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Lehman Derivative Litigation Still Looms Large

Law360, New York (June 14, 2013, 6:21 PM ET) -- The market's attention is fixed firmly on the future of derivatives. Questions about the implementation and impact of the Dodd Frank requirements, and to what extent the use of swaps in structured finance and other transactions will return, are front and center. And yet, there are also lessons to be learned from the past use of these somewhat esoteric financial instruments, which continue to be questioned and tested in litigation — with more to come.

Lehman Brothers affiliates reportedly had 930,000 derivatives contracts — credit default swaps, interest rate swaps and an array of more exotic instruments — on their books around the time they filed for bankruptcy. The vast majority of Lehman's counterparties appear to have terminated these derivatives transactions within a month or two after Lehman's bankruptcy filing. These terminations were permitted under the parties' agreements. In fact, the termination of these derivatives contracts is safe harbored under amendments to the Bankruptcy Code designed to facilitate the smooth functioning of the financial markets in the aftermath of a major swap participant's bankruptcy.

Notwithstanding that they were permitted, however, these terminations have led to countless disputes. Did the terminations meet the technical requirements of the governing documents? Did the counterparty calculate the correct breakage amount to be paid to (or received from) Lehman? Who was entitled to be paid first when structured finance transactions involving swaps were unwound — Lehman, as the bankrupt swap provider, or the investors who funded the transaction and, under typical deal documents, were to be paid first under the priority "waterfall" in the event of a Lehman bankruptcy? According to Lehman's lawyers, the answer to the latter question alone is worth billions of dollars to the Lehman estate. And these issues are not limited to Lehman. Ambac's derivatives trading subsidiaries were also faced with massive portfolios of derivatives that were terminated due to Ambac's financial plight, and similar questions may arise as other swap providers find themselves in financial straits.

While there have been some public skirmishes, most of the action so far in the Lehman bankruptcy case has taken place behind the scenes in confidential mediation. According to Lehman's May 15 status report to the bankruptcy court, Lehman has initiated 316 mediations as part of a court-ordered alternative dispute resolution program for claims related to derivatives "in the money" to Lehman — i.e., where Lehman asserts that it is entitled to a recovery. (Claims for a recovery against Lehman are covered by a different set of ADR procedures.) And Lehman has stated that it plans to serve at least 100 more ADR demands in the near future.

Many of these disputes may soon land in court, however. New York's six-year statute of limitations for contract claims will expire in September or October 2014 for terminations that occurred shortly after Lehman Brothers Holdings Inc. filed for bankruptcy in September 2008. And while much of the litigation that Lehman has brought to date — largely to meet the more abbreviated statute of limitations for bankruptcy law claims — has been stayed at Lehman's request, the bankruptcy court has started to show some impatience with Lehman's repeated requests to extend the stay, and creditors may be interested in seeing these claims move forward in court as well.

So what is coming down the pike?

To the extent that there has been active litigation in the Lehman cases, much of it has focused on the priority of payments issue mentioned above — or what Lehman has dubbed the "flip clause" issue. Credit default swaps and other derivative instruments were a component of many structured finance transactions, including CDOs and credit-linked note programs. The waterfall provisions of those deals typically provided that swap termination payments would be made to the swap provider (e.g., Lehman) first, before distributions to investors, unless the swap was terminated as the result of a swap provider default. At the insistence of the credit rating agencies, however, sponsors such as Lehman structured the transactions so that distributions to investors would come first if the swap provider was the defaulting party, thus protecting investors against a tactical default by the swap provider. This subordination of Lehman's payment priority is what Lehman refers to as a "flip" in its position — notwithstanding that in either situation it is receiving exactly what it contracted for, and so nothing has really changed, or "flipped."

To date, the bankruptcy court overseeing the Lehman bankruptcy has issued a series of rulings that favor Lehman in the "flip clause" cases. These rulings have come under heavy criticism, and when leave to appeal was granted on this issue, Lehman quickly settled — reportedly at a very steep discount. While other cases are being litigated at the bankruptcy court level, there is no district court or circuit level guidance as of yet. (Appeals from the bankruptcy court are taken to the district court in the first instance.) And so a state of uncertainty persists.

A more mundane issue — but possibly a more important one for the derivatives market — is how breakage amounts are to be calculated. The widely used 1992 versions of the International Swaps and Derivatives Association Inc.'s master agreements, for instance, allow the contracting parties to elect between two "payment measures" for calculating breakage. One method relies on market quotes provided by leading dealers for how much they would need to receive (or be willing to pay) to enter into a hypothetical trade on the same terms as the terminated transaction. Under the other method, the nondefaulting party determines in good faith its losses — including loss of bargain — and costs (or gain) as a result of the termination. The underlying goal of both methods is to determine the market value of the terminated transaction at or around the time of termination. (The "closeout amount" concept in the 2002 ISDA form similarly is designed to determine the market value of a terminated derivative.)

Nonetheless, both Lehman and Ambac have taken the position that breakage amounts should be determined using a mechanical calculation of so-called "mid-market" levels. Mid-market values are not reflective of any real "market." Rather, mid-market amounts are determined using a mathematical calculation that ignores any consideration of standard charges — including, for instance, credit charges, hedging costs and dealer profit margin — that are major drivers of actual swap market value. It is no coincidence that using mid-market values has the effect of maximizing the amount potentially due to the swap provider from the counterparty, or of minimizing the amount due from the swap provider to its counterparty, depending on who is "in the money" on the trade. Both Lehman and Ambac have recognized these market factors in other contexts, but take the position in litigation that they should be disregarded.

Lehman recently asserted its entitlement to use “mid-market” valuations in an adversary proceeding that it brought against the Federal Home Loan Bank of Cincinnati over the termination of a portfolio of 87 interest rate swap and option transactions, and Ambac has previously done so in other litigation. No U.S. court that we know of has addressed this issue thus far, however.

Another issue that may take center stage, at least in the bankruptcy context, is whether a bankruptcy court has the right to enter a final order or judgment on a claim for breach of a derivatives agreement — or any other contract. In its 2011 decision in Stern v. Marshall, the Supreme Court redefined the scope of the bankruptcy court’s power to enter final orders and judgments. The reasoning in Stern strongly suggests that a bankruptcy court lacks the power to enter a final judgment in a breach of contract case governed by state law, and instead can only make a report and recommendation to the district court. The courts continue to grapple with the implications and scope of Stern, and Stern may significantly impact the contours of derivatives and other contract litigation with bankrupt counterparties.

One word of caution here. Filing a bankruptcy claim may run the risk of waiving the right to have judgment entered in the district court. Filing a claim may also waive other potentially important rights — including the ability to contest venue or personal jurisdiction in the bankruptcy court (particularly relevant to non-U.S. litigants), the right to a jury trial (where such a right otherwise exists), and any rights to compel arbitration. Filing a claim may be the only sensible move where, for instance, a counterparty seeks a recovery from a bankrupt swap provider on a single terminated transaction. But the question may be closer for counterparties who had a portfolio of derivatives trades with a bankrupt swap provider — some of which are “in the money” to the counterparty, while others are “out of the money.” And the same questions may come up for parties that have a basis to assert a claim against the debtor that is unrelated to a disputed derivative. Filing a claim may well be prudent in any event, but these risks deserve to be considered.

We expect to see each of these issues play out in the Lehman bankruptcy, with the possibility of a significant spike in activity beginning within the next year as the statute of limitations clock runs down.

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