the Bankruptcy Code.

Comment

The decision is a reminder to swap counterparties to be diligent in taking steps to terminate any ISDA contract on the bankruptcy of a US counterparty so they may benefit from the safe harbour provisions in the US Bankruptcy Code. The ISDA legal department has indicated that, in its view, had Metavante proceeded expeditiously to close out, its reliance upon section 2(a)(iii) would not have been in issue.

It is worth noting that section 2(a)(iii) was considered not so long ago by the New South Wales Supreme Court in *Enron Australia v TXU* [2003] NSWSC 1169 where different law and facts produced a different result. In that case, Austin J held the Australian disclaimer provisions did not empower the court to make orders designating an Early Termination Date under the swap agreement in circumstances where the non-defaulting counterparty had exercised its rights not to pay under section 2(a)(iii). The decision was appealed by the Enron liquidators and upheld on appeal.

Metavante has filed a notice of appeal of Judge Peck's decision which is yet to be heard.
