UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

In re Lehman Brothers Holdings Inc., *et al.*, Debtors.	
Swedbank AB, Appellant, v. Lehman Brothers Holdings Inc., *et al*., Appellees.	No. 10-cv-04532 (NRB)

MOTION OF THE INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION FOR LEAVE TO FILE *AMICUS CURIAE* BRIEF IN SUPPORT OF NEITHER PARTY

The International Swaps and Derivatives Association, Inc. ("ISDA") respectfully moves for leave to file a brief as a*micus curiae* in the above-captioned bankruptcy appeal, in support of neither party. A copy of the proposed *amicus* filing is attached hereto as Exhibit A.

ISDA submits that consideration of the attached *amicus* brief will assist the Court in this case. While ISDA does not take a position on the specific question whether the bankruptcy court's judgment in this appeal should be affirmed or reversed, ISDA is concerned about the broader implications of the bankruptcy court's reasoning, and seeks to submit this *amicus* brief to provide the Court with background on the history and purpose of the Bankruptcy Code's safe harbor provisions, and to offer its views on how those provisions should be construed.

However the Court decides this appeal, hearing the perspective of leading industry representatives can only benefit the Court's decision-making process. The narrow construction of Sections 560 and 561 of the Bankruptcy Code endorsed by the bankruptcy court below threatens to inject significant uncertainty and disruption into the financial markets. That is precisely the danger Congress sought to avoid when it enacted the safe-harbor provisions. Interest-rate, currency, and other swap agreements provide a vital risk-management tool for businesses and governments around the world, and the swaps market has rapidly grown to a notional outstanding amount estimated at more than $426 trillion. Congress has repeatedly recognized the national interest in ensuring the efficient functioning of this important and necessary market, and it has acted to protect the market from the fundamental upheaval that would result if the contractual relationships governing swap transactions were subject to all of the Bankruptcy Code's provisions. In fact, while Congress has carefully considered and debated nearly every facet of the derivatives market over the past year, culminating in the Dodd-Frank Wall Street Reform and Consumer Protection Act, passed by the House of Representatives on June 30, 2010 and currently under consideration by the Senate, the "safe harbor" provisions enacted by Congress to exempt the exercise of contractual rights under swap agreements from restrictions imposed by bankruptcy law in the event of a counterparty's bankruptcy remain unchanged. Specifically, Congress provided, in the broadest possible terms, that the exercise of "any contractual right" to terminate a swap agreement in the event of a counterparty's bankruptcy, or to set off any payment amounts arising under the swap agreement, "shall not be stayed, avoided, or otherwise limited by operation of *any provision*" of the Bankruptcy Code. 11 U.S.C. § 560 (emphasis added).

Notwithstanding this clear statutory language, the bankruptcy court construed Section 560 narrowly to exempt the exercise of contractual rights under swap agreements merely from the "automatic stay" under Section 362 of the Bankruptcy Code, but not to protect swap agreements from limitations imposed by other provisions of the Bankruptcy Code, including Section 553 and its "mutuality" restrictions on setoff rights. The bankruptcy court's decision undermines the legal certainty Congress intended to provide swaps market participants, and threatens to stir up the very turmoil in the financial markets that Congress intended to prevent. Because this issue is of vital interest to the financial industry, ISDA files this brief to urge the Court to correct the bankruptcy court's erroneous construction of the Bankruptcy Code's safe-harbor provisions and to restore the certainty and protection those provisions were intended to provide the financial markets.

ISDA is the global trade association representing leading participants in the derivatives industry. Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business. ISDA was chartered in 1985, and is comprised of more than 830 member institutions from 57 countries on six continents. These members include most of the world's major institutions dealing in privately negotiated derivatives, as well as many of the businesses, governmental entities, and other end users that rely on over-the-counter derivatives to manage the market risks inherent in their core economic activities. ISDA publishes the ISDA Master Agreement, which serves as the contractual foundation for more than 90% of derivatives transactions globally (including the transactions at issue in this dispute), and distributes market-specific definitional booklets that supplement the Master Agreement.

Because of its role in the development of derivatives markets, ISDA is uniquely well-positioned to evaluate and comment on the interpretation of the safe harbor provision in Section 560 of the Bankruptcy Code. Indeed, ISDA actively participated in the enactment of the 1990 amendments to the Bankruptcy Code that added Section 560 and the other safe-harbor provisions for swap agreements, which were intended "to ensure that the swap and forward contract financial markets are not destabilized by uncertainties regarding the treatment of their financial instruments under the Bankruptcy Code." H.R. Rep. No. 101-484, at 1 (1990), *reprinted in* 1990 U.S.C.C.A.N. 223.

In bankruptcy appeals to district courts, Rule 29 of the Federal Rules of Appellate Procedure has been applied by analogy to determine the procedures to be followed by parties filing *amicus* briefs. *See Triad Int'l Maint. Corp. v. Southern Air Transp., Inc.*, No. 2:04-CV-1200, 2005 WL 1917512, at *1 (S.D. Ohio Aug. 10, 2005); *In re Dow Corning Corp*., 255 B.R. 445, 464 (E.D. Mich. 2000), *aff'd*, 280 F.3d 648 (6th Cir. 2002).

ISDA has sought the consent of Swedbank AB, Lehman Brothers Holdings Inc., and the Official Committee of Unsecured Creditors (the "Committee") for the filing of an *amicus* brief in support of neither party. Swedbank and the Committee both consented. Lehman also consented, but emphasized that its consent was conditioned on ISDA's representation that its *amicus* brief supported neither party. ISDA accordingly requests leave to file its proposed *amicus* brief.

WHEREFORE, ISDA respectfully requests that this Court enter an order in the form attached hereto as Exhibit B granting ISDA leave to file the proposed *amicus* brief attached hereto as Exhibit A.

Dated: July 14, 2010

Respectfully submitted,

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<u>EXHIBIT A</u>

UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

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Swedbank AB, Appellant, v. Lehman Brothers Holdings Inc., *et al.*, Appellees.	No. 10-cv-04532 (NRB)

BRIEF OF THE INTERNATIONAL SWAPS AND DERIVATIVES
<u>ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF NEITHER PARTY</u>

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The International Swaps and Derivatives Association, Inc. ("ISDA") respectfully submits this *amicus* brief to offer its perspective on the dispute now before this Court. ISDA takes no position on whether the judgment of the bankruptcy court in the specific dispute between these parties should be affirmed or reversed. Rather, ISDA submits this *amicus* brief to offer its perspective on the history and purpose of the financial contract "safe harbor" provisions of the Bankruptcy Code, and to urge this Court—regardless of how it resolves this particular dispute—to reject the unduly narrow reading of those provisions offered by the bankruptcy court below.

INTRODUCTION

The construction of Sections 560 and 561 of the Bankruptcy Code endorsed by the bankruptcy court below threatens to inject significant uncertainty and disruption into the financial markets. That is precisely the danger Congress sought to avoid when it enacted the safe-harbor provisions. Interest-rate, currency, and other swap agreements are vital risk-management tools for businesses and governments around the world, and the swaps markets has rapidly grown to a notional outstanding amount estimated at more than $426 trillion. Congress has repeatedly recognized the national interest in ensuring the efficient functioning of this important and necessary market, and it has acted to protect the market from the fundamental upheaval that would result if the contractual relationships governing swap transactions were subject to all of the Bankruptcy Code's provisions. It has thus enacted "safe harbor" provisions to exempt the exercise of contractual rights under swap agreements from restrictions imposed by bankruptcy law in the event of a counterparty's bankruptcy. Specifically, Congress provided, in the broadest possible terms, that the exercise of "any contractual right" to terminate a swap agreement in the event of a counterparty's bankruptcy, or to set off any payment amounts arising under the swap agreement, "shall not be stayed, avoided, or otherwise limited by operation of *any provision*" of the Bankruptcy Code. 11 U.S.C. § 560 (emphasis added).

Notwithstanding this clear statutory language, the bankruptcy court construed Section 560 narrowly to exempt the exercise of contractual rights under swap agreements merely from the "automatic stay" under Section 362 of the Bankruptcy Code, but not to protect swap agreements from limitations imposed by other provisions of the Bankruptcy Code, including Section 553 and its "mutuality" restrictions on setoff rights. The bankruptcy court's decision undermines the legal certainty Congress intended to provide swaps market participants, and threatens to stir up the very turmoil in the financial markets that Congress intended to prevent. Because this issue is of vital interest to the financial industry, ISDA files this brief—without taking a position whether the bankruptcy court's judgment on the facts of this case should be affirmed or reversed—to urge the Court to correct the bankruptcy court's erroneous construction of the Bankruptcy Code's safe-harbor provisions and to restore the certainty and protection those provisions were intended to provide the financial markets.

The bankruptcy court's construction of the safe-harbor provisions in Sections 560 and 561 of the Bankruptcy Code contravenes the plain meaning of their text. Its reliance on the bankruptcy policy underlying the mutuality doctrine—the equitable treatment of creditors—to justify its narrow reading of the safe-harbor provisions fails to recognize that the safe-harbor provisions also reflect a strong congressional policy of safeguarding the financial markets from the adverse effects of bankruptcy. Where those policies clash, courts must respect the congressional judgment about how to balance those competing policies, as reflected in the specific statutory language Congress chose to express its intent. The safe-harbor provisions should therefore be read to mean exactly what they say: the exercise of any contractual right to set off payment amounts arising in connection with the termination or liquidation of a swap agreement shall not be stayed, avoided, or otherwise limited by operation of any provision of the Bankruptcy Code, including Section 553.

Swedbank has argued that because the distinction between a "pre-petition" entity and a "post-petition" entity is entirely a creature of federal bankruptcy law, the safe harbor provisions thus permit it to exercise its contractual setoff rights. On the other hand, it can certainly be argued that the specific right of setoff that Swedbank seeks to exercise—the setting off of funds received from the Debtor's bankruptcy estate post-petition against a pre-petition obligation the Debtor owed to Swedbank—was not addressed specifically in the parties' agreement. ISDA takes no position on that question—whether a claimed non-mutual setoff right that is not expressly addressed in the parties' contract falls within the Bankruptcy Code's safe harbor. To the extent, however, the Court were to conclude that the Swedbank transaction at issue falls outside the scope of the safe harbor, ISDA respectfully urges the Court to limit such a decision to the unusual facts presented here—a party's effort to exercise non-mutual setoff rights that are not expressly provided for under the terms of the parties' agreement—leaving for future consideration a scenario in which a party seeks to exercise a setoff right that *is* expressly set forth in the parties' agreement, such as, for example, an express contractual cross-affiliate netting provision.

The "mutuality" requirement under Section 553 of the Bankruptcy Code has been held to encompass a number of distinct restrictions on setoff rights, including a requirement that offsetting obligations must run between the same two parties (even where the obligations are exclusively pre-petition). But relying on the safe-harbor provisions, market participants commonly include cross-affiliate netting provisions, otherwise referred to as "triangular" cross-affiliate netting provisions, that permit party *A* to set off its obligations to counterparty *B* against

B's obligations to *A's* affiliate, *C*. While courts have considered this distinct "same two parties" mutuality requirement outside the safe-harbor context, the enforceability of setoff rights in bankruptcy under "triangular" cross-affiliate netting provisions for safe-harbored contracts has, to ISDA's knowledge, not yet been addressed in a judicial opinion.[1]

ISDA therefore respectfully urges that, to the extent this Court finds that the Swedbank transactions fall outside the scope of the safe harbors, the Court not inadvertently or unnecessarily resolve the issue of the enforceability of a safe-harbored contract setoff provision that contains, for example, an express contractual limitation on mutuality, by painting with an unnecessarily broad brush. Rather, any decision in this appeal should appropriately leave consideration of that issue for decision in a future case that directly presents the issue.

STATEMENT OF INTEREST OF *AMICUS CURIAE*

ISDA is the global trade association representing leading participants in the derivatives industry. Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business. ISDA was chartered in 1985, and is comprised of more than 830 member institutions from 57 countries on six continents. These members include most of the world's major institutions dealing in privately negotiated derivatives, as well as many of the businesses, governmental entities, and other end users that rely on over-the-counter derivatives to manage the market risks inherent in their core economic activities. ISDA publishes the ISDA Master Agreement, which serves as the contractual foundation for more than 90% of derivatives transactions globally (including the transactions at

[1] *See In re SemCrude, L.P.*, 428 B.R. 590, 594 (D. Del. 2010) (holding that Section 553's "mutuality" requirement prohibits triangular setoff under express contractual cross-affiliate provision, but explicitly declining to consider an argument that the exercise of setoff rights under such agreement was protected by the safe-harbor provisions, because the issue was not timely raised below).

issue in this dispute), and distributes market-specific definitional booklets that supplement the Master Agreement.

Because of its role in the development of derivatives markets, ISDA is uniquely well-positioned to evaluate and comment on the interpretation of the safe harbor provision in Section 560 of the Bankruptcy Code. Indeed, ISDA actively participated in the enactment of the 1990 amendments to the Bankruptcy Code that added Section 560 and the other safe-harbor provisions for swap agreements, which were intended "to ensure that the swap and forward contract financial markets are not destabilized by uncertainties regarding the treatment of their financial instruments under the Bankruptcy Code." H.R. Rep. No. 101-484, at 1 (1990), *reprinted in* 1990 U.S.C.C.A.N. 223.

ARGUMENT

I. THE BANKRUPTCY CODE'S SAFE-HARBOR PROVISIONS EXEMPT THE EXERCISE OF CONTRACTUAL SETOFF RIGHTS IN CONNECTION WITH THE TERMINATION OR LIQUIDATION OF SWAP AGREEMENTS FROM THE OPERATION OF THE BANKRUPTCY CODE.

The Bankruptcy Code is designed to provide an orderly mechanism for the equitable resolution of creditors' claims and, in Chapter 11, the reorganization (or liquidation) of the debtor's business. To achieve these ends, bankruptcy law modifies in certain ways the procedural and substantive rights that the debtor and its creditors would otherwise enjoy under applicable law outside of bankruptcy. For example, the "automatic stay" generally halts creditor collection activity against the debtor or its property. *See* 11 U.S.C. § 362(a). Counterparties are prohibited (with certain exceptions) from terminating executory contracts with the debtor because of contractual provisions conditioned on the debtor's insolvency or bankruptcy filing. *See id.* § 365(e)(1). A trustee may "avoid" and recover (subject to certain defenses) certain transfers of assets made and obligations incurred by the debtor before bankruptcy. *See id.*

§§ 544, 547, 548, 550. And the common-law setoff rights of creditors may be limited, including by a bar against offsetting a post-petition debt owed to the debtor against a pre-petition claim against the debtor (even if such setoff would otherwise be enforceable under applicable non-bankruptcy law). *See id.* § 553(a).

Congress has recognized, however, that the operation of the Bankruptcy Code's provisions could destabilize the financial markets if the Code's provisions prevented parties to financial contracts, including swap agreements, from exercising their rights under those contracts upon a counterparty's bankruptcy filing. It has therefore enacted various "safe harbors" in the Bankruptcy Code to exempt the financial markets from these provisions, so that no single bankruptcy disrupts the functioning of the financial markets.

> U.S. bankruptcy law has long accorded special treatment to transactions involving financial markets, to minimize volatility. Because financial markets can change significantly in a matter of days, or even hours, a non-bankrupt party to ongoing securities and other financial transactions could face heavy losses unless the transactions are resolved promptly and with finality.

H.R. Rep. No. 101-484, at 2 (1990), *reprinted in* 1990 U.S.C.C.A.N. 223, 224. In the past 30 years, "[a]s new financial instruments have been developed, Congress has amended the 1978 Bankruptcy Code to keep pace in promoting speed and certainty in resolving complex financial transactions." *Id.*

Sections 560 and 561 are critical parts of this statutory scheme. These safe harbors protect parties to swap agreements (or related master netting agreements) from the legal effects of a counterparty's bankruptcy. Section 560 provides in relevant part:

> The exercise of any contractual right of any swap participant or financial participant to cause the liquidation, termination, or acceleration of one or more swap agreements because of a condition of the kind specified in section 365(e)(1) of this title [regarding the debtor's insolvency or bankruptcy] or to 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 shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title.

11 U.S.C. § 560.

Congress thus provided in the broadest terms that the exercise of "*any* contractual right" to "offset or net out any … payment amounts" in connection with the termination, liquidation, or acceleration of a swap agreement "shall not be stayed, avoided, or *otherwise limited* by operation of *any* provision of this title," *i.e.*, the Bankruptcy Code. *Id.* (emphasis added).

Section 561 similarly provides that such contractual rights may be exercised to set off payment amounts arising under swap agreements and various other financial contracts, including master netting agreements, without the limitations the Bankruptcy Code would otherwise impose. It provides in relevant part that:

> [T]he exercise of any contractual right, because of a condition of the kind specified in section 365(e)(1), to cause the termination, liquidation, or acceleration of or to offset or net termination values, payment amounts, or other transfer obligations arising under or in connection with one or more (or the termination, liquidation, or acceleration of one or more)—
>
> (1) securities contracts, as defined in section 741(7);
> (2) commodity contracts, as defined in section 761(4);
> (3) forward contracts;
> (4) repurchase agreements;
> (5) swap agreements; or
> (6) master netting agreements,
>
> shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by any order of a court or administrative agency in any proceeding under this title.

11 U.S.C. § 561.

The protection of swap agreements under these safe harbors reflects a strong and long-standing Congressional policy of safeguarding the financial markets from the disruptive effects of a counterparty's bankruptcy filing.

As early as 1982, Congress amended the Bankruptcy Code to add safe-harbor provisions exempting payments made in the securities, commodities, and forward contract trades from the bankruptcy avoidance powers (except in cases of actual fraud) and providing that rights to liquidate such contracts in the event of bankruptcy cannot be "stayed, avoided, or otherwise limited by operation of any provision of this title."[2] Following a judicial decision that injected uncertainty as to the enforceability of repurchase agreements in bankruptcy,[3] Congress acted again in 1984 to clarify that the Bankruptcy Code's safe-harbor protections extended to repurchase agreements.[4]

On both occasions, Congress sought to insulate the financial markets from the "ripple effect" that could result if a bankruptcy prevented counterparties to financial contracts from enforcing their rights upon default. *See* H.R. Rep. No. 97-420, at 1 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583 ("[C]ertain protections are necessary to prevent the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse

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[2] *See* 1982 Amendments to Bankruptcy Code, Pub. L. No. 97-222, 96 Stat. 235 (now codified, as amended, at 11 U.S.C. §§ 362(b)(6), 546(e), 555, 556); H.R. Rep. No. 97-420, (1982), *reprinted in* 1982 U.S.C.C.A.N. 583.

[3] In *In re Lombard-Wall, Inc.*, No. 82 B 11556 (Bankr. S.D.N.Y. Sept. 16, 1982), the court held that transfers made under repurchase agreements were not exempt from the automatic stay of the Bankruptcy Code. *See* S. Rep. No. 98-65, at 47 (1983). The *Lombard-Wall* proceedings "had an adverse impact on the financial markets and undermined the primary purposes of [the 1982 Amendments] because the repo market is subject to the same ripple effect as other securities markets." *Id*.

[4] *See* 1984 Amendments to Bankruptcy Code, Pub. L. No. 98-353, §§ 391-396, 98 Stat. 333 (now codified, as amended, at 11 U.S.C. §§ 362(b)(7), 546(f)), 559); S. Rep. No. 98-65 (1983).

of the affected market.")[5]; S. Rep. No. 98-65, at 47 (1983) ("The repo market is as complex as it is crucial. It is built upon transactions that are highly interrelated. A collapse of one institution involved in repo transactions could start a chain reaction, putting at risk hundreds of billions of dollars and threatening the solvency of many additional institutions.").[6]

In 1990, Congress extended safe-harbor protections to swap agreements. In the 1980s, over-the-counter derivatives products, or "swaps," were being developed by the financial markets as a way to hedge or reduce various kinds of risk in a particular business.

> A "swap" is a contract between two parties ("counterparties") 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 & Sav. Ass'n, 322 F.3d 1039, 1042 (9th Cir. 2003).

Even at that time, in the swap market's infancy, Congress recognized that swap agreements "are

[5] *See also Kaiser Steel Corp. v. Charles Schwab & Co.*, 913 F.2d 846, 849 (10th Cir. 1990) ("Congress's purpose was to minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries." (internal quotation marks and citation omitted)); *Bevill, Bresler & Schulman Asset Mgmt. Corp. v. Spencer Sav. & Loan Ass'n (In re Bevill, Bresler & Schulman Asset Mgmt. Corp.)*, 878 F.2d 742, 748 (3d Cir. 1989) ("The certainty and fluidity needed by professionals on both sides of the transactions is of such importance that one debtor's filing of a petition should not be permitted to impair the functioning of the market as a result of the Code's automatic stay, or have the integrity of contract relationships upset by the Code's avoidance provisions.").

[6] *See also In re Bevill, Bresler & Schulman Asset Mgmt. Corp.*, 878 F.2d at 748 ("Congress, the Board of Governors of the Federal Reserve, the Public Securities Association, the Investment Company Institute and others, were concerned that if *Lombard-Wall* [decision denying safe-harbor protection] became the law governing repo transactions, the failure of one repo dealer, and the consequent inability of repo participants to promptly liquidate their investments to obtain cash to meet obligations, could have a ripple effect throughout the country's financial markets, causing an otherwise isolated financial problem to spread to many other entities."); *id.* at 749 ("The ability of the repo market to serve all of its functions in the money market depends upon a high level of certainty about the ability of the various repo participants to close out repo transactions in the event of insolvency of the other party to the transaction, and to assure that repo transaction payments previously received from that party will not be reclaimed by the trustee under the Bankruptcy Code.") (quoting testimony of Robert C. Brown, Chairman, Public Securities Association to House Committee on the Judiciary).

a rapidly growing and vital risk management tool in world financial markets," allowing financial institutions, corporations, and governments "to minimize exposure to adverse changes in interest and currency exchange rates." S. Rep. No. 101-285 (1990), *available at* 1990 WL 259288, at *2.[7] For example, a business exposed to the risk and uncertainty of rising interest rates on a variable-interest rate loan can minimize that risk by entering into a swap agreement, whereby it agrees to pay interest at a fixed rate on a notional amount (based on the principal amount of the loan) in exchange for the counterparty's agreement to pay interest at a variable-interest rate on that same notional amount. To the extent the business's interest obligations under its variable-interest rate loan exceed the fixed rate under its swap agreement, it can use the net payments it receives from the swap counterparty to meet those obligations, thereby allowing the business, in effect, to transform its interest rate on the loan from a floating variable rate into a stable fixed rate. *Id.*

In the following twenty years, the swap markets have only increased in size, complexity, and importance, growing from an estimated $1 trillion in outstanding swaps transactions in 1989 to $426 trillion in 2009.[8] The 2009 ISDA Derivatives Usage Survey results show that more than

[7] *See also* H.R. Rep. 101-484, at 2-3 (1990), *reprinted in* 1990 U.S.C.C.A.N. 223, 224-225 (recognizing that "increasing use is being made of a new class of financial instruments, the interest rate or foreign exchange rate 'swap agreement,'" which "are entered into by corporations, financial institutions, and governmental entities to minimize borrowing costs and to hedge against fluctuations in interest rates and foreign exchange rates.").

[8] *See Interest Swap: Hearing on S. 396 Before the Subcommittee on Courts and Administrative Practices of the Senate Committee on the Judiciary*, 101st Cong. 14 (statement of Mark C. Brickell, Chairman, ISDA) (ISDA "estimated that in excess of $1 trillion in swap transactions [was] currently outstanding" in 1989) *with* ISDA Market Survey, *available at* http://www.ISDA.org/statistics/pdf/ISDA-Market-Survey-annual-data.pdf (outstanding swaps transactions exceeded $426 trillion in 2009).

94 percent of the Fortune Global 500—471 out of 500 companies—report using derivative instruments to manage and hedge their business and financial risks.[9]

Echoing the concerns that drove Congress to act in 1982 and 1984, Congress was concerned about "volatility in the swap agreement markets resulting from the uncertainty over their treatment in the Bankruptcy Code." H.R. Rep. No. 101-484, at 3 (1990), *reprinted in* 1990 U.S.C.C.A.N. 223, 225. As Senator Heflin explained, "[t]here is concern that if one of the parties to a swap agreement files for bankruptcy under the current Bankruptcy Code, the non-defaulting party is left with a substantial risk and, depending on the size of the swap agreement, could cause a rippling effect which would undermine the stability of the financial markets." *Interest Swap: Hearing on S. 396 Before the Subcomm. on Courts and Administrative Practices of the Senate Comm. on the Judiciary*, 101st Cong. 1 (1989).[10]

Specifically, "[t]he setoff process, which is at the center of the swap agreement, may be skewed if one of the parties has filed for bankruptcy." H.R. Rep. No. 101-484, at 3 (1990), *reprinted in* 1990 U.S.C.C.A.N. 223, 225. Although a swap agreement provides for an exchange of cash flows (such as interest payments under fixed and floating rates), the counterparties to a

[9] *See ISDA News Release: Over 94% of the World's Largest Companies Use Derivatives to Help Manage Their Risks, According to ISDA Survey*, Apr. 23, 2009, *available at* http://www.ISDA.org/press/press042309der.pdf (reporting use of foreign-exchange derivatives by 88% of companies and of interest-rate derivatives by 83% of companies).

[10] "The bankruptcy of a swap market participant could cause significant market disruption. This arises from the risk that an outstanding swap transaction would be held open during the bankruptcy, despite contractual provisions for its termination. Also, there is the risk that a defaulting party or a trustee in bankruptcy could assume favorable swap transactions and reject unfavorable ones—so-called cherry picking—even though the swap contract calls for liquidation of these obligations by netting. The exposure created by these risks takes on special significance in a volatile market." 136 Cong. Rec. S7536 (1990) (statement of Sen. Grassley); *see also Interest Swap: Hearing on S. 396*, 101st Cong. 16 (statement of Mark C. Brickell, Chairman, ISDA) ("Participants in the swap market are concerned that, if a counterparty files for bankruptcy, the automatic stay and other provisions of the Bankruptcy Code could be interpreted to bar the implementation of [] critical contractual provisions.").

swap agreement do not actually pay the full amount of each payment stream to each other. Instead, the counterparties periodically "net" their obligations against one another so that only the net amount due from one party to the other actually changes hands. *See id.*; *see generally* John C. Dugan, *Derivatives: Netting, Insolvency, and End Users*, 112 Banking L.J. 638 (1995). Indeed, the right of set-off is critical to reducing the exposure to the risk of loss upon a counterparty's insolvency, since the denial of such right would expose the creditor not only to loss on the payment amounts owed by the counterparty, but also to unexpected exposure on the gross amount of its payment obligations to the counterparty.[11]

Congress thus recognized that protecting setoff rights "is particularly important to swap participants since netting is the normal, intended course of dealing in swap transactions[,] unlike ordinary commercial transactions where setoff is an extraordinary remedy." S. Rep. No. 101-285 (1990), *available at* 1990 WL 259288, at *3. Congress therefore concluded that "setoffs effected under or in connection with [a swap] agreement, including any security arrangements related thereto, must be protected in order to preserve the functioning of the market." *Id.*

Accordingly, Congress enacted the 1990 Amendments to the Bankruptcy Code, which were designed to provide certainty to the over-the-counter derivatives markets by protecting swap transactions from the effects of bankruptcy. *See* 1990 Bankruptcy Amendments, Pub. L. No. 101-311, 104 Stat. 267; *see also* S. Rep. No. 101-285, at 1 (1990), *available at* 1990 WL

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[11] *See generally* Philip R. Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (2d ed. 2007) ("Set-off is …. a key comparative criterion of financial law. … It is a key criterion because the amounts involved are extremely large and because there is an acute collision of policies as to who to protect on insolvency. … Set-off usually only matters on insolvency. If everybody could pay there would be no need for the protection of set-off. … If a jurisdiction supports set-off to reduce exposures, in practice there must be no chink or Achilles heel in the armoury: it must be available on insolvency, against attaching creditors, assignees and other interveners and in the case of reorganization—at least by contract. There must be workable safe harbours for preference avoidance doctrines which might upset a set-off. If there is a single material gap, the reduction in exposure is unsafe.").

259288, at *1 (the purpose of the bill is "to clarify U.S. bankruptcy law with respect to the treatment of swap agreements and forward contracts. The bill would provide certainty for swap transactions in the case of a default in bankruptcy…."); H.R. Rep. No. 101-484, at 1 (1990) (the purpose of the bill "is to ensure that the swap and forward contract financial markets are not destabilized by uncertainties regarding the treatment of their financial instruments under the Bankruptcy Code"), *reprinted in* 1990 U.S.C.C.A.N. 223, 223.

The addition of section 560 to the Bankruptcy Code was a key element of this safe-harbor protection. *See* 1990 Bankruptcy Amendments, Pub. L. No. 101-311, § 106, 104 Stat. 267.[12] Section 560 was intended "to preserve a swap participant's contractual right to terminate a swap agreement and offset any amounts owed under it in the event that one of the parties to the agreement files a bankruptcy petition." *See* H.R. Rep. No. 101-484, at 5 (1990), *reprinted in* 1990 U.S.C.C.A.N. 223, 227. Through enactment of this safe harbor, Congress made clear that "the exercise of any such right shall not be … limited by operation of the Bankruptcy Code." *Id.* In other words, Section 560 "means that these contractual rights are not to be interfered with by any court proceeding under the [Bankruptcy] Code." S. Rep. No. 101-285 (1990), *available at* 1990 WL 259288, at *9; *see also* 136 Cong. Rec. 13,153 (June 6, 1990) (statement of Senator DeConcini) ("The effect of the swap provisions will be to provide certainty for swap transactions and thereby stabilize domestic markets by allowing the terms of the swap agreement to apply

[12] The text of section 560, as enacted in 1990, provided that: "The exercise of any contractual right of any swap participant to cause the termination of a swap agreement because of a condition of the kind specified in section 365(e)(1) of this title [regarding the debtor's insolvency or bankruptcy filing] or to offset or net any termination values or payment amounts arising under or in connection with any swap agreement shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title. As used in this section, the term 'contractual right' includes a right, whether or not evidenced in writing, arising under common law, under law merchant, or by reason of a normal business practice." 1990 Bankruptcy Amendments, Pub. L. No. 101-311, § 106, 104 Stat. 267, 268.

notwithstanding the bankruptcy filing."); *Thrifty Oil Co. v. Bank of Am. Nat'l Trust & Sav. Assoc.*, 322 F.3d 1039, 1050 (9th Cir. 2003) ("The legislative history of the Swap Amendments plainly reveals that Congress recognized the growing importance of interest rate swaps and sought to immunize the swap market from the legal risks of bankruptcy.").

Congress amended the Bankruptcy Code again in 2005, acting on recommendations of the President's Working Group on Financial Markets and the financial industry, to clarify and expand the safe harbor provisions to keep pace with the continuing evolution of the financial markets.[13] Among other provisions, it amended Section 560 to clarify that the safe harbor protected the "liquidation" or "acceleration" of one or more swap agreements, as well as the "termination" thereof; that its protections extended to "financial participants"; and that the protected contractual rights includes rights set forth in the rules or bylaws of various financial-market organizations, as well as those "under common law." *See* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 907(j), 119 Stat. 23. Congress also added Section 561 to the Bankruptcy Code, *id.* § 907(k), in order to "protect the contractual right of a master netting agreement participant to enforce any rights of termination, liquidation, acceleration, offset or netting under a master netting agreement." H.R. Rep. No. 109-31, at 132-33 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 193.

As with the earlier amendments, Congress emphasized that the 2005 amendments were "intended to reduce 'systemic risk' in the banking system and financial marketplace," by "allow[ing] the expeditious termination or netting of certain types of financial transactions."

[13] *See* H.R. Rep. No. 109-31, at 20 & n.79 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 105. The President's Working Group on Financial Markets included representatives from the Commodity Futures Trading Commission, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, the Securities and Exchange Commission, and the Department of Treasury, including the Office of the Comptroller of the Currency. *Id.*

H.R. Rep. No. 109-31, at 20 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 105-06.[14] As it explained:

> For the purposes of Bankruptcy Code sections … 560, and 561, it is intended that the normal business practice in the event of a default of a party based on bankruptcy or insolvency is to terminate, liquidate or accelerate … swap agreements and master netting agreements with the bankrupt or insolvent party.

Id. at 133.

In 2006, Congress enacted the Financial Netting Improvements Act, which further clarified the safe-harbor protections for financial contracts. Among other provisions, it amended the safe-harbor exceptions to the automatic stay under Section 362(b) to replace the previous language exempting a "setoff by a swap participant … of a *mutual debt and claim*" (emphasis added) with amended language that mirrored the text of Section 560, thus exempting "the exercise by a swap participant … of *any contractual right* (as defined in section 560) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such [swap] agreements." Financial Netting Improvements Act of 2006, Pub. L. No. 109-390, § 5, 120 Stat. 2692, 2697 (codified at 11 U.S.C. § 362(b)(17)) (emphasis added). Congress explained that these additional revisions to the safe harbor provisions, although "technical" in nature (as the bankruptcy court observed), were needed to "strengthen[] and clarify[] the enforceability of early termination and close-out netting provisions and related collateral arrangements in U.S. insolvency proceedings," in order to "help

[14] *Id.* at 20 n.78 ("Systemic risk is the risk that the failure of a firm or disruption of a market or settlement system will cause widespread difficulties at other firms, in other market segments or in the financial system as a whole. If participants in certain financial activities are unable to enforce their rights to terminate financial contracts with an insolvent entity in a timely manner, or to offset or net their various contractual obligations, the resulting uncertainty and potential lack of liquidity could increase the risk of an inter-market disruption.").

reduce systemic risk in the financial markets." H.R. Rep. No. 109-648 (2006), *available at* 2006 WL 6165926, at *1-2.[15]

As the foregoing history demonstrates, the safe-harbor provisions are critical to Congress's statutory design to protect the financial markets from the uncertainty and disruption of bankruptcy. Congress provided in sweeping language that a swap participant's exercise of "any contractual right" "to offset or net out" any "payment amounts" arising under or in connection with the termination, liquidation, or acceleration of one or more swap agreements "shall not be stayed, avoided, or otherwise limited by operation of *any* provision of this title." 11 U.S.C. § 560 (emphasis added). Consistent with its text and history, Section 560 should thus be read to mean exactly what it says: the exercise of any contractual right to offset payment amounts in connection with the termination or liquidation of a swap agreement must not be limited by operation of any provision of the Bankruptcy Code.

II. THE BANKRUPTCY COURT ERRED IN CONSTRUING THE SAFE-HARBOR PROVISIONS TO EXEMPT THE EXERCISE OF SETOFF RIGHTS ONLY FROM THE AUTOMATIC STAY, RATHER THAN FROM "ANY PROVISION" OF THE BANKRUPTCY CODE.

The bankruptcy court erroneously read Section 560 to exempt the exercise of contractual setoff rights under swap agreements only from the provisions of the automatic stay under Section 362 of the Bankruptcy Code, but not from other provisions of the Bankruptcy Code. It thus concluded that Section 560 does not exempt the exercise of such rights by swap participants from the limitations on setoff imposed by Section 553 of the Bankruptcy Code. *See* Mem. Decision, May 5, 2010, at 13 ("[T]he language in the safe harbor provisions relied on by Swedbank renders the automatic stay inapplicable in the context of safe harbored contracts—the

[15] It is also worth noting that the financial reform legislation now pending before Congress, a key purpose of which is to regulate the trading of swaps and other derivatives products, also contains provisions that maintain the bankruptcy safe harbors. *See* H.R. Rep. No. 111-517, at 833-835, 1090 (2010).

central purpose of the safe harbor provisions—and does not eliminate the mutuality requirement of section 553(a).").

The bankruptcy court's construction of Section 560 cannot be squared with the statutory text. The Supreme Court has repeatedly directed that the Bankruptcy Code, like any statute, must be construed in accordance with its plain meaning.[16] And the plain language of Section 560 unquestionably exempts the exercise of such rights from *any* provision of the Bankruptcy Code, not just the automatic stay.

By its terms, Section 560 provides, not only that the exercise of such setoff rights "shall not be stayed," but also that they "shall not be … avoided, or otherwise limited by operation of *any* provision of this title." 11 U.S.C. § 560 (emphasis added). Had Congress intended to limit the safe harbor merely to an exemption from the automatic stay, as the bankruptcy court concluded, Congress could have simply provided that the right of setoff shall not be "stayed by operation of the automatic stay under Section 362 of this title." Instead, Congress stated unequivocally that such rights shall not be "stayed, avoided *or otherwise limited* by operation of *any* provision of this *title*." *Id.* § 560 (emphasis added). Under basic canons of statutory construction, each of these three terms—"stayed," "avoided," or "otherwise limited"—separated

[16] *See, e.g.*, *United States v. Ron Pair Enters*, 489 U.S. 235, 242 (1989) (the "plain meaning of legislation should be conclusive, except in the rare cases in which the literal application of a statute will produce a result demonstrably at odds with the intention of the drafters" (internal quotation marks omitted)); *Lamie v. U.S. Trustee*, 540 U.S. 526, 534 (2004) ("It is well-established that when the statute's language is plain, the sole function of the courts—at least where the disposition required by the text is not absurd—is to enforce it according to its terms." (internal quotation marks omitted)); *Patterson v. Shumate*, 504 U.S. 753, 757, 759 (1992) ("[T]he plain language of the Bankruptcy Code … is our determinant. … We must enforce the statute according to its terms.").

by the disjunctive "or," must be given independent meaning.[17] Moreover, Congress provided that the exercise of such rights shall not be stayed, avoided or otherwise limited by "operation of *any provision of this title*." *Id.* § 560. "[T]his title" means Title 11, the Bankruptcy Code, and Section 553, like every other provision of Title 11, is a "provision" of the Bankruptcy Code. Thus, by its terms, Section 560 provides that the exercise of any contractual right of setoff in connection with the termination or liquidation of a swap agreement cannot be "limited" by operation of "any" provision of the Bankruptcy Code, including Section 553.

In reaching the contrary conclusion, the bankruptcy court misconstrued the legislative history of the safe harbor provisions, which makes clear that Congress was concerned about more than merely the automatic stay under Section 362. To be sure, Congress was particularly concerned about the effects of the automatic stay, as the bankruptcy court correctly observed. But it was also concerned about *any* provision of the Bankruptcy Code that could have the effect of impeding parties from exercising their contractual rights to terminate, close out, and net payment amounts under swap agreements and other financial contracts in the event of the bankruptcy of a counterparty. Any legal impediment to exercising such rights could threaten the functioning of the financial markets, whether it arises from the automatic stay or from some other provision of the Bankruptcy Code, such as Section 553. Indeed, in strengthening the safe harbor provisions in the 2005 amendments, Congress made clear that "[t]he protection of netting and offset rights in sections 560 and 561 is *in addition* to the protections afforded in sections 362(b)(6), (b)(7), (b)(17) and (b)(28) of the Bankruptcy Code," which exempt netting and offset

[17] *See Williams v. Taylor*, 529 U.S. 362, 404 (2000) (interpreting 28 U.S.C. § 2254(d)(1) and giving independent meaning to clauses separated by the word "or" because it is "a cardinal principle of statutory construction that [courts] must give effect, if possible, to every clause and word of a statute" (internal quotation marks omitted)).

rights under swap agreements from the automatic stay. H.R. Rep. No. 109-31, at 133 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 193 (emphasis added).

The bankruptcy court regarded its erroneous construction of the safe harbor provisions as necessary to achieve a result it perceived to be consistent with the bankruptcy policy underlying the mutuality doctrine, namely, equality of distribution among creditors. It acknowledged that Sections 560 and 561 provide that the "contractual rights of parties are to be respected and enforced," but it reasoned that this "does not justify overriding applicable bankruptcy jurisprudence," "especially … in the case of mutuality," which "would result in a windfall to Swedbank to the detriment of other creditors." *See* Mem. Dec. at 18. A court's view of good bankruptcy policy, however, cannot justify construing the statute contrary to its text.

It is certainly true that equality of distribution among creditors is a central policy of the Bankruptcy Code. *See Begier v. IRS*, 496 U.S. 53, 58 (1990). And permitting a creditor to exercise a right of setoff is in some respects in tension with that policy, because it generally enables the creditor to receive more favorable treatment of its claim, which is effectively paid in full to the extent that the creditor's debt to the debtor is set off against the claim. But equal treatment of creditors is not the only policy animating the Bankruptcy Code, and Congress has frequently balanced that policy against other policies and interests at stake in bankruptcy proceedings. *See, e.g.*, 11 U.S.C. §§ 361, 506(a)-(b), 507, 1129(b)(2)(A) (providing favored treatment to secured claims and various other unsecured claims of employees, taxing authorities and others). Indeed, even outside the safe-harbor context, creditors with setoff rights are treated as secured creditors and generally afforded more favorable treatment. *See id.* §§ 506(a), 553.

As set forth above, another key policy underlying the Bankruptcy Code is the strong congressional policy of protecting the financial markets from the destabilizing effects of the

Bankruptcy Code's provisions on the exercise of counterparties' contractual rights. *See, e.g.*, *Thrifty Oil Co. v. Bank of Am. Nat'l Trust & Sav. Ass'n*, 322 F.3d 1039, 1050 (9th Cir. 2003) ("[T]he Bankruptcy Code reflect[s] a strong Congressional policy of protecting interest rate swaps, termination damages and the swap market from the effects of bankruptcy.").

Where these policies clash, courts are required to respect the congressional judgment about how to balance those competing policies, reflected in the specific statutory language evidencing the congressional intent regarding the means by which those various purposes are to be carried out. As the Supreme Court has explained, Congress often has more than a single purpose in mind when it enacts a piece of legislation, and it must often weigh competing policies and interests when crafting the provisions of a statute. Courts must therefore construe statutes in accordance with the specific language Congress chose to resolve those competing goals in order to carry out Congress's intent. For example, in *Mertens v. Hewitt Assocs.*, 508 U.S. 248 (1993), the Supreme Court rejected an argument that it should construe a provision of ERISA[18] authorizing "appropriate equitable relief" to permit an award of monetary damages, "in order to achieve the 'purpose of ERISA to protect plan participants and beneficiaries.'" *Id.* at 261. As the Court explained:

> notions of a statute's 'basic purpose' are nonetheless inadequate to overcome the words of its text regarding the *specific* issue under consideration. This is especially true with legislation such as ERISA, an enormously complex and detailed statute that resolved innumerable disputes between powerful competing interests—not all in favor of potential plaintiffs. … Exposure to [damages] liability would impose high insurance costs … upon ERISA plans themselves. There is, in other words, a tension between the primary [ERISA] goal of benefitting employees and the subsidiary goal of containing pension costs. *We will not attempt to adjust the*

[18] Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 832 (codified at 29 U.S.C. § 1001 *et seq.*).

> *balance between those competing goals that the text adopted by Congress has struck*.

Id. at 261-63 (emphasis added).

The Court has repeatedly applied this principle of statutory construction when construing the Bankruptcy Code, an equally complex statute. For example, in *United States v. Ron Pair Enters.*, 489 U.S. 235 (1989), the Court construed section 506(b) of the Bankruptcy Code, which provides that "there shall be allowed to the holder of [an oversecured] claim, interest on such claim, and any reasonable fees … provided for under the agreement," *see* 11 U.S.C. § 506(b), to provide for the payment of post-petition interest to all oversecured creditors, including the holders of non-consensual liens (as to which there is no agreement). *Ron Pair Enters.*, 489 U.S. at 241. It noted that "the payment of postpetition interest is arguably somewhat in tension with the desirability of paying all creditors as uniformly as practicable"—just as might be said regarding the enforcement of setoff rights under financial contracts—but "Congress expressly chose to create that alleged tension. There is no reason to suspect that Congress did not mean what the language of the statute says." *Id.* at 245-46.

Similarly, in *Florida Dep't of Revenue v. Piccadilly Cafeterias*, 554 U.S. 33, 128 S. Ct. 2326 (2008), the Court "decline[d] to construe the [stamp-tax] exemption granted by [11 U.S.C.] § 1146(a) to the detriment of the State," "beyond what the statutory text can naturally bear," in order to serve the "ostensibly 'remedial' purpose" of the Code. *Id.* at 2338-39. As it explained:

> [T]his Court has rejected the notion that 'Congress had a single purpose in enacting Chapter 11.' Rather, Chapter 11 strikes a balance between a debtor's interest in reorganizing and restructuring its debts and the creditors' interest in maximizing the value of the bankruptcy estate. The Code also accommodates the interests of the States in regulating property transfers … Such interests often do not coincide, and in this case, they clearly do not.

Id. at 2339; *see also Owen v. Owen*, 500 U.S. 305, 313 (1991) ("Nor is there any overwhelmingly clear policy impelling us, if we possessed the power, to create a distinction that the words of the statute do not contain. [Although] Respondent asserts that it is inconsistent with the Bankruptcy Code's 'opt-out' policy, …. [w]e have no basis for pronouncing the opt-out policy absolute, but must apply it along with whatever other competing or limiting policies the statute contains.").

In short, the bankruptcy court's reliance on the perceived bankruptcy policy underlying the mutuality requirement cannot justify an unduly narrow construction of the safe harbor provisions under Sections 560 and 561 of the Bankruptcy Code. Congress meant the safe harbors to do exactly what it said in those provisions: to ensure that the contractual rights of swap participants to set off payment amounts in connection with the termination or liquidation of swap agreements "shall not be stayed, avoided, or otherwise limited by operation of any provision" of the Bankruptcy Code, including Section 553.

III. TO THE EXTENT THIS COURT FINDS THAT THE SWEDBANK TRANSACTION AT ISSUE IS OUTSIDE THE SCOPE OF THE SAFE HARBOR PROVISIONS, IT SHOULD RULE NO MORE BROADLY THAN NECESSARY TO RESOLVE THIS DISPUTE.

ISDA takes no position on whether Appellant had a contractual right of setoff arising under a swap agreement with respect to the deposit funds at issue, an issue the parties apparently disputed below, but that the bankruptcy court did not address. *See* Mem. Dec. at 7 n.12. For this reason, ISDA takes no position on the question whether the bankruptcy court's judgment should be affirmed or reversed.

Most critically from ISDA's perspective, however, if this Court affirms the bankruptcy court's judgment, it should not do so based on the sweeping and erroneous construction of the safe harbor provisions adopted by the bankruptcy court. In addition to its erroneous construction limiting the safe-harbor provisions to exempt the exercise of setoff rights only from the automatic stay rather than from "any provision" of the Bankruptcy Code, the bankruptcy court likewise erred in reasoning that a "contractual right of offset" does not exist in the absence of "mutuality." *See* Mem. Dec. at 11-12 ("To require that the offsetting balances are mutual does not stay, avoid, or limit the right to offset because the right only exists in bankruptcy when there is mutuality."). As the bankruptcy court acknowledged, while mutuality is generally a common-law requirement of the right of setoff, the strictest form of the "mutuality" requirement is a "principle of *bankruptcy* law, codified in section 553." *Id.* at 10 (emphasis added). Outside of bankruptcy, parties are free to contract for whatever rights of setoff they choose, and to enforce those rights in accordance with applicable contract or other law, whether or not such rights would be enforceable under the mutuality restrictions imposed under Section 553 in bankruptcy. And to the extent those rights are enforceable outside of bankruptcy under applicable non-bankruptcy law, and thus relied on by the financial markets in the event of insolvency or bankruptcy, Congress intended to protect those rights in bankruptcy to safeguard the functioning of the markets.

Accordingly, Congress made clear in Section 560 that all such rights are to be preserved by explicitly protecting "*any* contractual right" of setoff. It defined the term "contractual right" expansively in Section 560 to include any "right, whether or not evidenced in writing, arising under common law, under law merchant, or by reason of normal business practice," or any right "set forth in a rule or bylaw" of various specified financial-market organizations.[19] Thus,

[19] *See* 11 U.S.C. § 560 ("As used in this section, the term "contractual right" includes a right set forth in a rule or bylaw of a derivatives clearing organization (as defined in the Commodity Exchange Act), a multilateral clearing organization (as defined in the Federal Deposit Insurance Corporation Improvement Act of 1991), a national securities exchange, a national securities association, a securities clearing agency, a contract market designated under

Congress made clear that *any* right of setoff that may be *contracted for* outside of bankruptcy, under the common law or otherwise, is not to be "stayed, avoided, or otherwise limited" by operation of "any provision" of the Bankruptcy Code.

Swedbank has argued that because the distinction between a "pre-petition" entity and a "post-petition" entity is entirely a creature of federal bankruptcy law, the safe harbor provisions thus permit it to exercise its contractual setoff rights. On the other hand, it can certainly be argued that the specific right of setoff that Swedbank seeks to exercise—the setting off of funds received from the Debtor's bankruptcy estate post-petition against a pre-petition obligation the Debtor owed to Swedbank—was not addressed specifically in the parties' agreement. ISDA takes no position on that question—whether a claimed non-mutual setoff right that is not expressly addressed in the parties' contract falls within the Bankruptcy Code's safe harbor. To the extent, however, the Court were to conclude that the Swedbank transaction at issue falls outside the scope of the safe harbor, ISDA respectfully urges the Court to limit such a decision to the unusual facts presented here—a party's effort to exercise non-mutual setoff rights that are not expressly provided for under the terms of the parties' agreement—leaving for future consideration a scenario in which a party seeks to exercise a setoff right that *is* expressly set forth in the parties' agreement, such as, for example, an express contractual cross-affiliate netting provision.

This issue is of considerable importance to the financial markets because the bankruptcy-law principle of "mutuality" has been regarded by many courts to encompass a number of other, distinct, limitations on setoff rights. For example, in addition to the restriction barring the setoff

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the Commodity Exchange Act, a derivatives transaction execution facility registered under the Commodity Exchange Act, or a board of trade (as defined in the Commodity Exchange Act) or in a resolution of the governing board thereof and a right, whether or not evidenced in writing, arising under common law, under law merchant, or by reason of normal business practice.").

of pre- and post-petition obligations against one another, courts have also construed the "mutuality" requirement under Section 553 to require that the offsetting debts and claims run between the "same two parties." *See, e.g., In re Elcona Homes Corp.*, 863 F.2d 483, 487 (7th Cir. 1988). However, relying on the safe-harbor provisions, market participants commonly include cross-affiliate netting provisions, otherwise referred to as "triangular" cross-affiliate netting provisions, that permit party *A* to set off its obligations to counterparty *B* against *B*'s obligations to *A's* affiliate, *C*. While courts have considered this distinct "same two parties" mutuality requirement outside the safe-harbor context, the enforceability of setoff rights in bankruptcy under "triangular" cross-affiliate netting provisions for safe-harbored contracts has, to ISDA's knowledge, not yet been addressed in a judicial opinion. *See In re SemCrude, L.P.*, 428 B.R. 590, 594 (D. Del. 2010) (holding that Section 553's "mutuality" requirement prohibits triangular setoff under express contractual cross-affiliate provision, but explicitly declining to consider an argument that the exercise of setoff rights under such agreement was protected by the safe-harbor provisions, because the issue was not timely raised below).[20]

This appeal does not present the issue of whether a safe-harbor contract that contains an express contractual limitation on the "mutuality" requirement is enforceable. There is therefore no need to address in this case whether any "mutuality" restriction on the exercise of such cross-

[20] ISDA has supported proposed legislation that would have clarified that express cross-affiliate setoff provisions under swap agreements and other financial contracts enjoy safe-harbor protection. Congress did not enact this proposed clarifying legislation, and ISDA is not arguing here that the Court should rule that cross-affiliate setoff provisions are protected under the Bankruptcy Code. ISDA's position is that, if the Court affirms the bankruptcy court's decision, this case certainly presents no occasion to address the enforceability of contractual rights of setoff that parties expressly provide for in their agreement under the safe-harbor provisions.

affiliate setoff provision applies in regard to swap agreements.[21] Because of the widespread use of such cross-affiliate provisions to the financial markets, any statements that could potentially cast doubt on the protection of such rights under the Bankruptcy Code's safe-harbor provisions could cause significant uncertainty in the marketplace. Accordingly, ISDA respectfully submits that the Court's holding as to the application of the "mutuality" requirement in this appeal should be limited to the specific prohibition against offsetting pre- and post-petition obligations where the setoff clause fails to contemplate such setoff. Consideration of the enforceability of a setoff clause that expressly limits mutuality restrictions should be reserved for a future case squarely presenting that issue. *Thrifty Oil Co.*, 322 F.3d at 1050-51 ("[T]he Swap Amendments [safe harbors] … provide … policy principles applicable to the interpretation or application of any Bankruptcy Code provision …. [F]ederal courts should avoid interpreting or applying [such provisions] in a way that would … inject unnecessary legal uncertainty into the swap markets.").

[21] The obligations at issue in this case assertedly ran between the same two parties, Swedbank and LBHI. *See* Mem. Dec. at 5. Moreover, to the extent that any of the claims Swedbank sought to set off against the deposit funds in LBHI's account with Swedbank may have constituted claims against LBHI's affiliates, *see id.* at 3 (such as, for example, if one were to view the post-petition debtor as an "affiliate" of the pre-petition debtor), the agreement at issue in the case did not provide Swedbank a right to set off its obligations to LBHI against any claims against LBHI's affiliates. *See id.* at 4. n.4 (providing cross-affiliate setoff provisions only as to obligations running between the defaulting party (LBHI) and the non-defaulting party (Swedbank) or its affiliates). On these facts, therefore, no question is presented as to the enforceability of an express cross-affiliate setoff provision.

CONCLUSION

For the foregoing reasons, the bankruptcy court's erroneous construction of the Bankruptcy Code's safe harbor provisions in Sections 560 and 561 should be rejected.

Dated: July 14, 2010

Respectfully submitted,

/s/ Danielle Spinelli

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EXHIBIT B

UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

In re Lehman Brothers Holdings Inc., *et al.*, Debtors.	
Swedbank AB, Appellant, v. Lehman Brothers Holdings Inc., *et al.*, Appellees.	No. 10-cv-04532 (NRB)

ORDER GRANTING LEAVE TO FILE BRIEF OF THE INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF NEITHER PARTY

Upon consideration of the Motion of the International Swaps and Derivatives Association for leave to file a brief as *amicus curiae* in support of neither party, dated July 14, 2010, and for good cause shown, the motion is hereby GRANTED. The proposed *amicus curiae* brief, attached to the Motion as Exhibit A, shall be deemed FILED.

SO ORDERED.

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Judge Naomi Reice Buchwald
United States District Judge