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Preferential Treatment of Derivative Contracts – Savior or Scourge?

by Shmuel Vasser and Matthew K. Kerfoot
Dechert LLP

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The District of Columbia Terminates a Repo Contract

On April 11, 1985, Mayor Marion Barry announced that the District of Columbia ("D.C.") successfully closed out a $10 million repurchase agreement (or "repo") with Bevill, Bresler & Schulman Asset Management Company by selling the "collateral" it had originally received from Bevill.[1] Four days earlier, Bevill, a rapidly growing government securities broker/dealer, had filed a voluntary petition for Chapter 11 bankruptcy protection. Bevill suffered substantial losses in its government securities trading book and, at the time of the filing, had approximately $198 million in liabilities, including those owed to many repo participants.[2]

According to Deputy Mayor Alphonse G. Hill, D.C. had placed Bevill on a list of approved companies for securities dealing after a change in bankruptcy laws permitted the sale of collateral in the event of a bankruptcy. Among the changes to the federal Bankruptcy Code (or the "Code") in 1984—the year prior to Bevill's bankruptcy—was the inclusion of safe harbor provisions for terminating repurchase agreements. Congressional testimony at the time described the importance of the repo markets "to the health of the country's financial system," including the importance of such markets to state and local governments.[3] Relying on these safe harbors, D.C. terminated the repurchase agreement upon Bevill's bankruptcy and liquidated the securities that it had originally purchased under the repo. This liquidation, according to Mayor Barry, saved the city $10 million and accorded the mayor favorable press in the *New York Times*.[4] Bevill's bankruptcy case, of course, went on to become one of the early, well-known chapters in the ever-growing body of derivatives safe harbor literature.

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*Shmuel Vasser is a partner and Matthew K. Kerfoot is counsel with Dechert LLP, resident in the New York office. The views expressed herein are those of the authors, not the firm.

[1] Nathaniel C. Nash, *District Loan Recouped*, N.Y. Times, April 12, 1985.

[2] James Sterngold, *Bevill: Fast Growth Based on Repos*, N.Y. Times, April 10, 1985.

[3] S. Rep. No. 98-65, at 44-49 (1983), *reprinted in* 5 *Collier on Bankruptcy*, ¶ 559.LH (Alan N. Resnick, Henry J. Sommer & Lawrence P. King, eds., 15th ed. rev. 2005).

[4] Nathaniel C. Nash, *District Loan Recouped*, N.Y. Times, April 12, 1985.

This $10 million transaction was less than 1% of the exposure in Bevill's $1.2 billion repo book,[5] and a mere triviality in the context of the larger, global repo market. Yet this transaction tangibly illustrates much of our collective thinking behind identifying special contracts and treating them in special ways. The House Report[6] that helped support the passage of the repo safe harbors was eerily accurate in forecasting potential harm to local governments, particularly to Congress's home town. The $10 million that D.C. preserved in liquidating the collateral prevented the occurrence of a type of "daisy-chain" effect often cited in discussions of the safe harbors. In this case, the "transactions" on the other side of D.C.'s "book" were receivables from taxpayers and payables to D.C.'s debtholders. D.C.'s protection from the stay prevented losses from hitting D.C.'s investment portfolio that would have inevitably led to losses for taxpayers (in the form of additional or higher taxes) or debtholders (in the form of delayed or reduced repayments).

Of course, not everyone was as nimble as D.C. in terminating and liquidating repo transactions with Bevill. The list of Bevill's creditors included savings & loans and municipalities across the country who collectively suffered hundreds of millions of dollars of losses. Ultimately, the losses suffered by these counterparties to Bevill, and the actions taken by D.C. and others, have helped shape the debate over the repo safe harbors and the derivatives safe harbors in general throughout the subsequent 25 years.

Do Markets Benefit from Derivatives Safe Harbors?

Over the past quarter century, members of the House and Senate have stepped forward periodically to declare the importance of the derivatives markets to the nation and the need to mitigate related systemic risks.

In 1982, Senator Bob Dole discussed potential risk to the securities contract markets. Dole argued that the safe harbors are essential because "market fluctuations in the securities markets create an inordinate risk that the insolvency of one party could trigger a chain reaction of insolvencies of the others who carry accounts for that party and undermine the integrity of those markets."[7] Also in 1982, a House Report stated that due to the structure of the clearing system in the commodities industry, the Bankruptcy Code should strive to prevent the insolvency of one commodity firm from spreading to another, which could "possibly threaten[ ] the collapse of the affected market."[8]

Notably, early support for the safe harbor provisions came not from a particular politician or interest group, but from a variety of regulatory bodies such as the Federal Reserve Board, the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC").[9] Support

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[5] James Sterngold, *Bevill: Fast Growth Based on Repos*, N.Y. Times, April 10, 1985. The size of the book was likely even larger, as the NY Times reported that the rapidly growing firm had $599 million of repos and $588 million of reverse repos on its balance sheet as of June 30, 1984, nine months before its bankruptcy.

[6] H.R. Rep. No. 97-420, at 1 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583.

[7] 128 Cong. Rec. S15981 (daily ed. July 13, 1982) (statement of Senator Dole).

[8] H.R. Rep. No. 97-420, at 1 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583.

[9] H.R. Rep. No. 97-420, at 2 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583.

also came from a wide array of industry organizations including the predecessors to the Securities Industry and Financial Markets Association, The Clearing House Association, and the International Swaps and Derivatives Association, Inc.[10] The 1982 House Report cited above mentioned in particular that the testimony of the commissioners of the SEC and CFTC, general counsel of the Securities Investor Protection Corporation, and various representatives of commodities and securities brokers, was instrumental in passing the 1982 Bankruptcy Code amendments that provided safe harbors for both commodities and securities contracts.[11]

As the financial markets developed, newer products such as repos and swaps were also identified as agreements warranting protection from the stay. The overriding concern has been that the damage resulting from the insolvency of one derivatives institution should be isolated and limited to that specific institution to mitigate the potential for related daisy-chain insolvency events.[12]

Lehman Brothers[13]

In theory, the argument for safe harbors is compelling. In practice, it is difficult to obtain reliable, comprehensive information on the economic benefits of the safe harbors to the financial system. In respect of the Lehman Brothers bankruptcy, empirical studies will be needed to determine whether the safe harbors provided a net benefit to the bank's derivatives counterparties and to the financial system as a whole. One factor that will influence these studies is that Lehman's U.S. and UK entities were often the counterparties that were custodying collateral assets. Prior to the financial crisis, most end-users in OTC derivatives transactions were viewed as the less credit-worthy counterparty and were required to post initial and variation margin with the dealers. When counterparties to Lehman terminated their contracts upon Lehman's bankruptcy, their ability to foreclose on collateral and set off against the collateral was essentially meaningless. The derivatives marketplace, however, is already addressing this concern through migration of some contracts to third-party custodians.[14] Counterparties to highly liquid OTC derivatives transactions, however, such as foreign exchange and interest rate swaps and forwards, typically terminated these transactions immediately upon bankruptcy and entered into replacement transactions that greatly reduced potential losses.

The historic dimensions of the Lehman bankruptcy, however, already offer some evidence of the benefits of the safe harbors. As of November 13, 2008, only two months after it filed for bankruptcy, over 80% of the approximately 930,000 derivative contracts to which Lehman was a party had been terminated.[15] As

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[10] *See* 135 Cong. Rec. S1414 (daily ed. Feb. 9, 1989) (statement of Senator DeConcini).

[11] H.R. Rep. No. 97-420, at 2 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583.

[12] Among those who understand the workings of our financial system, there is very little doubt that the systemic risks associated with a failure of a large market participant are real. *See, e.g.,* Roberta S. Karmel, *Who Should Regulate Systemic Risk?,* N.Y. Law Journal, October 15, 2009, at 3.

[13] *In re Lehman Brothers Holdings, Inc.*, Case No. 08-13555 (JMP) (Jointly Administered) (Bankr. S.D.N.Y.); *Securities Investor Protection Corp. v. Lehman Brothers, Inc.*, Adv. No. 08-01420 (JMP) (Bankr. S.D.N.Y.).

[14] It is questionable how real this solution is since third parties are notorious in their refusal to act in the face of a bankruptcy filing.

[15] GuyLaine Charles, *OTC Derivative Contracts in Bankruptcy: The Lehman Experience*, 13 N.Y. Bus. L.J. 14, 16 (Spring 2009).

of January 9, 2009, Lehman's counterparties had terminated 3,453 ISDA Master Agreements, representing $14.3 billion payable to Lehman and $11 billion payable to Lehman's counterparties.[16] Although it is difficult to obtain data on the specific Lehman transactions at issue, a large portion of these derivatives transactions were likely part of larger back-to-back arrangements between additional dealers and derivatives participants. Had the counterparties facing Lehman not been able to terminate upon Lehman's bankruptcy, those counterparties would have been left with an unhedged portion of their trading book for an undetermined length of time, potentially incurring large losses and/or substantial costs in purchasing replacement hedges, provided such hedges were available at all.

The Breadth and Depth of the Derivatives Market

The back-to-back nature of the derivatives markets also underscores the extent to which the actions of individual market participants influence, and are influenced by, other market participants. Lehman's counterparties, in turn, faced other counterparties on the back-to-back transactions, who may have faced yet other counterparties. While it is difficult to quantify the systemic risk inherent in this market, the destabilization resulting from an inability to terminate the Lehman transactions may have been catastrophic. The benefit to the large financial community and, potentially, to the overall financial system would appear to outweigh the oft-expressed concerns about preserving assets of the estate of a particular debtor. As with derivatives themselves, a win-win outcome is unrealistic when choosing between the fortunes of a debtor and the greater good of the economy. Given that the market will have already provided its verdict on a bankrupt company, it is reasonable and understandable for society to choose to protect its financial system over the affairs of an insolvent derivatives counterparty, such as Lehman. Of course, Lehman was only the most recent example.

Long-Term Capital Management ("LTCM") was a "large and excessively leveraged hedge fund that lost over 90 percent of its capital between January and September of 1998."[17] Believing that LTCM's imminent failure threatened markets worldwide, the Federal Reserve Bank of New York facilitated a $3.6 billion recapitalization of LTCM.[18] Members of the consortium that financed LTCM's recapitalization determined that bankruptcy was not a viable solution because it would not accomplish the goal of restoring market stability and confidence.[19] The President's Working Group on Financial Markets later wrote that, "had termination not been available to the LTCM Fund's counterparties in the bankruptcy process, the uncertainty as to whether these contracts would be performed would have created great uncertainty and disruptions in these same markets, coupled with substantial uncontrollable market risk to the counterparties."[20]

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[16] *Id.*

[17] United States General Accounting Office, *Responses to Questions Concerning Long-Term Capital Management and Related Events*, 1 (February 23, 2000), *available at* http://www.gao.gov/archive/2000/gg00067r.pdf.

[18] *Id.* at 2.

[19] *Id.* at 13-14.

[20] The President's Working Group on Financial Markets, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*, 27 (April 1999), *available at* http://www.ustreas.gov/press/releases/reports/hedgfund.pdf.

Moreover, Chapter 11 itself may not be the ideal forum for resolving cases involving a large debtor, in which the outcome will have a significant impact on the entire economy. Evidence of this can be found in the U.S. Treasury's recent involvement in the *Chrysler*[21] and *General Motors*[22] cases. Because these companies are so large and the effects of their bankruptcies were expected to be felt throughout the entire economy, the Treasury orchestrated sales with restrictions placed on bidders that effectively resulted in a "de facto reorganization plan—[which] illegitimately distributed assets inconsistently with the priorities established under the Bankruptcy Code."[23] Thus, because of GM and Chrysler's impact on the economy as a whole, the federal government chose to intervene rather than let the Chapter 11 process unfold in accordance with the Bankruptcy Code.

The same rationale applies, perhaps even stronger, in the case of large financial institutions such as Lehman Brothers, which are parties to safe harbor contracts, regardless of whether these financial institutions are the debtors or the non-debtor counterparties. In the case of Lehman, it is estimated that "[a]s much as $75 billion of Lehman Brothers Holdings Inc. value was destroyed by the unplanned and chaotic form of the firm's bankruptcy filing… according to a three-month study by the advisory firm, Alvarez & Marsal [because a]n orderly filing would have enabled Lehman to sell some assets outside of federal bankruptcy-court protection, and would have given it time to try to unwind its derivatives portfolio in a way that might have preserved value."[24]

The lack of an orderly filing can hardly be blamed on the safe harbor provisions. And while Lehman and its creditors arguably lost $75 billion of value, one could only guess the catastrophic consequences to Lehman's counterparties and the broader economy if they had been frozen with unhedged positions of this size.

Are the "Special" Protections so Special?

Critics of the safe harbor protections mainly compare their treatment to that of a garden variety executory contract. That comparison, however, is baseless. Contracts that are financial in nature are treated differently than garden variety executory contracts even if they do not qualify for the safe harbor treatment. Loans and other monetary obligations accelerate as of the date of the bankruptcy filing.[25] Financial accommodations contracts are not assumable and assignable by a bankrupt debtor[26] and bankruptcy termination clauses in these contracts are enforceable.[27] In addition, while setoff generally is

[21] *In re Chrysler LLC*, 576 F.3d 108 (2d Cir. 2009).

[22] *In re General Motors, Corp.*, 407 B.R. 463 (Bankr. S.D.N.Y. 2009).

[23] Barry E. Adler, *What's Good for General Motors*, 3 (2009) (attached as Annex A to Congressional Oversight Panel, *September Oversight Report* (2009), *available at* http://cop.senate.gov/documents/cop-090909-report.pdf).

[24] Jeffrey McCracken, *Lehman's Chaotic Bankruptcy Filing Destroyed Billions in Value*, Wall St. J., December 29, 2008, *available at* http://online.wsj.com/article/SB123050916770038267.html.

[25] 11 U.S.C. § 502(b).

[26] 11 U.S.C. § 365(c).

[27] 11 U.S.C. § 365(e).

subject to the automatic stay, recoupment is not.[28] Thus, other than the right to foreclose on posted collateral, which right is useful in practice only when the non-debtor counterparty has actual possession of the collateral, the special protections granted to the safe harbor contracts do not appear to be so special.

Thirteen Ways (at least) of Looking at Financial Contracts in Bankruptcy: Areas for Improvement in the Safe Harbors

While the general consensus among Congress, regulators and industry organizations is that the safe harbors are a critical aspect of systemic risk management, the language in the relevant portions of the Bankruptcy Code, is, at times, overbroad and can be susceptible to abuse and misapplication. To that end, this paper reviews certain aspects of the various financial contracts eligible for safe harbor protection, along with related issues such as the treatment of *ipso facto* clauses and characterization of margin and settlement payments. This review underscores certain portions of the safe harbors that often present challenges and identifies opportunities for improvement on the basis of both specific practical experiences and general policy perspectives.

Repurchase Agreements

A "repurchase agreement" under the Bankruptcy Code is defined as an agreement that:

- Provides for the transfer
- of certificates of deposit, mortgage-related securities, mortgage loans, interests in such securities and loans, certain bankers' acceptances, or certain securities guaranteed by certain foreign governments or the U.S. government
- against the transfer of "funds"
- with the simultaneous agreement to transfer such assets back to the transferor
- no later than one year after the initial transfer.

Eligible Repo Assets

One issue that routinely arises in structuring a repo transaction is whether the assets under the proposed transaction will constitute qualifying assets under the definition. A larger issue is why the repo definition limits the type of qualifying assets in the first place. The earliest repo books largely traded government securities. As markets developed, however, dealers and end-users began to repo a wide variety of assets. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Amendments")[29] contemplated these developments by including additional qualifying assets such as mortgage loans and

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[28] *See, e.g., Holyoke Nursing Home, Inc. v. Health Care Financing Administration,* 372 F.3d 1, 3 (1st Cir. 2004).

[29] Pub.L. 109-8, § 1501, 119 Stat. 23 (2005). Additional technical amendments were made by the Financial Netting Improvements Act of 2006, Pub.L. 109-390, 120 Stat. 2692 (2006).

mortgage-related securities. Nevertheless, other assets subject to repos in the market remain excluded from the definition.

A securities or swap transaction on equity securities—that is, non-qualifying assets under the repo definition—can be structured to replicate the economics of a repo and receive safe harbor treatment under other provisions of the Code. Structuring the same economic arrangement, however, under a repo agreement would disqualify it from safe harbor protection. Given that a securities transaction or swap agreement on equity securities would be eligible for safe harbor treatment under the Bankruptcy Code, there does not seem to be a persuasive argument for preventing a dealer's repo desk from entering into an economically identical repo transaction on equity securities and enjoying analogous safe harbor treatment.

One-Year Maturity Limit

The one-year limitation on the repurchase of the assets under a repo is also puzzling. While the initial repo market generally featured short-term, even overnight, repos, the current market often includes multi-year transactions. This is particularly true when an end-user is in need of longer-term financing. Such was the situation in the recent *American Home* case, in which the court held that the repo at issue constituted a qualifying repurchase agreement under the Bankruptcy Code.[30]

Dealers typically prefer to fund transactions on a 364-day basis to limit applicable regulatory capital charges. Borrowers, however, often prefer to lock in term financing for stable balance sheet management and other general corporate finance purposes. The repo agreement between American Home Mortgage Corp. ("American Home") and Calyon New York Branch ("Calyon") provided a mutually beneficial solution. How did the parties structure such a multi-year deal that ultimately qualified as a safe-harbored, one-year "repurchase agreement"?

The repo's initial purchase date was November 21, 2006, and the repurchase date was November 20, 2007. The parties, however, agreed upon an "annual extension date," whereby the maturity of the repo—upon notice from American Home—would extend by an additional 364 days.[31] Accordingly, Calyon was able to fund the transaction on a renewable, 364-day basis and reduce its regulatory capital charge and American Home was able to receive a "soft commitment" on longer-term financing. Both parties were thus able to successfully structure the transaction around the one-year maturity limitation, essentially rendering this requirement of the definition meaningless. If repo participants can so deftly contract around the one-year limitation, it is unclear why it should remain in the definition at all.

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[30] *Calyon NY Branch v. American Home Mortgage Corp. (In re American Home Mortgage, Inc.)*, 379 B.R. 503 (Bankr. D. Del. 2008).

[31] *Id., see* Repurchase Agreement by and among American Home Mortgage Corp., et al. and BNP Paribas, November 21, 2006, filed on August 28, 2007, Docket No. 426 as Exhibit A.

Forward Contract

A "forward contract" is defined as a contract

- For the purchase, sale or transfer
- of a commodity or any similar good, article, service, right or interest
- which is presently or in the future becomes the subject of dealing in the forward contract trade.

One may ask why forward contracts are limited to commodities and not, for example, other assets such as securities, when commonly traded forward transactions reference a wide variety of underlying assets. Limiting forward contracts to commodities and providing safe harbor protection only on those contracts effectively incentivizes dealers to market and sell a greater number of forward commodities contracts than other forward contracts. In response, drafters of the Bankruptcy Code could presumably point to safe harbors elsewhere available for other forward contracts. Unfortunately, a bankruptcy judge or lawyer approaching the definition of a forward contract for the first time could be faced with a strange scenario. A forward contract on equity securities can be a "swap agreement." A prepaid forward contact can be a "securities contract." Neither of these forward contracts, however, is a "forward contract." It is not difficult to imagine the confusion arising from the Bankruptcy Code's unusual definitional methodology.

Forward Contract Merchants

A "forward contract merchant" ("FCM") means a Federal reserve bank, or an entity, the business of which consists in whole or in part of entering into forward contracts as or with merchants in a commodity (as defined in Section 761 the Bankruptcy Code) or any similar good, article, service, right or interest which is presently or in the future becomes the subject of dealing in the forward contract trade.[32] The issue with the FCM definition is its breadth. In order to qualify as an FCM and thereby be protected under the safe harbors, a counterparty need only be *partly* in the business of entering into forward contracts on commodities. Does a business having only one contract, which is a forward, qualify as a FCM? Under *Mirant*, a business must enter into forward contracts for the purpose of seeking profit in the forward contract trade in order to qualify as a FCM.[33] Aside from *Mirant*, though, the FCM definition in its current form could be misused to protect businesses and contracts—such as vendors writing "forwards" on retail goods—that were not intended to be covered by the safe harbors.[34]

[32] 11 U.S.C. § 101(26).

[33] *In re Mirant Corp.*, 314 B.R. 347 (Bankr. N.D. Tex. 2004).

[34] An obvious potential for conflict is for an electric utility to argue that it can terminate an electricity supply agreement with a commercial user under the forward contract safe harbor rather than having to comply with the utility service provisions of the Bankruptcy Code. 11 U.S.C. § 366.

Securities Contract

The Bankruptcy Code defines a “securities contract” in part as a contract

- For the purchase, sale or loan
- of a security, a certificate of deposit, a mortgage loan (including any interest in a mortgage loan) or groups or indices of, or options on, the foregoing;
- any option on foreign exchange;
- guarantees of by or to securities clearing agencies of cash, securities, certificates of deposit, mortgage loans (including any interest in mortgage loans) or options on any of the foregoing;
- any margin loan;
- any loan transaction coupled with a securities collar transaction, any prepaid forward securities transaction or any total return swap transaction coupled with a securities sale transaction.

Public vs. Private

The reference to “securities” in the securities contract definition does not indicate whether the securities are publicly or privately issued securities. Legislative history from 1982 indicates that safe harbor protection was aimed at the public securities markets: e.g., the “securities markets operate through a complex system of accounts and guarantees.”[35] The case law provides support for both sides of the argument.[36] While it is clear that securities transactions that impact the public markets ought to be covered by the safe harbors, it is not clear which private transactions, if any, should be covered. The question is particularly acute in the 144A market. The large and relatively liquid institutional securities market may be considered “public” enough to warrant safe harbor protection, but there is no clear guidance from the existing “securities contract” definition.

Determining Whether a Loan is a “Loan”

One of the frequent issues lawyers face when advising clients on securities transactions is what constitutes a safe-harbored loan against securities—which could include a margin loan or an equity collar and loan transaction—as opposed to a non-safe-harbored loan against securities—such as a traditional credit facility written by a commercial bank and secured by securities.

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[35] H.R. Rep. No. 97-420, at 1 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583.

[36] *Compare Munford v. Valuation Research Corp.*, 98 F.3d 604, 609-10 (11th Cir. 1996) (LBO is essentially a private transaction; no protection from avoidance); with *Lowenschuss v. Resorts Int’l, Inc. (In re Resorts Int’l, Inc.)*, 181 F.3d 505, 514-16 (3d Cir. 1999) (LBO of privately held company protected).

The 2005 Amendments helpfully included in the revised definition additional transactions such as margin loans, loans coupled with equity collars, and prepaid forward contracts.[37] These explicit inclusions have clarified that these transactions are to be safe-harbored, as many practitioners previously believed. After the 2005 Amendments enumerated specific types of loans such as margin loans, however, some lawyers have reasonably wondered whether the exclusion of other types of loans is intentional and meaningful.

Economically there is no difference between a 50% loan-to-value Regulation T margin loan extended by a dealer and a 50% loan-to-value Regulation U loan against securities extended by a commercial bank. From a bankruptcy perspective, however, the first loan is clearly covered by the safe harbors, while it is uncertain whether the second loan is covered or not. Legislative history to the 2005 Amendments states the intent to cover any loans known in the securities industry as margin loans or where a protected party extends credit in connection with the purchase, sale, carrying, or trading of securities.[38] Loans merely secured by securities, however, are apparently not intended to be included. Arguments can be made both ways, and the potential exists for protecting certain "securities contracts" that were not intended beneficiaries of protection.

Bankruptcy Code Arbitrage

The decision by Congress to include or exclude certain contracts from the safe harbors also has economic consequences. Treating one type of securities contract differently from another (*i.e.*, favoring securities contracts on public securities over securities contracts on private securities) may lead to arbitrage under the Bankruptcy Code. When certain transactions are afforded safe harbor treatment, the Code effectively subsidizes such transactions by reducing the risk—*i.e.*, *the cost*—of these transactions. A securities contract that provides certainty to a dealer that it will receive safe harbor treatment will lower the risk of entering into the contract. In turn, transactions that feature a lower risk profile will generally be priced lower given a traditional risk/return pricing methodology. Thus, Congress ought to consider the policy underlying the preference of one category of contracts over others, rather than focus on the technical form of the transactions.

Swap Agreements

The Bankruptcy Code provides a lengthy, contract-specific definition for a swap agreement, including any agreement that is

- an interest rate swap, option, future or forward, including a cap, floor, collar, foreign exchange rate swap and basis swap;
- one of a variety of commodity and foreign exchange spot and forward contracts;
- one of a variety of currency, equity, debt, credit, weather, emissions or inflation swaps, options, futures or forward contracts.

[37] 11 U.S.C. § 741(7).

[38] *See* H.R. Rep. No. 109-31, at 129-30 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 190.

Forward Contracts as Swap Agreements

Notwithstanding the efforts of Congress to broaden the protections of the safe harbors in the 2005 Amendments, in 2007 a bankruptcy court held that a forward contract on natural gas did not constitute a "commodity forward contract" as understood under the swap agreement definition.[39] According to the court, a natural gas forward contract was a simple supply contract involving the sale of natural gas from a supplier to a customer, and not a contract deserving safe harbor treatment. The Fourth Circuit reversed and clarified that commodity forward contracts are swap agreements for purposes of the Bankruptcy Code.[40] The original holding, however, that a commodity forward contract did not qualify as a swap agreement, notwithstanding that this contract is explicitly included in the swap agreement definition, highlights the shortcomings of a circular definition that simply lists examples of qualifying transactions.

Swap Agreements as Financings

In 2005, the SEC settled an administrative proceeding against Canadian Imperial Bank of Commerce ("CIBC") in respect of certain total return swap transactions.[41] The SEC recharacterized the swaps as improper extensions of credit that violated federal margin rules. A total return swap, however, is specifically listed as a "swap agreement" in the Bankruptcy Code. Bankers and their in-house counsel have understandably asked whether these transactions, deemed secured loans by the SEC, would constitute swaps or loans for bankruptcy purposes and whether the criteria for distinguishing a swap from a loan used by the SEC should be the same as, or different from, that used by bankruptcy courts. If the criteria are the same, then the definitional inclusion of the term "total return swap" may not be helpful. If the criteria are different, then lawyers and bankers can envision opportunities for regulatory arbitrage. From a public policy perspective, it might not be important whether or not a swap is essentially a loan.[42]

***Ipso Facto* Clauses**

Ipso facto clauses, or "walk-away provisions," are typically unenforceable in bankruptcy.[43] However, an exception applies to contractual rights provided in securities contracts, forward contracts, commodities contracts, repos and swap agreements. Therefore, the determination that a particular contract qualifies as one of the foregoing is a crucial issue in determining whether a party will be able to exercise its *ipso facto* rights in the first place. The 2005 Amendments broadened the use of walk-away clauses by allowing not only for the liquidation, but also for the termination and acceleration of safe-harbored contracts.

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[39] *Hutson v. Smithfield Packing Company*, 369 B.R. 884 (Bankr. E.D.N.C. 2007).

[40] *Hutson v. E.I. Du Pont*, 556 F.3d 247 (4th Cir. 2009).

[41] SEC Press Release No. 2005-103, Settled Administrative Proceeding Against Canadian Imperial Bank of Commerce Subsidiaries (July 20, 2005), *available at* http://www.sec.gov/news/press/2005-103.htm.

[42] *See Thrifty Oil Co. v. Bank of America National Trust and Savings Assoc. (In re Thrifty Oil Co.)*, 249 B.R. 537, 543-51 (S.D. Cal. 2000), *aff'd*, 322 F.3d 1039 (9th Cir. 2003).

[43] 11 U.S.C. §§ 365(e)(1); 541(c)(1).

Metavante

Notwithstanding the congressional intent to widen the scope of walk-away provisions, the recent *Metavante* decision[44] appeared, to some lawyers at least, to unexpectedly narrow its applicability. To others, the court's ruling may not have been a surprise. As early as 1991, the Southern District of New York held that unless a protected party exercises its rights as soon as possible after the counterparty's bankruptcy, courts may refuse to apply the safe harbors, and thus prohibit termination.[45] Courts may rely on the doctrine of waiver, finding that the creditor's continuing post-petition performance and failure to enforce the event of default could constitute waiver.[46] Similarly, in *Metavante*, the court found that Metavante did not attempt to liquidate, terminate, or accelerate the agreement. Instead, the court stated that Metavante was "riding the market for the period of one year, while taking no action whatsoever."[47] The court did not cite to *National Westminster*, but could have readily done so in concluding that Metavante's failure to terminate the agreement after one year essentially constituted waiver. While *Metavante* may have been correctly decided under *National Westminster*, the residual uncertainty could be resolved by providing for a specific time period during which a non-defaulting party must exercise any termination or other related contractual rights.

Settlement and Margin Payments

Stay-protected settlement and margin payments directly address the issue of systemic risk among financial participants. Regardless of whether a particular contract is classified as a securities contract, a repurchase agreement, or otherwise, it is ultimately the payment of cash flows from one entity to another, or the set-off and netting of obligations against such payments, that can help prevent a daisy-chain of related counterparty defaults.

Margin Payments

A margin payment under the Bankruptcy Code means, for purposes of the forward contract provisions of the code, a payment or deposit of cash, a security, or other property, that is commonly known in the forward contract trade as original margin, initial margin, maintenance margin, or variation margin, including mark-to-market payments or variation payments.[48] The Bankruptcy Code has similar definitions for margin payments in the securities trade[49] and commodities trade.[50] Curiously, there is no definition of

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[44] Transcript of the U.S. Bankruptcy Court's Ruling on a Motion by Lehman Brothers Special Financing Inc. to Compel Performance of Metavante Corporation's Obligations under Open Derivatives Contracts (Issued by Judge Peck on September 15, 2009).

[45] *Nat'l Westminister Bank, U.S.A. v. Ross*, 130 B.R. 656 (S.D.N.Y. 1991), *aff'd sub nom. Yaeger v. Nat'l Westminister*, 962 F.2d 1 (2d Cir. 1992).

[46] *Id.*

[47] Metavante Transcript at 110.

[48] 11 U.S.C. § 101(38).

[49] 11 U.S.C. § 741(5).

[50] 11 U.S.C. § 761(5).

the term for repos and swaps. The concept of variation margin has generally been recognized by the courts as constituting a "margin payment" for safe harbor purposes. This has not always been the case with initial margin.

Initial Margin

At least two courts have suggested that an initial payment made to open a margin account, at a time when no trades had yet taken place (and, of course, when no account deficiency existed) is not a margin payment.[51] One court, in particular, stated that it "would be hard-pressed to find that a payment made to open an account with a stockbroker, prior to any trading, constituted a margin payment."[52]

An initial margin payment, however, is typically required to open any type of margin account with a stockbroker. Initial margin in the form of cash or U.S. government securities is required by exchanges and brokers, and in turn driven by relevant SEC regulations.[53] Moreover, such initial margining will likely increase in light of recent proposals from the U.S. Treasury department to regulate the OTC derivatives markets. Initial margin is not only standard in the forward contract markets, but throughout the lending markets. Secured loans made by commercial banks to corporate customers include initial margin in the form of secured interests on hard assets, receivables, and the like. In the housing market, the initial margin, obviously, is the borrower's down payment. Given the ubiquity of initial margining arrangements throughout the financial markets, it is important to protect initial margin in the context of safe-harbored contracts.

Failure to recognize initial margin under the safe harbors is also a bad outcome. Dealers may not require—to the extent they have the ability—initial margin on certain transactions, which would have the perverse effect of encouraging more highly leveraged transactions. In the alternative, failure to provide safe harbor recognition to initial margin may dissuade dealers from opening accounts to newer, less-established institutions and customers. Such customers would necessarily benefit from the safety provided to dealers through stay-protected initial margin payments.

Settlement Payments

The Bankruptcy Code definition of a settlement payment, as with a margin payment, largely provides examples of settlement payments: a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, a net settlement payment, or any other similar payment commonly used in the forward contract trade.[54] Section 741(8) of the Bankruptcy Code has a substantially similar definition of settlement payments in the securities trade.[55]

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[51] *See Seitter v. Farmer's Commodities Corp.*, 220 B.R. 402 (Bankr. D. Kan. 1998); *Biggs v. Smith Barney, Inc. (In re David)*, 193 B.R. 935 (Bankr. C.D. Cal. 1996).

[52] *In re David*, 193 B.R. at 940.

[53] *See*, *e.g.*, 17 C.F.R. § 1.17(b)(8); *Customer Margin Rules Relating to Security Futures*, Securities Exchange Act Rel. No. 46292 (Aug. 1, 2002), 67 FR 53145 (Aug. 14, 2002).

[54] 11 U.S.C. § 101(51A).

[55] 11 U.S.C. § 741(8).

Similar to the lack of definition of margin payments for all safe harbor contracts, there is no definition of the term settlement payment for repos, swaps, and commodities contracts.

This definition is essentially circular, which has led to all manner of interpretations by the courts. For example, *Munford*[56] held that at a minimum a settlement payment must involve the intermediaries and guarantees typical of the securities industry. Such intermediaries and guarantees are generally found in the publicly traded debt and equities markets. In similar fashion, a court held that the redemption of equity interests in an LLC that was run as a ponzi scheme was not protected as a settlement payment because of the non-public nature of unregistered securities.[57] Another court held that a private stock sale was not protected by the Bankruptcy Code because the sale lacked the impact on the public market trading systems that Congress intended to protect.[58] Conversely, other courts have refused to deny protection if the transaction fails to impact the public markets.[59] In the context of forward contracts, a court has stated that a settlement payment does not have to be cleared or settled through a centralized system.[60]

Damages

The decision as to when damages are calculated is vitally important given that the underlying assets, as Congress has stated repeatedly, are highly volatile and subject to enormous price swings. The 2005 Amendments clarified that damages are to be measured on the earlier of the rejection of the contract or the liquidation, termination, or acceleration date.[61] The listing of three potentially separate events unfortunately raises various issues for practitioners, such as whether there is a difference between each of these dates and whether these different dates can lead to different damages calculations. To date, the case law has not provided guidance on these and related issues.

Determining the Amount of Damages

Notwithstanding the uncertainty as to when to calculate damages, the *manner* in which a counterparty calculates its damages has been relatively straightforward—until recently. Traditionally, damages under safe-harbored contracts have been determined by reference to similar, well-known commercially reasonable methods of valuation. For example, counterparties can look to the costs of replacement transactions or they can provide a value based on an average of market quotations. In the recent *American*

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[56] *Munford v. Valuation Research Corp.*, 98 F.2d 604 (11th Cir. 1996).

[57] *In re Grafton Partner L.P.*, 321 B.R. 527 (9th Cir. 2005).

[58] *Jewel Recovery, L.P. v. Gordon*, 196 B.R. 348 (N.D. Tex. 1996).

[59] *Lowenschuss v. Resorts Int'l, Inc.*, 181 F.3d 505 (3d Cir. 1999); *In re Hechinger Inv. Co. of Delaware*, 274 B.R. 71 (D. Del. 2002).

[60] *In re Olympic Natural Gas Co.*, 258 B.R. 161 (Bankr. S.D. Tex. 2001), *aff'd*, 294 F.3d at 737 (5th Cir. 2002).

[61] 11 U.S.C. § 562(b).

Home case,[62] however, the court held that "expert testimony" is a commercially reasonable manner of obtaining damages when no market is available for the underlying assets.

The obvious irony, here, is that expert testimony, in the form of inflated housing appraisals, was one of the reasons for American Home's insolvency in the first place. Similarly, expert testimony from ratings agencies resulted in super senior CDO tranches receiving AAA ratings that later fell to CCC- or worse. Setting aside the obvious drawbacks and empirical shortcomings of expert testimony, the question is why the lack of a market is not a meaningful price discovery function on its own terms. "When no market is available" is itself a price—zero. Stated differently, why isn't the market price, whatever it may be, controlling?[63]

Conclusion

Congress, regulators and industry groups have rightly decided that certain financial contracts are worthy of protection upon counterparty insolvencies. While the goal is laudable, the means of reaching that goal—through the bankruptcy safe harbor provisions—is not a model of statutory clarity. Imprecise drafting and a wide variety of judicial readings of the safe harbor language allow for potential abuse and misunderstanding as to what types of financial arrangements are actually deserving of safe harbor treatment. The solution, however, is not simply the wholesale abolition of the safe harbors, particularly in light of the interconnected nature of the financial markets, as discussed above. An imperfection of a statute is not a sufficient reason for its abrogation. The Internal Revenue Code comes to mind as an example. Rather, Congress should focus on the nature of transactions and counterparties whose protection serves the global good, even at the expense of these institutions' and their creditors' well being. Only then should Congress turn to a precise and careful drafting designed to achieve these goals.

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[62] *In re American Home Mortgage, Inc.*, 379 B.R. 503 (Bankr. D. Del. 2008).

[63] *VFB LLC v. Campbell Soup Co.,* 482 F.3d 624, 633 (3d Cir. 2007) (market price is more reliable than expert testimony).