

Financial Contract Provisions of New Bankruptcy Legislation

July/August 2005

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Introduction

President George W. Bush gave his imprimatur to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act") on April 20, 2005, thereby effecting the most sweeping changes to U.S. bankruptcy law in more than a quarter century. Although a significant part of the legislation is devoted to curbing alleged consumer bankruptcy abuse, the Act also contains important changes to the laws, rules and procedures governing business bankruptcy cases. Prominent among these modifications are provisions intended to clarify, expand and add provisions to title 11 of the United States Code (the "Bankruptcy Code") dealing with financial transactions. What's more, the additional and modified financial contract provisions will apply to cross-border bankruptcy and insolvency cases filed under new chapter 15 of the Bankruptcy Code after the amendments become effective in cases filed on or after Monday, October 17, 2005.

These provisions are briefly summarized and explained below.

Overview of Code Provisions Affecting Financial Markets

Sections 555, 556, 559 and 560 of the Bankruptcy Code currently provide special protections to transactions involving financial markets. Without them, sections 362 and 365(e)(1) of the

Bankruptcy Code would prevent a non-debtor party to a financial contract from taking immediate action to limit exposure occasioned by a bankruptcy filing by or against the counterparty. Lawmakers, however, recognized that financial markets can change significantly almost overnight, and that non-debtor parties to certain types of complex financial transactions may incur heavy losses unless the transactions are promptly and finally closed out and resolved. . In a series of measures enacted ending in 1990, Congress exempted most kinds of financial contracts from these prohibitions. It also amended the Bankruptcy Code to insulate these transactions from avoidance (*i.e.*, revocation or unwinding) as preferential or fraudulent transfers unless the transaction was made with actual intent to hinder, delay or defraud creditors of the debtor.

Impetus for Change

Since the 1990s, it has been widely perceived that existing provisions governing financial transactions fail to account for certain kinds of transactions and participants in a rapidly expanding industry. These new parties and transactions are currently subject to uncertainty regarding what rights and obligations apply if a counterparty files for bankruptcy. The financial provisions of the Act are designed, in part, to dispel such uncertainty by facilitating the close-out, setoff and netting of a broader array of financial contracts. The Act amends sections 555, 556, 559 and 560 of the Bankruptcy Code to expand and clarify the protections afforded to "securities contracts," "forward contracts," "repurchase agreements" and "swap agreements" under the Bankruptcy Code. It also adds sections 561 and 562 to the Bankruptcy Code to protect master netting agreements and to define the timing of the measure of damages under such agreements.

Broad Application to Financial Participants

The Act broadens the class of parties protected by the financial transaction provisions in the Bankruptcy Code. Protected parties now include all "financial participants." These include most clearing organizations as well as any entity which, on any day during the 15 months immediately preceding the commencement of a bankruptcy case, has had securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements or master netting agreements involving non-affiliates with a total gross dollar value of not less than \$1 billion in principal amount outstanding or had gross mark-to-market positions of not less than \$100 million (aggregated across counterparties).

Termination and Acceleration of Qualifying Financial Contracts

The Act also provides that neither the filing of a stockbroker liquidation case under the Securities Investor Protection Act of 1970 ("SIPA") nor the issuance, at the behest of the Securities Investor Protection Corporation, of a court order may act as a stay of any contractual right to "liquidate, terminate, or accelerate a securities contract, commodity contract, forward contract, repurchase agreement, swap agreement, or master netting agreement," to offset or net termination payments or other obligations arising under such agreements, or to foreclose on cash collateral. However, a SIPA application or court order may still prevent foreclosure or other disposition of securities pledged by a debtor as collateral.

The Act clarifies sections 555, 556, 559 and 560 by providing that the liquidation of a qualifying securities contract also encompasses termination and acceleration. The Act broadens the definition of "contractual right" to include:

(a) rights set forth in a bylaw of a derivative clearing organization, a multilateral clearing organization, a national securities exchange, a national securities association, a contract market designated under the Commodity Exchange Act, a derivatives transaction execution facility registered under the Commodity Exchange Act or a board of trade, or in a resolution of the governing board thereof; and

(b) rights arising under common law, merchant law, or by reason of normal business practice.

Expanded Financial Contract Definitions

The Act expands the definitions of sections 555 (securities contracts), 556 (commodity or forward contracts), 559 (repurchase agreements) and 560 (swap agreements) of the Bankruptcy Code.

Securities Contracts

"Securities contract" now includes any contract for the purchase, sale or loan of a mortgage loan or interest in a mortgage loan and options on any of the foregoing, including repurchase or reverse repurchase transactions. The revised definition of "securities contract" expressly includes, among other things:

(a) a contract for the purchase, sale, or loan of a security, a certificate of deposit, a mortgage loan or any interest in a mortgage loan, a group or index of securities, certificates of deposit or mortgage loans or interests therein or options on any of the foregoing;

(b) the guarantee by or to any securities clearing agency of a settlement of cash, securities, certificates of deposit, mortgage loans, or interests therein, group or index of securities, or mortgage loans or interests therein or option of any of the foregoing;

(c) any margin loan; and

(d)(i) any other agreement or transaction that is similar to an agreement or transaction described above, (ii) any combination of agreements or transactions referred to above, (iii) any option to enter into any agreement or transaction referred to above, (iv) a master agreement that provides for an agreement or transaction referred to above, and (v) a security agreement or arrangement, or other credit enhancement related to any agreement or transaction referred to therein but not to exceed the damages in connection with any such agreement or transaction measured in accordance with section 562.

However, the definition of "securities contract" explicitly excludes any purchase, sale, or repurchase obligation under a participation in a commercial mortgage loan.

Commodities Contracts

Section 761(4) of the Bankruptcy Code formerly defined a "commodity contract" as:

- (a) with respect to a futures commission merchant, a contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade;
- (b) with respect to a foreign futures commission merchant, a foreign future;
- (c) with respect to a leverage transaction merchant, a leverage transaction;
- (d) with respect to a clearing organization, a contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization, or commodity option traded on, or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization; or
- (e) with respect to a commodity options dealer, a commodity option.

The Act expands the definition of a "commodity contract" to include, among other things, (i) any other agreement or transaction that is similar to those described above, (ii) any combination of the foregoing, (iii) any option to enter into any of the foregoing, (iv) any master agreement

providing for any of the foregoing, and (v) a security agreement or arrangement, or other credit enhancement related to any of the foregoing, but not to exceed the damages in connection with any such agreement or transaction measured in accordance with section 562.

Forward Contracts

Section 101(25) of the Bankruptcy Code formerly defined a "forward contract" as a contract (other than a commodity 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, or product or byproduct thereof, with a maturity date more than two days after the date the contract is entered into, including, but not limited to, a repurchase transaction, reverse repurchase transaction, consignment, lease, swap, hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction, or any combination thereof or option thereon.

The Act deletes the ambiguous reference to "any combination thereof or option thereon" and replaces it with "any other similar agreement." It also adds to the definition: (i) any combination of agreements or transactions referred to above; (ii) any option to enter into an agreement or transaction referred to above; (iii) a master agreement to the extent that it provides for an agreement or transaction referred to above; and (iv) a security agreement or arrangement, or other credit enhancement related to any covered agreement or transaction, but not to exceed the damages in connection with any such agreement or transaction measured in accordance with section 562.

Repurchase Contracts

Formerly, section 101(47) of the Bankruptcy Code narrowly defined repurchase agreements as agreements that provide "for the transfer of certificate of deposits, eligible bankers' acceptances or securities that are the direct obligations of, or that are fully guaranteed as to the principal or interest, by the United States" or any agency thereof with a simultaneous agreement by the transferee to transfer to the original transferor a certificate of deposit or other similar obligation either on demand or at a date not later than one year after the transfer.

The Act expands the definitions of "repurchase agreement" and "reverse repurchase agreement" to include mortgage-related securities (as defined in the Securities Exchange Act of 1934), mortgage loans, interests in mortgage-related securities or mortgage loans and qualified foreign government securities. Excluded from the definition is a repurchase obligation under a participation in a commercial mortgage loan (such as recourse obligations). However, a repurchase transaction involving the transfer of participations in commercial mortgage loans with a simultaneous agreement to repurchase the participation on demand or within one year of the transfer would constitute a "repurchase obligation."

Swap Agreements

The Act amends section 101(53B) of the Bankruptcy Code to define in greater detail various types of swap agreements, including:

- (a) a rate floor, rate cap, rate collar, cross-currency rate swap and basis swap;
- (b) spot, same day-tomorrow, tomorrow-next, forward, or other foreign exchange or precious metal agreement;
- (c) currency swap;

- (d) equity index or equity swap;
- (e) debt index or debt swap;
- (f) total return, credit spread or credit swap;
- (g) commodity index or commodity swap; and
- (h) weather swap, weather derivative or weather option.

Moreover, the Act definition contains an open-ended provision that would include as a "swap agreement" any agreement that is similar to any other agreement or transaction referred to in the expanded definition and that is "presently, or in the future becomes, the subject of recurrent dealings in the swap market and is a forward, swap, future or option on one or more rates, currencies, commodities, equity securities, or other equity instruments, debt securities or other debt instruments, or economic indices or measures of economic risk or value." However, a "rule of construction" in the Act provides that an arrangement covered by the Bankruptcy Code definition of "swap agreement" does not necessarily constitute a swap agreement under other federal statutes, rules and regulations.

New Provisions Concerning Master Netting Agreements and Calculation of Damages

The Act adds section 561 to the Bankruptcy Code to protect contractual rights to terminate, liquidate, accelerate or offset under a master netting agreement and across contracts. New section 561 defines a "master netting agreement" as an agreement "providing for the exercise of rights, including rights of netting, setoff, liquidation, termination, acceleration or closeout," or any security agreement or arrangement or other credit enhancement related to one or more of the foregoing. It also defines "master netting agreement participant" as an "entity that, at any time

before the date of the filing of the petition, is a party to an outstanding master netting agreement with the debtor."

Section 561 provides a general prohibition against staying, avoiding, or otherwise limiting a non-debtor counterparty's ability to exercise rights under the various types of financial contracts covered by master netting agreements. Corresponding amendments were made to the definitions of forward contract, repurchase agreement, swap agreement, securities contract and commodity contract to include within the scope of each crossproduct master agreements, but only if transactions or agreements under the master agreement otherwise meet the applicable definition. "Netting" refers to the aggregate payments due to a swap participant when the agreement is terminated, for instance, by a counterparty filing for bankruptcy. Upon termination, the non-defaulting party has the right to set off and liquidate the amount owed by the other party under a master netting agreement, regardless of whether or not the various transactions under the master netting agreement involve the same type of financial product.

As a consequence of the amendments, the Bankruptcy Code will permit multiple-transaction, multiple-contract and cross-product netting. As such, the broad netting that the International Swaps and Derivatives Association 1992 and 2002 Master Agreement forms permit if the parties elect "Multiple Transaction Payment Netting" would become enforceable in a U.S. bankruptcy case. Section 561 and the relevant corresponding amendments would appear to permit the full implementation of early termination for bankruptcy or insolvency and close-out netting under the ISDA 1992 and 2002 Master Agreement forms.

The Act also amends section 362(b) of the Bankruptcy Code to provide that setoff by a master netting agreement participant is excepted from the scope of the automatic stay. Section 546, which limits a trustee's avoiding powers under certain circumstances, is also amended to add subsection 546(j), which provides that in the absence of actual intent to defraud creditors, the trustee may not avoid a transfer made within two years of the commencement of the case by or to a master netting agreement participant under or in connection with any master netting agreement or any individual contract covered thereby. These changes will permit a party to a financial contract to realize the benefits and control its exposure even though its counterparty is on the verge of bankruptcy without worrying that the transactions occurring during the period immediately preceding a bankruptcy filing will later be undone by a bankruptcy trustee in the absence of actual intent to defraud.

The Act adds section 562 to the Bankruptcy Code, which provides that damages under a swap agreement, securities contract, forward contract, commodity contract, repurchase agreement, or master netting agreement will be measured as of the earlier of the date of (a) rejection by the trustee or (b) liquidation, termination or acceleration of such contract or agreement by a forward contract merchant, stockbroker, financial institution, securities clearing agency, repo participant, financial participant, master netting agreement participant, or swap participant. A corresponding change was made to section 502(g) to provide that claims for damages under section 562 will be pre-petition claims.

Application to Cross-Border Insolvency Cases

Unlike most other provisions of the Bankruptcy Code, the Act expressly makes the financial contract provisions applicable to cross-border bankruptcy and insolvency cases commenced

under new chapter 15 of the statute, which supersedes former section 304. Thus, if the accredited representative of a debtor in a non-U.S. bankruptcy or insolvency proceeding files a chapter 15 case in the U.S., the special protections for financial contracts contained in sections 555, 556, 557 and 559 through 562 will apply in the case. An article discussing new chapter 15 appeared in the May/June 2005 edition of the *Business Restructuring Review* (vol. 4, no. 3).

Conclusion

The new legislation significantly augments and clarifies setoff, netting, termination and close-out rights under financial contracts in the event that one or more parties to the contract becomes embroiled in a bankruptcy case. The amendments provide a greater degree of certainty concerning the kinds of financial contracts that are entitled to safe-harbor protection. This, in turn, should promote greater confidence among players in the market, whether in the U.S. or abroad, when structuring these transactions.