Special Bankruptcy Code Protections for Derivative and Other Financial Market Transactions

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The Bankruptcy Code contains important provisions designed to protect certain derivative and other financial market transactions. This outline will discuss (I) the need for the protections, (II) what transactions are protected, (III) the protections permitting close-out of transactions free from stay, (IV) the protections permitting exercise of setoff and secured party rights free from stay, (V) the protections against avoidance and (VI) relevant non-bankruptcy laws.

I. Background — The Need for Protection

A. Vulnerability of financial markets to stay and avoidance risks

1. “Ripple effect” of failure of major market participant.
   a. Extended exposure of counterparties to market volatility
   b. Prolonged illiquidity of substantial capital positions
   c. Impossibility of effective hedging

2. Importance of markets to national policy and health; magnitude of markets; sensitivity to delays.
   a. Repurchase agreements are crucial to the financing of the national debt because they are a principal method by which primary dealers finance their inventories of government debt securities.
   b. The Federal Reserve Bank of New York reports that as of July 30, 2014, the outstanding amount of repurchase agreements for U.S. Treasury securities, U.S. agency securities, mortgage-backed securities and corporate securities entered into by the primary dealers alone was more than $2.2 trillion, of which the substantial majority were for U.S. Treasury and agency securities (and most of those were overnight or demand transactions) (http://www.newyorkfed.org/banking/reportingforms/primarystats/deal.pdf). As of the same date, the outstanding amount of reverse repurchase agreements for U.S. Treasury securities, U.S. agency securities, mortgage-backed securities and corporate securities entered into by the primary dealers was more than $1.8 trillion. Id. In contrast, note that the same report shows that the net outright positions of the primary dealers at the same time in U.S. government securities were far smaller — approximately $21.6 billion in U.S. Treasury securities and $95.4 billion in U.S. agency securities.
securities. *Id.* In sum, the primary dealers largely finance their positions in U.S. Treasury and agency securities, and most of that financing is effected through repurchase and reverse repurchase agreements, many of which are overnight or demand transactions.


d. Securities loans are a principal means by which short sales are covered in the financial markets.

e. According to the International Swaps and Derivatives Association ("ISDA"), the following were the outstanding notional amounts (which is a measure of volume rather than of market value or risk) as of August 1, 2014 of the following types of privately negotiated derivatives (http://www.swapsinfo.org):

<table>
<thead>
<tr>
<th>Derivative Type</th>
<th>Notional Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate derivatives</td>
<td>$574.2 trillion</td>
</tr>
<tr>
<td>Credit default swaps (CDS)</td>
<td>$18.6 trillion</td>
</tr>
</tbody>
</table>

f. According to the Office of the Comptroller of the Currency Administrator of National Banks, in the first quarter of 2013 the notional amount of derivatives held by U.S. commercial banks was approximately $230.6 trillion in the following categories (http://occ.treas.gov/topics/capital-markets/financial-markets/trading/derivatives/dq114.pdf):

<table>
<thead>
<tr>
<th>Derivative Type</th>
<th>Notional Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate contracts</td>
<td>$185.8 trillion</td>
</tr>
<tr>
<td>Foreign exchange contracts</td>
<td>$30.2 trillion</td>
</tr>
<tr>
<td>Equity contracts</td>
<td>$2.2 trillion</td>
</tr>
<tr>
<td>Commodity/other</td>
<td>$1.3 trillion</td>
</tr>
<tr>
<td>Credit derivatives</td>
<td>$11.2 trillion</td>
</tr>
</tbody>
</table>

Measures of notional amounts may be substantially overstated. For example, existing swap positions are often offset or hedged by entry into new swaps, with both the original and hedged positions remaining in place. Thus, a swap counterparty may be "flat" as a result of offsetting positions with other parties, but the gross notional amount of each position may be included in measures of outstanding notional amounts. Even when this overstatement is taken into consideration, the amounts of outstanding swap positions remain enormous.
During the first quarter of 2014, U.S. commercial banks reported trading revenues of $6.1 billion in trading in cash and derivative instruments. The net credit exposure of such banks at the end of that quarter was reported as $279 billion. *Id.*

g. By way of comparison, the Securities Industry and Financial Markets Association ("SIFMA") reports that the total amount of U.S. corporate bonds issued in 2013 was $1.4 trillion (http://www.sifma.org/WorkArea/DownloadAsset.aspx?id=8589942781).

3. Examples of Congressional concern.

a. H. Rep. No. 420, 97th Cong., 2d Sess. 1 (1982) ("The commodities and securities markets operate through a complex system of accounts and guarantees. Because of the structure of the clearing systems in these industries and the sometimes volatile nature of the markets, certain protections are necessary to prevent the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market.").

b. 128 Cong. Rec. 58,133 (July 13, 1982) (Statement of Sen. Dole) ("It is essential that stockbrokers and securities clearing agencies be protected from the issuance of a court or administrative agency order which would stay the prompt liquidation of an insolvent’s positions, 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.").


B. **Market Risk.** Absent protections, "cherry-picking" (i.e., selective assumption and rejection) of financial market transactions would create an inequitable opportunity for use of hindsight by debtors, effectively shifting the entire market risk of open transactions to counterparties and potentially distorting credit risk by undermining the parties' expectations regarding netting (i.e., application of setoff rights).

C. **Limited Effect on Reorganizations.** The Bankruptcy Code provides for the liquidation — not reorganization — of stockbrokers and commodity brokers. Section 109(d); subchapters III and IV of chapter 7. There is little realistic prospect for reorganizing hedge funds, investment funds, financial services firms and other debtors whose principal business is entering into derivatives and financial market contracts. Similarly, mortgage loan originators and other financial services firms that may utilize repurchase and reverse repurchase agreement financing have little chance of reorganizing under chapter 11 and, at best, may sell portions of their businesses as going concerns. For other debtors, elimination of stay and avoidance protections with respect to derivatives and financial market contracts generally does not have a material effect on their prospects for reorganization because the transactions are generally closed-out at current market prices and do not involve operating or irreplaceable assets. Consequently, with the possible exception of certain supply contracts for commodities that may be used in a debtor's business, see discussion at II.C.5 below, it is unlikely that the protections will deprive many debtors of a realistic opportunity to reorganize or result in the loss of a substantial number of jobs.

D. **Market Self-Protection.** The underlying theme of Bankruptcy Code protective provisions is this: Allow the markets to protect themselves without interference from stays and avoidance actions. *Query* whether this is always the best approach?

E. **Dodd-Frank Act.**

1. Allowing unfettered close-outs and enforcement of remedies can be effective and critically important to protect the liquidity of major market players, but the failure of a huge market player (such as Lehman Brothers) can result in a huge number of simultaneous close-outs and collateral sales in a market that may already have been destabilized by the debtor's failure. This could result in depressing the market even further, thus causing loss of value to the estate, its creditors and the non-defaulting counterparties.

2. The Dodd-Frank financial regulatory reform legislation enacted in the wake of the financial crisis provides an alternate approach where the government has identified the debtor as a systemically important player.

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2 Unless otherwise specified, all Section, chapter and subchapter references in this outline refer to the Bankruptcy Code.
that should be liquidated under different rules. See Title II (Orderly Liquidation Authority) Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010) (“OLA”). OLA is modeled on the Federal Deposit Insurance Act’s receivership provisions and contains protections for “qualified financial contracts,” a collective term that includes securities contracts, commodity contracts, forward contracts, repurchase agreements and swap agreements (which terms are all defined in a manner similar to the corresponding Bankruptcy Code definitions). See id. § 210(c)(8)(A).

3. OLA Section 210(c)(8)(A) protects the exercise of termination, close-out, netting and secured party rights of counterparties to qualified financial contracts notwithstanding the appointment of a receiver, but with some important differences from the Bankruptcy Code approach. In the case of the transfer by the FDIC, as receiver of a covered financial company, of assets of the company, the receiver can transfer all (but not less than all) or none of the qualified financial contracts between such company and a counterparty. See id. § 210(c)(9)(A). However, the receiver must notify the counterparty of such transfer by no later than 5pm Eastern Time on the business day following the date of the appointment of the receiver or the counterparty may exercise its default remedies. Id. § 210(c)(10)(A)(ii). After such a transfer, the counterparty can exercise remedies based on performance-based defaults, but not based on the appointment of the receiver or the transfer of the contracts. This was the approach used in the transfer of Washington Mutual’s derivatives portfolio to JPMorgan in connection with the transfer of much of WaMu’s business assets to JPMorgan.

4. Currently, there are legislative efforts to add provisions to the Bankruptcy Code to handle systemically important financial firms, either as an alternative to or as a replacement for OLA. If such provisions are enacted, it is expected that they will include protections for qualified financial contracts and allow qualified financial contracts to be transferred quickly to an acquirer or a trust to preserve their value and reduce systemic disruption.

II. What Transactions are Protected?

Securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements and master netting agreements are all covered by the special Bankruptcy Code protections described in this outline. Such transactions are sometimes referred to collectively in this outline as “Protected Transactions.”

A. Securities contracts

1. Section 741(7)(A): “(i) a contract for the purchase, sale or loan of a security, a certificate of deposit, a mortgage loan, any interest in a mortgage
loan, a group or index of securities, certificates of deposit, or mortgage loans or interests therein (including an interest therein or based on the value thereof), or option on any of the foregoing, including an option to purchase or sell any such security, certificate of deposit, mortgage loan, interest, group or index, or option and including any repurchase or reverse repurchase transactions on any such security, certificate of deposit, mortgage loan, interest, group, or index, or option (whether or not such repurchase or reverse repurchase transaction is a "repurchase agreement", as defined in Section 101); (ii) any option entered into on a national securities exchange relating to foreign currencies; (iii) the guarantee (including by novation) 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 (including any interest therein or based on the value thereof), or option on any of the foregoing, including an option to purchase or sell any such security, certificate of deposit, mortgage loan, interest, group or index, or option (whether or not such settlement is in connection with any agreement or transaction referred to in clauses (i) through (xi)); (iv) any margin loan; (v) any extension of credit for the clearance or settlement of securities transactions; (vi) 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; (vii) any other agreement or transaction that is similar to an agreement or transaction referred to in this subparagraph; (viii) any combination of the agreements or transactions referred to in this subparagraph; (ix) any option to enter into any agreement or transaction referred to in this subparagraph; (x) a master agreement that provides for an agreement or transaction referred to in clause (i), (ii), (iii), (iv), (v), (vi), (vii), (viii), or (ix), together with all supplements to any such master agreement, without regard to whether the master agreement provides for an agreement or transaction that is not a securities contract under this subparagraph, except that such master agreement shall be considered to be a securities contract under this subparagraph only with respect to each agreement or transaction under such master agreement that is referred to in clause (i), (ii), (iii), (iv), (v), (vi), (vii), (viii), or (ix); or (xi) any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in this subparagraph, including any guarantee or reimbursement obligation by or to a stockbroker, securities clearing agency, financial institution, or financial participant in connection with any agreement or transaction referred to in this subparagraph, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562."

Section 741(7)(B) excludes from the definition of securities contracts "any purchase, sale, or repurchase obligation under a participation in a commercial mortgage loan."
2. "Security" is broadly defined at Section 101(49).

3. Note that a loan of a security secured by cash collateral (i.e., a securities loan) is a securities contract, but a loan of cash secured by securities collateral generally is not. However, the definition of "securities contract" expressly includes margin loans (Section 741(7)(A)(iv)) and extensions of credit in connection with the clearance or settlement of securities transactions (Section 741(7)(v)).

4. Changes to the Bankruptcy Code included in BAPCPA and FNIA make clear that repurchase and reverse repurchase transactions can be "securities contracts." This can be important because, as discussed in II.D below, the Bankruptcy Code's definition of "repurchase agreement" excludes long-term repurchase transactions and certain other repos that are widely transacted in the markets. On the other hand, as discussed in III.B.1 below, the universe of non-debtor counterparties protected with respect to securities contracts is somewhat narrower than the universe of non-debtor counterparties protected with respect to repurchase agreements.

   a. Section 741(7)(A)(i) expressly includes as a "securities contract" any repurchase or reverse repurchase transaction for any security or mortgage loan, but excludes a repurchase obligation under a participation agreement for commercial mortgage loans.

   b. Section 741(7)(A)(i) makes clear that such repurchase or reverse repurchase transaction can qualify as a securities contract "whether or not such repurchase or reverse repurchase transaction is a 'repurchase agreement', as defined in [Section 101(47) of the Bankruptcy Code]."

   c. Notwithstanding their frequent use for financing purposes, repurchase and reverse repurchase transactions are typically documented as purchase and sale transactions. Not surprisingly, parties have sought to recharacterize repos and reverse repos as secured loans in various contexts. Before BAPCPA and FNIA changed the securities contract definition expressly to include repurchase and reverse repurchase transactions, the qualification of such a transaction as a securities contract hinged on whether the purchase and sale characterization would withstand challenge (so as to qualify as a "contract for the purchase, sale...of a security" under Section 741(7)(A)(i)). The issue remains relevant in determining whether the disposition of the securities by a non-defaulting repo buyer pursuant to default remedies is subject to the "commercially reasonable" standards of Article 9 of the UCC (which are applicable to secured loans but not purchase transactions) and, perhaps, whether the repurchase agreement buyer is entitled to retain any proceeds obtained from the underlying securities
in excess of the repurchase price.\(^3\) Note in this regard that, as discussed in II.D.5 below, Section 559 specifically deals with the pricing of repo securities that are not sold on the date of the liquidation of a repurchase agreement, but Section 555 does not have corresponding provisions.

d. Most courts that have considered the issue in the bankruptcy/UCC context have concluded that a repurchase agreement effected on standard terms is a purchase and sale of a security, rather than a secured loan of cash secured by a security. See *In re Palmdale Hills Prop., LLC*, 457 B.R. 29, 44-45 (B.A.P. 9th Cir. 2011); *In re Bevill, Bresler & Schulman Asset Mgmt. Corp.*, 878 F.2d 742, 745 (3d Cir. 1989); *In re Nat'l Forge Co.*, 344 B.R. 340, 361 (W.D. Pa. 2006); *In re Granite Partners, L.P.*, 17 F. Supp. 2d 275 (S.D.N.Y. 1998); *In re Comark*, 145 B.R. 47, 53-54 (B.A.P. 9th Cir. 1992); *In re Bevill, Bresler & Schulman Asset Mgmt. Corp.*, 67 B.R. 557, 598 (D.N.J. 1986); *In re Residential Res. Mortgage Inv. Corp.*, 98 B.R. 2, 23 (Bankr. D. Ariz. 1989); *In re Fin. Corp.*, 1 B.R. 522 (W.D. Mo. 1979), aff'd, 634 F.2d 404 (8th Cir. 1980); *Gilmore v. State Board of Admin. of Florida*, 382 So.2d 861 (Fla. App. 1980). Query whether the courts may move to a plain language approach in interpreting the “repurchase or reverse repurchase transaction” language of Section 741(7)(A)(i) similar to the trend with respect to the interpretation of “repurchase agreement” under Section 101(47)? See II.D.6 below.

e. Consistent with the purchase and sale characterization, the bankruptcy court in *In re Residential Res. Mortgage Inv. Corp.* held that reverse repurchase agreements for CMOs (collateralized mortgage obligations) and residual interests in REMICs (real estate mortgage investment conduits), which were not “repurchase agreements” within the meaning of the Bankruptcy Code, were securities contracts and, thus, could be closed-out immediately. Note that, in this case, close-out was stayed temporarily to afford the court an opportunity to determine the applicability of Section 555. See also 129 Cong. Rec. 17,482 (June 27, 1983) (Statement of Rep. Fauntroy) (“In particular, a repurchase agreement as defined in the amendments, insofar as it applies to a security, would continue to be a securities contract as defined in the Code and thus also would be subject to the Code provisions pertaining to securities contracts.”); *In re Hamilton Taft & Co.*, 114 F.3d 991 (9th Cir. 1997) (the anti-avoidance protections in respect of payments made in connection with repurchase agreements contained in Section 546(f) supplement, rather than supersede, the

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\(^3\) Unlike Bankruptcy Code Section 559 applicable to repurchase agreements, Section 555 does not require that such proceeds be turned over to the debtor. Industry standard agreements do not typically require such turnover as a contractual matter, but such excess is often turned over in customary market practice.
corresponding protections in respect of securities settlement payments contained in Section 546(e)).

f. It must be noted, however, that in a number of other contexts and when dealing with non-standard repurchase transactions, courts have held repurchase agreements to be secured loans. See, e.g., *Nebraska Dep't of Revenue v. Lowenstein*, 115 S. Ct. 557, 564 (1994) (tax context; “Our decision today is an interpretation only of 31 U.S.C. § 3124(a) — not the Securities Exchange Act of 1934, the Bankruptcy Code or any other body of law.”); *Resolution Trust Corp. v. Aetna Casualty & Surety Co.*, 25 F.3d 570 (7th Cir. 1994) (blanket bond insurance coverage context); *In re Lombard-Wall Inc.*, No. 82-B-11556, bench op. (Bankr. S.D.N.Y. Sept. 16, 1982) (bankruptcy context; non-standard repo under which repo purchaser had no rights to possession or use of repo securities during the term of the repo); *Bewley v. Franchise Tax Bd.*, 886 P.2d 1292 (Cal. 1995) (tax context; agreement required repo purchaser to pay over to defaulting seller liquidation proceeds in excess of repo obligations). Cf. *Garamendi v. Executive Life Ins. Co.*, 21 Cal. Rptr. 2d 578, 581-82 (Cal. Ct. App. 1993) (insurance insolvency context; whole loan reverse repurchase agreements). See also *Gen. Motors Corp. v. Franchise Tax Bd.*, 139 P.3d 1183, 1190 (Cal. 2006) (tax context; “In some circumstances, [a repurchase agreement] is properly characterized as a secured loan; in other circumstances, it is properly characterized as a purchase and sale of a security. Which characterization fits depends heavily on context . . .”).

g. In *In re Criimi Mae, Inc.*, 251 B.R. 796 (Bankr. D. Md. 2000), deciding in the context of a determination whether to approve a disclosure statement, the court held that material questions of fact existed as to whether the subject repurchase agreement was a purchase and sale or a secured loan transaction. Earlier in the Criimi Mae chapter 11 case, the same court had created a stir in the securities industry by staying the close-out of the same repurchase agreement, notwithstanding the fact that the counterparty took the position that it was a securities contract (it did not come within the Bankruptcy Code’s repurchase agreement definition), until the court determined whether it was a securities contract — and scheduling a hearing several months in the future to consider the characterization issue. Query whether such stay violated Section 555? Query whether it would have been more consistent with all of the provisions of the Bankruptcy Code for no special stay to have been issued, and to have held the counterparty liable for monetary damages for violating the automatic stay if it closed-out the repurchase agreement and the transaction was ultimately determined not to have been a securities contract?
B. Commodity contracts

1. Section 761(4) —

“(A) with respect to a futures commission merchant, 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, foreign future;

(C) with respect to a leverage transaction merchant, leverage transaction;

(D) with respect to a clearing organization, 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;

(E) with respect to a commodity options dealer, commodity option;

(F) (i) any other agreement or transaction that is similar to an agreement or transaction referred to in this paragraph; and (ii) with respect to a futures commission merchant or a clearing organization, any other contract, option, agreement, or transaction, in each case, that is cleared by a clearing organization;

(G) any combination of the agreements or transactions referred to in this paragraph;

(H) any option to enter into an agreement or transaction referred to in this paragraph;

(I) a master agreement that provides for an agreement or transaction referred to in subparagraph (A), (B), (C), (D), (E), (F), (G), or (H), together with all supplements to such master agreement, without regard to whether the master agreement provides for an agreement or transaction that is not a commodity contract under this paragraph, except that the master agreement shall be considered to be a commodity contract under this paragraph only with respect to each agreement or transaction under the master agreement that is referred to in subparagraph (A), (B), (C), (D), (E), (F), (G), or (H); or

(J) any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in this paragraph, including any guarantee or reimbursement obligation by or to a commodity broker or financial participant in connection with any
agreement or transaction referred to in this paragraph, but not to exceed
the damages in connection with any such agreement or transaction,
measured in accordance with section 562.”

2. Several of the terms used in Section 761(4) are defined at Section 761(8)
by reference to their definitions under the Commodity Exchange Act
(“CEA”):

a. Contract of sale

b. Commodity (Query whether this was intended to include any
commodity as defined in CEA Section 2 or only any such
commodity that is subject to regulation under the CEA?)

c. Derivatives clearing organization

d. Future delivery

e. Board of trade

f. Registered entity

g. Futures commission merchant

3. Some other terms are defined as those subject to regulation under
specified sections of the CEA such as:

a. Commodity option — Section 761(5); CEA section 4c(b)

b. Leverage transaction — Section 761(13); CEA section 19

C. Forward contracts

1. Section 101(25) —

“(A) a contract (other than a commodity contract, as defined in section
761) for the purchase, sale, or transfer of a commodity, as defined in
section 761(8) of this title, 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 or reverse repurchase
transaction (whether or not such repurchase or reverse repurchase
transaction is a “repurchase agreement”, as defined in this section),
consignment, lease, swap, hedge transaction, deposit, loan, option,
allocated transaction, unallocated transaction, or any other similar
agreement;
(B) any combination of agreements or transactions referred to in subparagraphs (A) and (C);

(C) any option to enter into an agreement or transaction referred to in subparagraph (A) or (B);

(D) a master agreement that provides for an agreement or transaction referred to in subparagraph (A), (B), or (C), together with all supplements to any such master agreement, without regard to whether such master agreement provides for an agreement or transaction that is not a forward contract under this paragraph, except that such master agreement shall be considered to be a forward contract under this paragraph only with respect to each agreement or transaction under such master agreement that is referred to in subparagraph (A), (B), or (C); or

(E) any security agreement or arrangement, or other credit enhancement related to any agreement or transaction referred to in subparagraph (A), (B), (C), or (D), including any guarantee or reimbursement obligation by or to a forward contract merchant or financial participant in connection with any agreement or transaction referred to in any such subparagraph, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562.”

2. Note that the terms “repurchase transaction,” “reverse repurchase transaction” and “swap” are used rather than the defined terms “repurchase agreement” and “swap agreement.” As in Section 555, FNIA added language making clear that repurchase transactions and reverse repurchase transactions are not limited to transactions that qualify as repurchase agreements under Section 101(47).

3. In contrast, FNIA added language to Section 101(25) to make clear that the term “commodity contract” used in the critical parenthetical phrase near the start of subsection (A) is used as defined in Section 761. This helps to clarify that “commodity contract” is intended to include regulated and exchange-traded contracts, whereas “forward contract” is intended to cover over-the-counter transactions.

4. Note also that “maturity date more than two days after the date the contract is entered into” appears to exclude spot transactions. Spot foreign exchange transactions are instead included as “swap agreements” (see Section 101(53B)(A)(i)(II) and II.E.2 below).

5. Supply contracts — Some of the thorniest safe harbor issues have arisen in the context of distinguishing between forward contracts and other commercial contracts. Two excellent bankruptcy judges came to opposite and irreconcilable conclusions as to the eligibility of a natural gas supply contract for protection as a “forward contract” or “swap agreement” —
In re Borden Chems. & Plastics Operating Ltd. P'ship, 336 B.R. 214 (Bankr. D. Del. 2006) (Walsh, B.J.) – Held that a natural gas supply contract was a forward contract, the natural gas company was a forward contract merchant, the prepetition payments by the debtor under the contract were settlement payments and, therefore, Section 546(e) exempted such payments from avoidance as preferential. Key components of the court’s rationale include:

i. An expectation of delivery of the actual commodity is an indicia of a forward contract.

ii. The court approvingly cites 5 Collier on Bankruptcy ¶556.02[2] at 556-5 (15th ed. rev. 2002) (“Thus, the terms ‘commodity contract’ and ‘forward contract,’ taken together, seamlessly cover the entirety of transactions in the commodity and forward-contract markets, whether exchange-traded, regulated, over-the-counter or private.”) Id. at 218.4

iii. As noted previously, FNIA added language clarifying that the term “commodity contract” in the parenthetical phrase at the beginning of the Section 101(25) definition of “forward contract” has the meaning given to “commodity contract” in Section 761(4). The Borden case predated that clarification, but Judge Walsh nonetheless applied the Section 761(4) definition. By coupling the Section 761(4) definition with the point in clause ii immediately above, Judge Walsh concluded that the term “forward contract” includes all contracts for the forward sale of commodities that are not regulated or exchange-traded “commodity contracts.”

iv. The debtors argued that commercial supply contracts, as opposed to financial market or trading contracts, are not intended to be protected as forward contracts. The debtor pointed to a passage in the legislative history of BAPCPA:

Title II of the bill amends the provisions of the Bankruptcy Code which protect forward contract termination and setoff rights against the automatic stay and trustee avoidance provisions of the Bankruptcy Code. Section 201 of the bill amends section 101 of the Bankruptcy Code to clarify the definition of “commodity” as it relates to forward contracts and forward contract merchants. A

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4 The author of this outline is also the author of the cited chapter of Collier on Bankruptcy.
"commodity" is defined to include the commodities enumerated in the Commodity Exchange Act, as well as 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. This amendment is intended to clarify that these exemptions in the Bankruptcy Code apply to genuine forward contracts regarding a commodity not currently listed in the Commodity Exchange Act, but that the exemptions do not apply to ordinary supply-of-goods contracts, which are not essentially financial in character. H. Rep. No. 484, 101st Cong., 2d Sess. at 6 (1990) (emphasis supplied).

Judge Walsh noted that the foregoing quote appears in the context of an explanation for the modification of the term "commodity" to conform to the Commodity Exchange Act definition, and that Congress' concern was about protecting only contracts for the future delivery of commodities and other goods that are the subject of trading in the forward contract market. "Therefore, as noted by the Fifth Circuit, there is no basis from which to distinguish amongst forward contracts." Id. at 220. Accord In re Olympic Natural Gas Co., 294 F.3d 737 (5th Cir. 2002).

b. In re National Gas Distributors, 369 B.R. 884 (Bankr. E.D.N.C. 2007) (Small, B.J.), rev'd, 556 F.3d 247 (4th Cir. 2009). Held that a natural gas supply contract is neither a forward contract nor a swap agreement and, therefore, the prepetition payments by the debtor thereunder are not protected from avoidance. Key components of the court's rationale include:

i. It is ambiguous whether the phrase "presently or in the future becomes the subject of dealing in the forward contract trade" in the Section 101(25) definition of "forward contract" qualifies "contract" rather than qualifying "similar good, article, service or interest" (though noting that the latter was more likely). Id. at 893-94 fn. 3.

5 The decision does not make clear why the parties were proceeding under the swap agreement provisions rather than the more clearly applicable forward contract provisions, but it appears that there would have been a serious issue as to whether the defendant would have qualified as a forward contract merchant entitled to protection under Section 546(e). In any event, the court fully discussed whether the supply contract qualified as a forward contract.
The term “commodity contract” in the parenthetical phrase at the beginning of Section 101(25) is not necessarily defined by Section 761(4). The court was aware that FNIA had amended Section 101(25) to specify that “commodity agreement” was used as defined in Section 761(4), but disregarded the clarification because the case predated the applicability of FNIA. *Id.* at 895 fn 5. The court rejected the *Collier* explanation that was accepted by the Fifth Circuit and found that

“[a]n equally plausible and more basic argument can be made that ‘commodity contract, as used in § 101(25), should be given its ‘plain meaning,’ which is a simple commodity supply contract.” *Id.* at 893-4.

The court concluded that it was reasonable to interpret “commodity contract” for Section 101(25) purposes as “a contract involving a commodity to be delivered in the future, but one that is not the ‘subject of dealing in the forward contract trade.’” *Id.* at 894.

Based on i and ii above, “the court believes that a simply (sic) supply contract should not be included within the definition of a forward contract.” *Id.* at 894.

The court also distinguished the instant facts from the Olympic Natural Gas situation, in which the non-debtor counterparty was Morgan Stanley Capital Group (“not a supplier” of natural gas) and the contract was “not an actual supply contract.” *Id.*

In the “swap agreement” analysis, the focus was on qualification within the Section 101(53B)(a)(i)(VII) term “commodity…forward agreement.” The court determined that “[a] forward contract is not identical to a forward agreement…and if the contract is not a forward agreement, it is not a swap agreement.” *Id.* at 895.

“Congress … clearly stated … that it did not intend for supply agreements to be swept into the realm of swap agreements.” *Id.* at 898 (emphasis in original). The court quoted the following legislative history:

“The definition of ‘swap agreement’ in [Section 101(53B)] should not be interpreted to permit parties to document non-swaps as swap
transactions. Traditional commercial arrangements, such as supply contracts ... cannot be treated as 'swaps' under the FDIA, the FCUA, or the Bankruptcy Code because the parties purport to document or label the transactions as 'swap agreements.'” H.R. Report No. 109-31 at 128-29 (emphasis in original).

c. Some observations —

i. Many bankruptcy practitioners expressed support for Judge Small’s decision, but it has now been reversed by the Court of Appeals for the Fourth Circuit (although the Fourth Circuit did not explicitly reverse the bankruptcy court’s conclusion that the gas contracts at issue were simple supply contracts and not commodity forward agreements). See In re Nat’l Gas Distribs., 556 F.3d 247 (4th Cir. 2009). In the view of the Court of Appeals, even if the term forward contract is limited to exchange-traded contracts or contracts not contemplating physical delivery of the commodity, the term “commodity forward agreement” (the corresponding component term in the definition of swap agreement) is not so limited. In the view of the Court of Appeals, commodity forward agreement includes any transaction (a) the subject of which is a commodity, and (b) that requires a payment for a specified quantity of the commodity at a specified price for delivery on a specified date that is more than two days after the date the contract is entered into, with such price, quantity and delivery date all agreed at the time of contracting. Additionally, in view of the fact that FNIA is now applicable and, as a result, the statute now specifies that “commodity contract” for purposes of the forward contract definition is defined by Section 761(4), it is doubtful that Judge Small’s “forward contract” rationale will be adopted by future bankruptcy courts. See Lightfoot v. MXEnergy, Inc. (In re MBS Mgmt. Servs., Inc.), 690 F.3d 352, 356 (5th Cir. 2012) (but finding that forward commodity contract does not have to specify a set quantity or date for delivery); Hutson v. U.S. (In re Nat’l Gas Distributors), 415 B.R. 209 (Bankr. E.D.N.C. 2009); Hutson v. M.J. Soffe Co. (In re Nat’l Gas Distributors), 412 B.R. 758, 762-63 (Bankr. E.D.N.C. 2009).

ii. Judge Walsh’s “forward contract” analysis in Borden now seems on more solid ground, having adopted the view that “commodity contract” was defined by Section 761(4) as
was ultimately codified by FNIA. See In re Eastern Livestock Co., LLC, 2012 WL 4210347 (Bankr. S.D. Ind. Apr. 5, 2012) (finding contracts for the purchase and sale of cattle for future delivery were forward contracts); In re Cascade Grain Prods., LLC, 465 B.R. 570 (Bankr. D. Or. 2011) (finding corn supply contracts were forward contracts); In re Renew Energy LLC, 463 B.R. 475 (Bankr. W.D. Wis. 2011) (finding natural gas supply contracts were forward contracts); In re Magnesium Corp. of America, 460 B.R. 360 (Bankr. S.D.N.Y. 2011) (agreeing with Borden analysis in pre-FNIA case).

iii. But some uncertain areas remain, such as whether, contrary to the plain text of Section 101(25), a supply contract must have financial characteristics in order to be considered a forward contract. See In re Magnesium Corp. of America, 460 B.R. 360 (Bankr. S.D.N.Y. 2011) (noting difficult issue of whether contract must have financial characteristics, but leaving the issue undecided because the supply contract at issue did have financial characteristics).

iv. In addition, courts have reached differing conclusions in the context of supply contracts as to the meaning of “maturity date” as used in Section 101(25)(A). Section 101(25)(A) requires a forward contract have a maturity date more than two days after the date the contract was entered into, but the Bankruptcy Code does not define the term “maturity date.” The common usage of the term would generally refer to the date that all obligations under the contract have been performed and there is nothing left to do but tender payment and, therefore, in the supply contract context, should refer to the delivery date on which the debtor’s final obligation to render payment becomes due. See In re Renew Energy LLC, 463 B.R. 475, 482 (Bankr. W.D. Wis. 2011); see also In re Laurel Valley Oil Co., 2013 WL 832407 (Bankr. N.D. Ohio Mar. 5, 2013) (finding maturity date is the date on which the benefit and detriment of the contract will be realized by the parties and that the maturity date for a prepaid supply contract is therefore the delivery date, not payment date). Other courts, however, have taken different approaches. See Lightfoot v. MXEnergy, Inc., 2011 WL 1899764 (E.D. La. May 19, 2011), aff’d, 690 F.3d 352 (5th Cir. 2012) (suggesting maturity date is the initial delivery date); In re Cascade Grain Prods., LLC, 465 B.R. 570 (Bankr. D. Or. 2011) (finding maturity date is “the future date at which the commodity must be bought or sold,” which is the date
when ownership and risk of loss passes to the buyer); *In re Magnesium Corp. of America*, 460 B.R. 360 (Bankr. S.D.N.Y. 2011) (suggesting, in the context of a supply contract having daily deliveries and monthly payments, that each date of delivery is a maturity date); *In re Mirant Corp.*, 310 B.R. 548 (Bankr. N.D. Tex. 2004) (finding maturity date to be the due date for commencement of performance).

v. Although it is easy to sympathize with Judge Small’s evident discomfort in applying extraordinary protections to what may be ordinary supply contracts outside the financial markets that Congress sought to protect, the facts of *National Gas* point out the difficulty of effectively dealing with this situation. First, *National Gas* was an attempt to avoid contracts with clear hedging elements as fraudulent transfers. Courts often give lip service to valuing transactions as of the date of the transfer, and then use hindsight to take subsequent price movement into consideration. This can be particularly perilous to a counterparty in the context of any transaction with price hedging elements, and there is a reasonable view that it is an abuse of the Bankruptcy Code. Second, it can be extremely difficult to determine when a commodity supply contract is solely and absolutely for use in the debtor’s business operations, because many entities engage in trading of the commodities that they use in their operations.

vi. This remains a point of focus by critics of the safe harbors, and it is possible that any future legislation addressing the safe harbors will pare back coverage to exclude contracts for goods and provision of services with end-users.

D. **Repurchase agreements**

1. **Section 101(47) —** “(which definition also applies to a reverse repurchase agreement)

   (A) means —

   (i) an agreement, including related terms, which provides for the transfer of one or more certificates of deposit, mortgage related securities (as defined in section 3 of the Securities Exchange Act of 1934), mortgage loans, interests in mortgage related securities or mortgage loans, eligible bankers’ acceptances, qualified foreign government securities (defined as a security that is a direct obligation of, or that is fully guaranteed by, the central government of a member of the Organization for Economic
Cooperation and Development), or securities that are direct obligations of, or that are fully guaranteed by, the United States or any agency of the United States against the transfer of funds by the transferee of such certificates of deposit, eligible bankers’ acceptances, securities, mortgage loans, or interests, with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, eligible bankers’ acceptance, securities, mortgage loans or interests of the kind described in this clause, at a date certain not later than 1 year after such transfer or on demand, against the transfer of funds;

(ii) any combination of agreements or transactions referred to in clauses (i) and (iii);

(iii) an option to enter into an agreement or transaction referred to in clause (i) or (ii);

(iv) a master agreement that provides for an agreement or transaction referred to in clause (i), (ii), or (iii), together with all supplements to any such master agreement, without regard to whether such master agreement provides for an agreement or transaction that is not a repurchase agreement under this paragraph, except that such master agreement shall be considered to be a repurchase agreement under this paragraph only with respect to each agreement or transaction under the master agreement that is referred to in clause (i), (ii), or (iii); or

(v) any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in clause (i), (ii), (iii), or (iv), including any guarantee or reimbursement obligation by or to a repo participant or financial participant in connection with any agreement or transaction referred to in any such clause, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562 of this title; and

(B) does not include a repurchase obligation under a participation in a commercial mortgage loan.”

2. Even though the Section 101(47) definition of repurchase agreements has been expanded over time to include transactions for a broadened range of securities and instruments, such as mortgage loans, mortgage-related securities and qualified foreign government securities, the universe of qualifying securities under the repurchase agreement definition is still narrower than under the securities contract definition (Section 741(7)) which includes all securities and is not limited to transactions having a term of one year or less. To take advantage of the securities contract protections, however, the non-debtor counterparty would have to be eligible under the somewhat more restrictive counterparty limitations of

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Section 555 (see III.B.1 below) rather than the relatively loose counterparty provisions of Section 559.

3. Transactions that do not have the attributes of a repurchase agreement and are not integral to a repurchase agreement may not be treated as a repurchase agreement merely because they are included in a master repurchase agreement. For example, servicing agreements embedded in a master repurchase agreement that are not integral to the purchase and sale of the underlying securities, instruments or loans may be treated as separate or severable from the core provisions of the repurchase agreement and denied stay-exemption, avoidance exemption and other protection.

a. In *In re American Home Mortgage, Inc.*, 379 B.R. 503 (Bankr. D. Del. 2008), the court held that mortgage loan servicing rights contained in a mortgage loan repurchase agreement are severable and do not constitute a repurchase agreement or other protected agreement. In arriving at its decision, the court determined that applicable New York contract law would allow the court to sever the portions of the agreement dealing with mortgage servicing rights.

b. Consequently, a non-debtor counterparty seeking to obtain or dispose of mortgage loans on a servicing released basis may find it necessary to terminate the servicing contract prepetition, obtain relief from the automatic stay to terminate, or await the expiration of the servicing contract.

4. Repurchase transactions with a zero purchase price (*i.e.*, transfers of securities to be held as free collateral in connection with certain other repos entered into at the same time) have been held to be “repurchase agreements” within the meaning of Section 101(47). See *In re HomeBanc Mortgage Corp.*, 2014 WL 1268677, at *3-4 (D. Del. Mar. 27, 2014), where the court reasoned that although the disputed securities were not transferred “against the transfer of funds” as required by Section 101(47)(A)(i), the disputed repo transactions nonetheless fit into the catchall clause (v) of Section 101(47)(A) because they were “credit enhancements” related to undisputed repo transactions under the same master repurchase agreement.

5. **What is an “agency”?**

a. 129 Cong. Rec. 17,483 (June 27, 1983) (Statement of Rep. Fauntroy) — “The reference to ‘direct obligations of, or that are fully guaranteed...by, the United States or any agency of the United States’ is based on section 14(b) of the Federal Reserve Act, 12 U.S.C. § 355, and is intended to include all obligations of, or that are fully guaranteed...by, any entity whose obligations are determined by the Board of Governors of the Federal Reserve
System to be eligible for purchase by Federal Reserve banks under the similar language of section 14(b) of the Federal Reserve Act.”

b. The Board of Governors of the Federal Reserve System, in its published Interpretations of Regulation A (FRRS 2-040), lists the 20 principal type of obligations eligible for purchase by Reserve Banks under section 14(b). Included among the listings are:

i. FNMA (Fannie Mae) and FHLMC (Freddie Mac) notes, debentures and guaranteed certificates of participation

ii. Obligations of or fully guaranteed by GNMA (Ginnie Mae)

iii. FHA (Federal Housing Administration) debentures (but not insured mortgage loans)

iv. FHLB (Federal Home Loan Banks) notes and bonds

Because a repurchase agreement is, by its very nature, a credit transaction, there is a natural temptation to seek to treat a repurchase agreement as a secured loan. Nonetheless, whether an agreement is a “repurchase agreement” is determined by applying the plain language of Section 101(47). As stated by one bankruptcy court:

Succinctly stated, if the definition of “repurchase agreement” is met, the section 559 safe harbor provisions apply, period. Similarly, if the definitions of “securities contract” and “financial institution” are met, the section 555 safe harbor applies, period. This conclusion is compelled by the plain meaning of the statute and is consistent with the policy and legislative history underlying the relevant provisions of the Bankruptcy Code.


E. Swap agreements

1. Section 101(53B)

“(A) means —

(i) any agreement, including the terms and conditions incorporated by reference in such agreement, which is —
(I) an interest rate swap, option, future, or forward agreement, including a rate floor, rate cap, rate collar, cross-currency rate swap, and basis swap;

(II) a spot, same day-tomorrow, tomorrow-next, forward, or other foreign exchange, precious metals, or other commodity agreement;

(III) a currency swap, option, future, or forward agreement;

(IV) an equity index or equity swap, option, future, or forward agreement;

(V) a debt index or debt swap, option, future, or forward agreement;

(VI) a total return, credit spread or credit swap, option, future, or forward agreement;

(VII) a commodity index or a commodity swap, option, future, or forward agreement;

(VIII) a weather swap, option, future or forward agreement;

(XI) an emissions swap, option, future, or forward agreement; or

(X) an inflation swap, option, future, or forward agreement;

(ii) any agreement or transaction that is similar to any other agreement or transaction referred to in this paragraph and that —

(I) is of a type that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap or other derivatives markets (including terms and conditions incorporated by reference therein); and

(II) is a forward, swap, future, option, or spot transaction on one or more rates, currencies, commodities, equity securities, or other equity instruments, debt securities or other debt instruments, quantitative measures associated with an occurrence, extent of an occurrence, or contingency associated with a financial, commercial, or economic consequence, or economic or financial indices or measures of economic or financial risk or value;

(iii) any combination of agreements or transactions referred to in this subparagraph;
(iv) any option to enter into an agreement or transaction referred to in this subparagraph;

(v) a master agreement that provides for an agreement or transaction referred to in clause (i), (ii), (iii), or (iv), together with all supplements to any such master agreement, and without regard to whether the master agreement contains an agreement or transaction that is not a swap agreement under this paragraph, except that the master agreement shall be considered to be a swap agreement under this paragraph only with respect to each agreement or transaction under the master agreement that is referred to in clause (i), (ii), (iii), or (iv); or

(vi) any security agreement or arrangement or other credit enhancement related to any agreements or transactions referred to in clause (i) through (v), including any guarantee or reimbursement obligation by or to a swap participant or financial participant in connection with any agreement or transaction referred to in any such clause, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562; and

(B) is applicable for purposes of this title only, and shall not be construed or applied so as to challenge or affect the characterization, definition, or treatment of any swap agreement under any other statute, regulation, or rule, including the Gramm-Leach-Bliley Act, the Legal Certainty for Bank Products Act of 2000, the securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934) and the Commodities Exchange Act.”

2. Foreign exchange agreements are covered within the definition of swap agreement. Forward foreign exchange agreements are swap agreements and, probably, forward contracts, but spot foreign exchange agreements are solely swap agreements.

3. The changes effected by BAPCPA and FNIA made clear that the sweep of the term swap agreement is quite broad and protects such important markets as equity derivatives and credit derivatives that were not clearly protected under the prior language. In view of the heavy credit/loan aspects of some credit derivatives, such as credit default swaps and total return swaps, this addition was somewhat contentious and opens avenues for reconfiguration of normal loan transactions subject to the automatic stay into swap agreements that are protected from the stay. See II.H below.

4. Supplemental agreements not specifically referenced in a swap agreement and not expressly dealing with liquidation, termination or acceleration may be considered as falling outside the definition of “swap agreements” for purposes of Section 101(53B). In In re Lehman Bros. Holdings Inc.,
422 B.R. 407, 421 (Bankr. S.D.N.Y. 2010), Bankruptcy Judge Peck held that so-called “flip clauses” in Supplemental Trust Deeds that changed the order of priority in which proceeds of swap agreements were to be distributed did not comprise part of the swap agreements because there was no reference in the swap agreements to the Supplemental Trust Deeds and they dealt with “the alteration of rights as they then exist” rather than liquidation, termination or acceleration. See also In re Lehman Bros. Holdings Inc., 452 B.R. 31 (Bankr. S.D.N.Y. 2011) (applying similar reasoning). In two subsequent decisions, however, Judge Peck showed more willingness to treat provisions in ancillary agreements as part of the safe-harborred contract. See discussions of Lehman/MSHDA in III.E.4.d below (assignment and amendment agreement part of safe-harborred swap agreement) and Lehman/JPMC in V.A.1.c below (guarantee, security and account control agreements related to safe-harborred securities contract, thereby constituting safe-harborred securities contracts themselves). Note also that Judge Peck held in a later decision that whether a security agreement comes within the “forming a part of or related to any swap agreement” language of the Section 362(b)(17) exception to the automatic stay for swap agreements will depend upon whether the relevant security agreement has a “sufficient connection” to a swap agreement, which is a case by case determination based on a review of the facts and circumstances. In re Lehman Bros. Holdings Inc., 439 B.R. 811, 835 (Bankr. S.D.N.Y. 2010) (“Lehman/BofA”).

5. Transactions in the debtor’s stock — Some securities contracts and swap agreements involve a forward purchase by a debtor of its own stock. Assume: Issuer has entered into a prepetition swap with Dealer, the final transfers of which are to occur on a settlement date two years in the future and include the payment by the Issuer of $10,000, either in cash or in its own stock valued at the fair market value on the final settlement date; one year after entry into the agreement, the debtor becomes a Bankruptcy Code debtor and its stock is then worthless. Query whether Dealer has an allowable claim for $10,000 in Issuer’s bankruptcy case? Do Sections 510(b) or (c) or other equitable principles subordinate the claim or convert it into an equity interest? Does it matter whether settlement was gross or net? Does it matter whether the contract specified that cash settlement was required in the case of Issuer’s bankruptcy?

F. Master netting agreements

1. Section 101(38A)

“(A) means an agreement providing for the exercise of rights, including rights of netting, setoff, liquidation, termination, acceleration, or close out, under or in connection with one or more contracts that are described in any one or more of paragraphs (1) through (5) of section 561(a), or any security agreement or arrangement or other credit
enhancement related to one or more of the foregoing, including any guarantee or reimbursement obligation related to 1 or more of the foregoing; and

(B) if the agreement contains provisions relating to agreements or transactions that are not contracts described in paragraphs (1) through (5) of section 561(a), shall be deemed to be a master netting agreement only with respect to those agreements or transactions that are described in any one or more of paragraphs (1) through (5) of section 561(a)."

2. This definition covers contractual cross-product netting and cross-default rights, whether contained in a separate cross-product netting agreement or the default provisions of a Protected Transaction.

G. Definition format

1. As part of the BAPCPA and FNIA amendments, Sections 101(25), 101(47), 101(53B), 741(7) and 761(4) were drafted in a more uniform style, making clear that the definitions of forward contract, repurchase agreement, swap agreement, securities contract and commodity contract, respectively, include related master agreements (to the extent such master agreement covers contracts of the relevant type), security agreements, credit enhancements, guarantees and reimbursement obligations.

2. Thus, a counterparty may exercise its remedies under guarantees and security arrangements relating to Protected Transactions provided by debtors (e.g., a secured guarantee provided by the principal party’s corporate parent/debtor). See IV.A-B below and discussion of Lehman/JPMC in V.A.1.c and V.A.1.i below.

H. Disguised transactions – Much has been made of the potential for abuse under the safe harbor provisions by disguising loans and other commercial transactions as Protected Transactions. Query whether a bankruptcy court has the power to recharacterize a “disguised loan” transaction that facially qualifies as a Protected Transaction? Inasmuch as full recourse margin loans, reverse repurchase agreements and total return swaps are expressly covered as Protected Transactions, does it continue to make sense to argue that a transaction that has the economic attributes of a loan should not be characterized as a Protected Transaction? Are the transactions described below Protected Transactions? Would inclusion of operating assets, subsidiary stock and other non-market standard collateral increase the likelihood of successful challenge?

1. Is the swap described below a protected “swap agreement”?

   Party A pays Party B $1 million on Transaction Date.
   Party B pays Party A $1 million on
Termination Date.  
Party A pays Party B 0.5% per annum on $1 million Notional Amount.  
Party B pays Party A LIBOR + 1.5% per annum on $1 million Notional Amount.  
Parties agree that swap payments can be netted.  
Foregoing is documented under an industry-standard ISDA Master Agreement.

2. **Is the credit default swap described below a protected “swap agreement”?**

Lender makes a $100 million loan to Parent’s newly-formed, wholly owned and nominally capitalized subsidiary, Borrower Sub.  
Parent enters into a credit default swap with Lender under which Parent agrees to purchase from Lender at par plus accrued interest Borrower Sub’s note in the event of a payment or bankruptcy default by Borrower Sub. Parent secures its obligations under the credit default swap with a blanket lien on all of its property in favor of Lender.  
Foregoing is documented under an industry-standard ISDA Master Agreement.

3. **Is the reverse repurchase agreement described below a protected “securities contract”?**

Bank enters into a reverse repurchase agreement with Parent whereby Bank buys from Parent all of the stock of Parent’s principal operating subsidiary (Op Sub) for a $100 million Purchase Price, and Parent agrees to repurchase the Op Sub stock two years later at a Repurchase Price equal to the Purchase Price plus a Purchase Price Differential computed by applying LIBOR to the Purchase Price for the term of the transaction.  
Foregoing is documented under an industry-standard SIFMA Master Repurchase Agreement.

III. **Close-Out Protections — Sections 555, 556, 559, 560, 561 and 562**

Sections 555, 556, 559, 560, 561 and 562 provide powerful anti-stay protections for the close-out of Protected Transactions. The stockbrokers, financial institutions, securities clearing agencies, commodity brokers, forward contract merchants, repo participants, swap participants and financial participants who are entitled to the benefits of these and other protections described in this outline, as applicable depending on the nature of the relevant Protected Transactions, are sometimes referred to collectively herein as “Protected Counterparties.”
A. General — a contractual right to liquidate, terminate or accelerate a Protected Transaction triggered by a condition of the kind specified in Section 365(e)(1) (i.e., ipso facto clauses) shall not be stayed, avoided or otherwise limited by operation of any provision of Title 11 or court order. Section 555 covers securities contracts; Section 556 covers commodities contracts and forward contracts; Section 559 covers repurchase agreements; Section 560 covers swap agreements; Section 561 covers master netting agreements; and Section 562 covers the measure of damages for Protected Transactions.

1. Right to liquidate, terminate or accelerate refers to termination or acceleration of the Protected Transaction and fixing the obligations of parties based on then current market values. Industry-standard and negotiated agreements have liquidation/termination/acceleration provisions of this sort.

2. Sections 555, 556, 559, 560 and 561 each use a broad, nearly identical formulation of “contractual right.” The following is the relevant language of Section 555:

“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 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 in writing, arising under common law, under law merchant, or by reason of normal business practice.”

Thus, the source of the protected right may not be purely “contractual.”

3. Section 562 complements Sections 555, 556, 559, 560 and 561 by dealing with the measure of damages arising from the liquidation, termination or acceleration of a Protected Transaction.

a. Section 562(a) provides that damages arising from the liquidation, termination or acceleration of a Protected Transaction by a Protected Counterparty, or rejection of a Protected Transaction by a trustee or debtor, are measured as of the earlier of the date of rejection or the date(s) of liquidation, termination or acceleration. Note that Section 562(a) addresses the measure of damages; it does not expressly affect the valuation of collateral.
b. If there are no commercially reasonable determinants of value on the date determined by Section 562(a) — which can arguably happen if there is a serious market disruption (keep in mind that such market disruption may, in fact, be the reason for the debtor’s failure) — then Section 562(b) provides that damages are to be measured as of the earliest subsequent date(s) on which there are commercially reasonable determinants of value. Section 562(c) provides that, in the case of a dispute, the party taking the position that there was no commercially reasonable determinant of value has the burden of proof on that issue. The Court of Appeals in In re American Home Mortgage Holdings, Inc., 637 F.3d 246 (3d Cir. 2011), rejected the argument that there were no “commercially reasonable determinants of value” on the date of rejection, liquidation, termination, or acceleration even though there was no market or sale value on that date because of a dysfunctional market, and held that the discounted cash flow method constituted a “commercially reasonable determinant of value” for mortgage loans in such a market. The Court decided that a non-sale, non-market based determinant of value was permissible — notwithstanding that “commercially reasonable” was evidently sourced from the Uniform Commercial Code’s standards for sales of collateral and the painfully obvious intent of Section 562(b) — largely because “determinants” is plural in the statute. Query whether there could ever be no commercially reasonable determinants of value under this decision? This could be an area for future legislation to clarify that a commercially reasonable determinant of value should be market-based or based on an otherwise enforceable contractual provision.

c. Query whether, in the case of an option or derivative, the termination payment should be (i) the difference between the option/derivative price and the current market value of the underlying security, index or other property or measure or (ii) the cost of a replacement option or derivative?

d. Query under what circumstances do the values/costs of unwinding related hedge transactions become relevant?

e. Assume the Protected Counterparty does not terminate an outstanding swap agreement or option agreement with the debtor, and 30 days after the filing of its petition the debtor rejects the agreement as an executory contract. Assume also that the agreement is secured and permits the Protected Counterparty to rehypothecate the collateral which it is holding. Section 562 clarifies that claims arising from the rejection, liquidation, termination or acceleration of Protected Transactions are
prepetition claims to be measured as of the earlier of the date of rejection or the date of liquidation, termination or acceleration, but what about these other issues –

i.  *Query* whether the counterparty remains free to rehypothecate the collateral postpetition?

ii.  *Query* whether the debtor may assume the swap agreement rather than reject it (i.e., is Section 365(e)(1) or (2) applicable)?

iii. *Query* whether delay by the counterparty in terminating based on the bankruptcy default may eventually constitute a waiver of its right to terminate based on such default? See Transcript of Hearing Held on Sept. 15, 2009 at 101-13, *In re Lehman Bros. Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. Sept. 17, 2009), where Bankruptcy Judge Peck held that a swap counterparty’s one-year delay in exercising its termination right under the safe harbor constituted a waiver thereof. The counterparty, Metavante Corporation, had entered into an interest rate swap with Lehman Brothers Special Financing Inc. ("LBSF") under which Metavante was out-of-the-money due to declining interest rates. Upon the Lehman chapter 11 filing, Metavante had the contractual right, protected from stay by Section 560, to terminate the swap agreement. Nonetheless, it chose not to do so and instead withheld the quarterly payments owing to LBSF under the swap agreement for the ensuing year. Judge Peck found Metavante’s behavior “simply unacceptable and contrary to the spirit of [the safe harbor provisions of the Bankruptcy Code]” and ordered Metavante to perform under the swap agreement until assumed or rejected by LBSF, declaring that its “window to act promptly under the safe harbor provisions ha[d] passed.” See also *In re Amcor Funding Corp.*, 117 B.R. 549 (D. Ariz. 1990); *In re Enron Corp.*, 2005 WL 3874285, at *4 (Bankr. S.D.N.Y. Oct. 5, 2005) (“To avail itself of the ‘safe harbor’ provisions of the Bankruptcy Code, however, the swap participant must opt for the early termination of the swap agreement based upon one of the reasons enumerated in section 365(e)(1) of the Bankruptcy Code and if based upon the bankruptcy filing, the election to terminate must be made fairly contemporaneously with the bankruptcy filing.”).

iv. *Query* whether there is ever any good reason for a counterparty to delay its close-out?
4. Note also that New York has a special statute of frauds that protects certain Protected Transactions that are documented or evidenced in a manner other than on paper. See New York General Obligations Law Section 5-701.b.

5. Provisions applicable only to particular types of Protected Transactions are discussed below.

B. Securities contracts — Section 555

1. Protects only a limited group of counterparties:
   a. Stockbroker — Section 101(53A)
      i. Under the Section 101(53A) definition, a stockbroker is any person who (A) has a customer (as defined in Section 741(2)) and (B) is engaged in the business of effecting securities transactions for the account of others or with members of the general public from or for its own account.
      ii. In some instances, obvious stockbrokers (such as Morgan Stanley) have been challenged as not qualifying as Protected Counterparties because they were not acting as stockbrokers in connection with the subject transactions. Nonetheless, the relevant provisions discussed in this outline do not require that a stockbroker be acting as such in connection with a transaction to qualify as a Protected Counterparty. Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 476 B.R. 715, 719 (S.D.N.Y. 2012); In re Stewart Finance Co., 367 B.R. 909, 918-19 (Bankr. M.D. Ga. 2007). But see In re Residential Res. Mortgage Inv. Corp., 98 B.R. 2, 20-23 (Bankr. D. Ariz. 1989).
   b. Securities clearing agency — Section 101(48)
   c. Financial institution — Section 101(22)
      i. Note that this definition includes federal reserve banks, commercial banks, trust companies, federally insured credit unions, registered investment companies and thrifts.
      ii. Any customer of a commercial bank or trust company is treated as a financial institution if such bank or trust company "is acting as agent or custodian for [such] customer (whether or not a "customer," as defined in Section 741) in connection with a securities contract (as defined in Section 741)." Query as to what level of...
involvement by the bank or trust company in the relevant Protected Transaction is necessary to confer financial status on its customer?

iii. Accordingly, individuals, insurance companies, mutual funds and other non-banks get the benefit of Section 555 when they transact through a bank acting as agent or custodian.

iv. The Delaware district court in Hechinger Inv. Co. of Delaware v. Fleet Retail Fin. Group, et al., 274 B.R. 71, 87-88 (D. Del. 2002) held that a disbursing agent that was apparently not a bank or savings and loan nonetheless qualified as a financial institution for purposes of Section 546(e).

v. Most courts have held that transfers to a financial institution qualify for Section 546(e) protection, even where the financial institution is acting only as an intermediary or a conduit. See In re Quebecor World (USA) Inc., 719 F.3d 94, 98 (2d Cir. 2013); In re QSI Holdings, Inc., 571 F.3d 545, 550-51 (6th Cir. 2009); Contemporary Indus. Corp. v. Frost, 564 F.3d 981, 986-88 (8th Cir. 2009); In re Resorts Int’l, Inc., 181 F.3d 505, 516 (3d Cir. 1999). But see In re Munford, Inc., 98 F.3d 604, 610 (11th Cir. 1996) (requiring the financial institution to have acquired a beneficial interest in the relevant funds or securities in order for Section 546(e) to apply).

d. Financial participant — Section 101(22A)

i. An entity that, at the time it enters into a Protected Transaction, or at the time the petition is filed, had one or more Protected Transactions with the debtor or any other unaffiliated entity of a total gross dollar value of at least $1 billion in notional or actual principal amount outstanding (aggregated across counterparties) at such time or on any day during the 15-month period preceding the date of the filing of the petition, or had gross mark-to-market positions of at least $100 million (aggregated across counterparties) in one or more Protected Transactions on any day during the 15-month period preceding the date of the filing of the petition, or

ii. is a “clearing organization” within the meaning of section 402 of the Federal Deposit Insurance Corporation Improvement Act of 1991.
2. Also protects against administrative agency orders, but orders under the following laws are excluded from the scope of the Section 555 protections:

a. Securities Investor Protection Act of 1970 ("SIPA")

i. At the commencement of a SIPA proceeding, the Securities Investor Protection Corporation ("SIPC") generally seeks and obtains an order staying the close-out of at least some securities contracts, including securities loans.

ii. By letter dated June 25, 2002 (the "June 25 TBMA Letter") addressed to the General Counsel of The Bond Market Association ("TBMA"), the President of SIPC agreed to clarify the factors SIPC considered important in determining whether to consent to a close-out of a securities lending transaction. In an August 29, 1988 letter to TBMA (the "August 29 TBMA Letter"), SIPC agreed to modify its standard form of order, while still barring the immediate close-out of securities lending transactions, to permit close-out of securities lending transactions which would otherwise be protected under Section 555 upon written consent of SIPC and the trustee appointed in the case (thus eliminating the need for court relief). The June 25 TBMA Letter explained that SIPC would consent (and would urge the trustee to consent) to a close-out of securities lending transactions if (a) it received an affidavit of the counterparty attesting that it has no knowledge of fraud in the transaction and (b) by the terms of the transaction the counterparty has either acquired ownership rights in or a perfected security interest in the collateral; and thereafter would lift the stay or perform the debtor's obligations under the transaction.

iii. The August 29 TBMA Letter stated that SIPC would act promptly to determine whether the subject securities are necessary to satisfy the claims of customers (stating 4 to 5 days after the initiation of the proceeding as a hoped-for time frame).

iv. Section 5(b)(2) of SIPA blocks SIPC from seeking a stay of the exercise of contractual rights with respect to Protected Transactions, except that it may seek to stay the foreclosure
of securities collateral pledged by the debtor (whether or not with respect to one or more such contracts or agreements), securities sold by the debtor under a repurchase agreement and securities lent under a securities lending agreement. Thus, a Protected Counterparty may be able to terminate/accelerate a securities contract (and thus reduce its exposure to market movements), but might be stayed from foreclosing on the related securities collateral.

v. The initial orders entered in the Lehman Brothers and MF Global SIPA proceedings were generally consistent with this approach. See Sec. Investor Prot. Corp. v. Lehman Brothers Inc., Order Commencing Liquidation, No. 08-CIV-8119 (S.D.N.Y. Sept. 19, 2008) (available as ECF 1 in Lehman Brothers Inc. SIPA proceeding docket); Sec. Investor Prot. Corp. v. MF Global Inc., Order, No. 11-CIV-7750 (S.D.N.Y. Oct. 31, 2011) (available as ECF 1 in MF Global Inc. SIPA proceeding docket). The stays on safe harbor agreements were limited to 21 days, and collateral could be liquidated with the consent of SIPC and the trustee. Anecdotally, SIPC and the trustees generally gave their consent to the liquidation of readily marketable collateral within 5 days after receiving reasonable evidence of the regularity of the transactions.

b. Any statute administered by the Securities and Exchange Commission (“SEC”).

C. Commodity contracts and forward contracts — Section 556

1. Protects only a limited group of counterparties:

   a. Commodity broker — Section 101(6) (“futures commission merchant, foreign futures commission merchant, clearing organization, leverage transaction merchant, or commodity options dealer, as defined in section 761 of this title, with respect to which there is a customer, as defined in section 761 of this title”).

   b. Forward contract merchant — Section 101(26) (“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) 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”). Because of the “in whole or in part” language, this definition arguably covers any entity that enters into a forward contract in a business context. See, e.g., In re Renew Energy LLC, 463 B.R.
475, 482 (Bankr. W.D. Wis. 2011) (finding natural gas supplier demonstrated it was a “forward contract merchant” by showing two supply contracts it entered into were forward contracts). The court in *In re Magnesium Corp. of America*, 460 B.R. 360, 369 (Bankr. S.D.N.Y. 2011), however, rejected the notion that only a “peppercorn of activity” in entering into forward contracts could qualify an entity as a “forward contract merchant,” emphasizing that the business must be, in whole or in part, entering into forward contracts. In a similar vein, the court in *In re Eastern Livestock Co., LLC*, 2012 WL 4210347, at *6 (Bankr. S.D. Ind. Apr. 5, 2012), found that in order for an entity to be considered a “forward contract merchant,” it must have been acting as a forward contract merchant in its transactions with the debtor. Note that this definition was amended as part of the BAPCPA Amendments in 2005 to allow for “entities” to be “forward contract merchants.” Before BAPCPA, it was uncertain whether a governmental entity could be a forward contract merchant. *In re Mirant Corp.*, 303 B.R. 319, 326 (Bank. N.D. Ill. 2003) (finding that government entities are not “persons” and thus not “forward contract merchants”).

c. Financial participant — see III.B.1.d above.

2. Does not expressly protect against administrative agency orders

D. Repurchase agreements — Section 559

1. Protects any “repo participant” — defined broadly in Section 101(46) to include any entity that had an outstanding repurchase agreement with the debtor at any time before the filing of the petition.

2. Also protects “financial participants” as Protected Counterparties — see III.B.1.d above.

3. Also protects against administrative agency orders, but exclusions from stay protection include, in the case of a debtor that is a stockbroker or securities clearing agency, an order authorized under:

   a. SIPA

      i. At the commencement of a SIPA proceeding, SIPC generally seeks and obtains an order staying the close-out of repurchase agreements.

      ii. In the June 25 TBMA Letter, the President of SIPC agreed to clarify the factors SIPC considered important in determining whether to consent to a close-out of a
repurchase transaction. In a February 4, 1986 letter to TBMA (the “February 4 TBMA Letter”), SIPC agreed to modify its standard form of order, while still barring the immediate close-out of repurchase agreements, to permit close-out of repurchase agreements that would otherwise be protected under Section 559 upon written consent of SIPC and the trustee appointed in the case (thus eliminating the need for court relief). The letter indicates that SIPC would consent (and would urge the trustee to consent) if (a) it received an affidavit of the counterparty attesting that it has no knowledge of fraud in the transaction and (b) by the terms of the transaction the counterparty has either acquired ownership rights in or a perfected security interest in the subject securities; and thereafter would lift the stay or perform the debtor’s obligations under the transaction. The February 4 TBMA Letter was limited to transactions in which the SIPC member acted as repo seller. The June 25 TBMA Letter expanded the coverage to transactions in which the SIPC member acted as repo buyer.

iii. Note the discussion at III.B.2.a.iii above regarding timing and major stockbroker cases.

b. Any statute administered by the SEC.

4. Section 559 specifies that any excess proceeds or value remaining after the repo participant or financial participant has recovered the amounts owed to it by the debtor are part of the estate, subject to the available rights of setoff. Note that Sections 555 and 556 do not have similar language relating to excess proceeds even though certain repurchase transactions and reverse repurchase transactions qualify as securities contracts and forward contracts.

5. Section 559 expressly provides that, if any assets subject to a repurchase agreement are not disposed of on the date of the liquidation of the repurchase agreement, the assets will be treated as having been disposed of at the prices available at the time of liquidation of such repurchase agreements from a generally recognized source or the most recent closing bid quotation from such source. This has the effect of permitting a non-defaulting repo buyer to close-out at current market prices while retaining the underlying repo securities. Query whether this provision operates as written even in the event that on the date of liquidation there are no commercially reasonable determinants of value? See Section 562(b).
E. Swap agreement — Section 560

1. Protects any financial participant (see III.B.1.d above) or “swap participant” — defined broadly at Section 101(53C) to include any entity that had a prepetition swap agreement with the debtor. Therefore, essentially protects any entity in need of protection.

2. Also protects against administrative agency orders.

3. Expressly protects the contractual right to offset or net out any “termination values or payment amounts.” Query whether this protects contractually created cross-affiliate or triangular setoff rights. See discussion of SemCrude, Lehman/UBS and American Home in V.C.3 below.

4. Issues may arise regarding the computation of termination damages under swap agreements.
   a. The practice (which is no longer common) of denying a defaulting swap counterparty the termination value of a swap transaction was held enforceable in Drexel Burnham Lambert Products Corp. v. Midland Bank PLC, No. 92 Civ. 3098 (S.D.N.Y. Nov. 10, 1992) (avail. on LEXIS at 1992 U.S. Dist. LEXIS 21223).
   b. The “Market Quotation” measure of damages under the 1992 ISDA Master Agreement does not use the lowest bid, but rather uses either (i) the average of the two middle bids obtained from four reference market makers or (ii) the middle bid of three bids so obtained. Cf Drexel Burnham Lambert Products Corp. v. Mcorp, 1989 WL 16981, at *5-6 (Del. Super. Ct. August 13, 1991) (Market Quotation method is a reasonable method of determining damages even though claimant did not actually enter into a replacement agreement).
   c. The measure of damages under the 2002 ISDA Master Agreement — “Close-out Amount” — is a lengthy definition that leaves to the determining party the determination of its losses or costs that are or would be incurred under then prevailing circumstances in good faith and using commercially reasonable procedures. It is intended as a liquidated damages provision. See 2002 ISDA Master Agreement, Section 6(e)(v).
   d. Contractual provisions in swap agreements specifying agreed-upon liquidation methodologies have been held to be protected by the
“plain language” of Section 560. *In re Lehman Bros. Holdings Inc.*, 502 B.R. 383 (Bankr. S.D.N.Y. 2013) (“*Lehman/MSHDA*”) (reasoning that a safe harbored contractual right to cause the liquidation of a swap agreement necessarily must include the methodology for carrying it out). Note that the provision at issue was found not in the swap agreement itself, but in an assignment and amendment agreement that purportedly amended the liquidation methodology set forth in the swap agreement. It was undisputed among the parties that the swap agreement, as amended by the assignment and amendment agreement, constituted a safe-harbored swap agreement.

e. Damages under interest rate swap agreements are not subject to disallowance as “unmatured interest” under Section 502(b)(2). *In re Thrifty Oil Co.*, 249 B.R. 537 (S.D.Cal. 2000), aff’d, 310 F.3d 1188 (9th Cir. 2002).

F. Master netting agreement — Section 561

1. Protects the exercise of any contractual right, triggered by a bankruptcy-type default, 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 Protected Transactions from any stay, avoidance or other limitation by operation of the Bankruptcy Code, order of a court or administrative agency in a proceeding under the Bankruptcy Code. It protects cross-product netting and cross-default provisions.

2. Contractual rights are protected under Section 561 only to the extent that the counterparty could exercise such rights under Section 555, 556, 559 or 560, as the case may be, for the individual Protected Transactions covered by the master netting agreement.

IV. Protection of Netting and Secured Party Rights — Sections 362(b)(6), (7), (17) and (27); 362(o)

*Sections 362(b)(6), (7), (17) and (27), and 362(o), provide powerful anti-stay protections for the exercise of netting and secured party rights under Protected Transactions by Protected Counterparties.*

A. General — as a result of automatic stay exemptions provided by Sections 362(b)(6), (7), (17) and (27), the filing of a petition under Section 301, 302 or 303 or of an application under Section 5(a)(3) of SIPA does not stay a Protected Counterparty’s exercise of any contractual right (x) under any security agreement or other credit enhancement that is part of or related to a Protected Transaction, or (y) to offset or net out any termination value, payment amount or other transfer obligation arising under or in connection with one or more Protected
Transactions. “Contractual right” has the definition afforded such term in the corresponding close-out protection provision (Section 555, 556, 559, 560 or 561).

1. These provisions were somewhat confusing before the enactment of FNIA because they used setoff terms to describe not only setoff, but exercise of secured party rights against collateral. The FNIA clarifies that contractual rights beyond setoff are now protected. The current language is arguably broad enough to cover any secured party contractual rights.

2. Additionally, as currently formulated, the exemptions relating to offsetting/netting any termination value, payment amount, or other transfer obligation no longer contain an express mutuality requirement. One possible reading of the statute is that it exempts from stay contractually-based setoff or netting regardless of whether it is mutual (e.g., a triangular setoff whereby the Protected Counterparty reduces its obligation to the debtor by the amount of an obligation owing to the Protected Counterparty by the debtor’s subsidiary). But see In re SemCrude, Lehman/Swedbank, Lehman/UBS and American Home discussed in V.C.3 below. However, it should be kept in mind that these are anti-stay provisions, and as such they do not expressly deal with the validity of the contractual rights exempted from the stay. See the discussion in V.C below regarding setoff protections under Section 553.

3. Protection of netting and cross-collateralization of transactions is a key element of the Bankruptcy Code protections. Most industry standard agreements contain netting, cross-collateralization and cross-default provisions and compute collateral requirements on a net exposure basis for transactions of the same type.

B. **No restriction on types of collateral** — the protections for the exercise of secured party rights are not limited by collateral type. Therefore, in theory, relief from the automatic stay under Section 362(b)(6), (7), (17) or (27) might permit a Protected Counterparty to foreclose on assets necessary to the continued operation of the debtor’s business. In practice, however, Protected Transactions would normally be secured by assets of the kind involved in the transaction or cash equivalents. And, of course, the collateral must actually have been pledged to secure the relevant Protected Transactions. *In re Amerson*, 2012 WL 3249603, at *3-4 (Bankr. E.D.N.C. Aug. 7, 2012); *Lehman/BofA* at 439 B.R. 835. Query whether a purported Protected Transaction secured by operating assets, subsidiary stock or other collateral not customary for the relevant market is more likely to be considered a disguised loan or, at the least, subject to more vigorous challenge by the debtor and searching inquiry by the bankruptcy court? See II.H above.

C. **Protection against stays under Section 105** — Section 362(o) exempts the exercise of rights protected under 362(b)(6), (7), (17) and (27) from stay by any order of a court or administrative agency in a Bankruptcy Code, including any stay purportedly authorized by Section 105. This BAPCPA amendment brought
the provisions of Section 362 in line with Sections 555, 556, 559, 560 and 561, which are also protected from a stay under Section 362(a) as well as the remainder of the Bankruptcy Code.

D. Protection against stays in chapter 15 proceedings — Sections 1519(f) and 1522(f) exempt the exercise of rights protected under 362(b)(6), (7), (17) and (27) from stay by any order of a court or administrative agency in a chapter 15 proceeding.

E. Collateral outside the control of the Protected Counterparty

1. The close-out and anti-stay protection provisions permit Protected Counterparties to exercise their rights; the provisions do not require the debtor to cooperate.

2. Thus, if the Protected Counterparty does not have possession or other control of the collateral, it may still need to obtain court relief to realize on the collateral.

3. Collateral held by a custodian can be sold under the provisions without court relief if the custodian will follow the Protected Counterparty’s directions.

   a. Query what your custodial agreement provides regarding post-default instructions?

   b. Query what your custodial agreement provides regarding disputes?

   c. Indemnification and expense provisions

4. The provisions prevent interference by the Bankruptcy Code and certain other U.S. laws with realization on collateral held outside the U.S., but foreign laws (i.e., foreign insolvency proceedings) may block realization.

5. Note that the special distribution provisions of SIPA and the Stockbroker Liquidation subchapter may have the effect of sweeping collateral outside the counterparty’s control into the “customer property” pool.

6. Note also that collateral provided by the counterparty to the debtor can give rise to troublesome issues. Indeed, in view of the protections discussed in the outline, such collateral will often be a counterparty’s principal “real” exposure.

   a. Query whether such collateral remains the counterparty’s property and/or can become subject to superior rights of other persons (including a trustee as lien creditor) if it is commingled? Rehypothecated? Sold? Traceable or untraceable?
b. **Query** whether cash collateral is particularly vulnerable?

c. **Query** to what extent this problem is reduced by requiring that collateral provided by the counterparty be held by a custodian?

d. **Query** whether this problem, as it relates to mark-to-market collateral, is largely protected by setoff rights?

e. **Query** whether failure to return collateral gives rise to a claim against the debtor which can be netted against the termination amount owing to the debtor?

f. **Query** whether and/or under what circumstances a constructive trust may be imposed on such collateral?

V. Protection Against Avoidance — Sections 546(e), (f), (g) and (j); 548(d)(2)(B), (C), (D) and (E); 553(a)(2)(B)(ii), (a)(3)(C) and (b)(1)

The foregoing Sections provide comprehensive protection against the avoidance of prepetition transfers and setoffs under Protected Transactions by, to or for the benefit of Protected Counterparties, except intentional fraudulent transfers.

A. Protection of Prepetition Transfers, Sections 546(e), (f), (g) and (j) — notwithstanding Sections 544, 545, 547, 548(a)(1)(B) and 548(b), protections contained in Sections 546(e) (securities contracts, commodity contracts and forward contracts), 546(f) (repurchase agreements), 546(g) (swap agreements) and 546(j) (master netting agreements) exempt prepetition transfers in connection with Protected Transactions by or to (or for the benefit of) Protected Counterparties from avoidance as preferences or fraudulent transfers. Intentional fraudulent transfers under Section 548(a)(1) are not protected. But transferees in a fraudulent scheme, such as a Ponzi scheme, are not excluded from safe harbor protection unless they had actual knowledge of the underlying fraud. See Peterson v. Somers Dublin Ltd., 729 F.3d 741, 748-50 (7th Cir. 2013); Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 2013 WL 1609154 (S.D.N.Y. Apr. 15, 2013); In re Arbco Capital Mgmt., LLP, 498 B.R. 32, 42-44 (Bankr. S.D.N.Y. 2013). The drafting of such subsections of Section 546 is not entirely uniform:

1. Section 546(e) (securities contracts, commodity contracts and forward contracts) — the current version retains language that, in addition to protecting prepetition “transfers” made to a Protected Counterparty in connection with a securities contract, commodity contract or forward contract, expressly protects a “margin payment” (as defined in Sections 101(38) (forward contract context), 741(5) (securities contract context) and 761(15) (commodity contract context)) and “settlement payment” (as defined in Sections 101(51A) (forward contract context) and 741(8)
(securities contract context)) made to a Protected Counterparty. Note that there is no express requirement that such a margin payment or settlement payment be made in connection with a Protected Transaction. But see V.A.I,j below. This may have the effect of preserving the upshot of pre-BAPCPA/FNIA case law affording a broad reach to Section 546(e) protections, most notably decisions offering protection to LBO payouts as settlement payments:


7 There is no separate definition for "settlement payment" in the commodity contract context, but the Section 761(15) definition of "margin payment" in the commodity contract context includes settlement payments.
Court opinions in the Western and Northern Districts of New York have implicitly rejected Judge Drain's reasoning, applying Section 546(e) to shield small private LBOs and refusing to make factual determinations as to whether the transaction at hand would impact the financial markets. *In re Batavia Nursing Home, LLC*, 2013 WL 3934237 (Bankr. W.D.N.Y. Jul. 29, 2013) (refusing to inquire into whether undoing the LBO would cause the type of disruption to the financial markets that the statute sought to avoid because doing so would effectively call into question every small LBO); *In re Tougher Indus., Inc.*, 2013 WL 5592902 (Bankr. N.D.N.Y. Oct. 10, 2013) (refusing to make a factual determination into whether the dollar amount of a transaction would have an impact on the financial markets).

b. More broadly, the Court in *In re Enron Creditors Recovery Corp. v. Alfa, S.A.B.*, 651 F.3d 329 (2d Cir. 2011) held that Section 546(e) protected settlement payments beyond those “commonly used” in the securities trade, and that a securities transaction does not necessarily entail a sale or other transfer of ownership of the security. Accordingly, the Court held that payments made to redeem commercial paper by the issuer prior to maturity, using the DTC, were protected from avoidance under Section 546(e) as “settlement payments.” The Court of Appeals held that the 546(e) safe harbor was available even though the purchases were out of the ordinary course, involved the payment at full accreted value of commercial paper then trading at a discount, and allegedly resulted from pressure on the debtor. *See also In re Quebecor World (USA) Inc.*, 719 F.3d 94 (2d Cir. 2013), which applied Section 546(e) to purchases of debt made by an affiliate of the issuer rather than the issuer itself, finding the transactions to be transfers to a financial institution “in connection with a securities contract” and, moreover, “purchases” of securities rather than “redemptions.”

c. Several recent opinions in the Second and Seventh Circuit Courts of Appeals and the Southern District of New York confirm the broad breadth of Section 546(e) by making clear that Section 546(e) is to be strictly construed in accordance with its plain meaning, even if to the detriment of the estate and its creditors or if resulting in inequitable outcomes. *See Grede v. FCStone, 746 F.3d 244, 252-54 (7th Cir. 2014); In re Enron Creditors Recovery Corp. v. Alfa, S.A.B.*, 651 F.3d 329, 335, 339 (2d Cir. 2011); *In re Quebecor World (USA) Inc.*, 480 B.R. 468, 475-78 (S.D.N.Y. 2012), aff’d, 719 F.3d 94 (2d Cir. 2013); *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 476 B.R. 715, 721-22 (S.D.N.Y. 2012); *Picard v. Katz*, 462 B.R. 447, 452 (S.D.N.Y. 2011); *In re Lehman Bros. Holdings Inc.*, 469 B.R. 415, 436 (Bankr. S.D.N.Y. 2012) (“Lehman/JPMC”). Bankruptcy Judge
Peck in *Lehman/JPMC* dismissed numerous constructive fraud and preference claims against JPMorgan Chase Bank ("JPMC"), applying the "plain meaning" of Sections 546(e) and 741(7) to protect transfers made to JPMC under various securities clearance agreements and related guarantee, security and account control agreements. In particular, Judge Peck read the "related to...or...in connection with [another securities contract]" language in clause (xi) of the definition of "securities contract" in Section 741(7)(A) literally, holding that the aforementioned guarantee, security and account control agreements were "securities contracts" because they secured debts related to safe-harbored contracts (i.e., the clearance agreements) and that the liens granted and perfected and collateral transferred thereunder were safe-harbored transfers as well. 469 B.R. at 435-43. See also discussion of Judge Peck’s protection of guarantee obligations in *Lehman/JPMC* in V.A.1.i below.

d. District Judge Rakoff similarly applied the "literal language" of Section 546(e) in *Picard v. Katz*, 462 B.R. at 451-53, to grant safe harbor protection to payments made to customers of Bernard L. Madoff Securities Investment LLC ("Madoff Securities"), even though Madoff Securities itself could not avail itself of the safe harbors. Judge Rakoff reasoned that Madoff Securities, a registered stockbrokerage firm, was a "stockbroker" and that the payments clearly met the "extremely broad" definition of "settlement payments" or were otherwise "transfers" made "in connection with a securities contract." *Id.* Judge Rakoff applied the same reasoning in a similar case, *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 476 B.R. at 719-22, and went on to hold that Section 546(e) applied to the return of money provided by customers for Madoff Securities to engage in securities transactions, even though Madoff Securities never engaged in any such transactions.

e. Return of excess margin above contractual requirements has also been found to be protected. *In re Comark*, 971 F.2d 322 (9th Cir. 1992).

f. Section 546(e) has been held to protect a margin payment made by a corporate debtor to satisfy the margin obligations of its individual principal. *In re Stewart Finance Co.*, 367 B.R. 909 (Bankr. M.D. Ga. 2007). It has also been held to protect commissions and fees commonly paid to stockbrokers as part of the settlement of regular securities transactions and margin payments paid to stockbrokers on brokerage accounts. *In re Derivium Capital LLC*, 716 F.3d 355 (4th Cir. 2013).
g. But in *In re Qimonda Richmond, LLC*, 467 B.R. 318 (Bankr. D. Del. 2012), the court found that a payment on a letter of credit was not protected by Section 546(e) even though the letter of credit provided credit support for bonds and payment on the letter of credit was used to redeem the bonds. The court reasoned that the payment on the letter of credit was not a “settlement payment” because it was independent of the obligation to repay the bonds and because letters of credit are clearly excluded from the definition of “security” in Section 101(49)(B)(i), and that it was not “in connection with a securities contract” because neither the bonds nor the related indenture were a “securities contract” within the meaning of Section 741(7). *Id.* at 322-23. Similarly, Section 546(e) was found not to apply to the sale of a company in which the funds used to purchase the debtor were borrowed against the debtor’s real estate, which was transferred to the purchaser for little or no consideration, because the multiple transactions were collapsed into a single conveyance and because the transactions surrounding the sale were not protected settlement payments. *See In re Mervyn’s Holdings, LLC*, 426 B.R. 488, 500 (Bankr. D. Del. 2010).

h. Section 546(e) has also been found not to apply to a dividend paid in connection with an LBO. The court in *In re Appleseed’s Intermediate Holdings*, 470 B.R. 289, 302 (D. Del. 2012), stated that although the LBO was protected under Section 546(e), the dividend was not automatically exempt simply because it was part of the same multifaceted transaction. Moreover, the court reasoned that the dividend was not a “settlement payment” because it was merely a one-way payment rather than an exchange of value. *Id.*

i. The court in *Lehman/JPMC* also held that Section 546(e), while protecting transfers, does not protect the incurrence of obligations. 469 B.R. at 443-46. Nonetheless, the court dismissed claims attempting to avoid obligations under guarantees, reasoning that although the obligations were not protected under Section 546(e), the liens and related collateral transfers were independently immune from avoidance regardless of whether the plaintiffs could succeed in avoiding the guarantees. *Id.* at 446. Allowing the plaintiffs to proceed with these claims would be a “vain and wasteful exercise.” *Id.* at 423. *See also In re MacMenamin’s Grill, Ltd.*, 450 B.R. at 428-31 (holding that Section 546(e) does not protect the incurrence of obligations, but noting that the avoidance of the incurrence of the obligation with respect to a securities contract would not result in the avoidance of the payments and lien granted in connection with the securities contract, because they remained protected transfers).
j. Although, as noted above, there is no express requirement that a settlement payment be made in connection with a Protected Transaction, some courts have recently read such a requirement into the Bankruptcy Code in the context of supply contracts, requiring that a payment, in order to be a “settlement payment” subject to Section 546(e), arise under a forward contract. See In re Renew Energy LLC, 463 B.R. 475, 480 (Bankr. W.D. Wis. 2011); In re Magnesium Corp. of America, 460 B.R. 360, 370 (Bankr. S.D.N.Y. 2011).

k. Courts have found Section 546(e) to preempt state law claims to the extent such claims seek to recover the same transfers that Section 546(e) has made unavoidable. These courts have reasoned that allowing these state law claims to proceed would frustrate the purpose of Section 546(e) by permitting the unwinding of settled securities transactions. See Contemporary Indus. Corp. v. Frost, 564 F.3d 981, 988 (8th Cir. 2009) (unjust enrichment claim and claim for illegal/excessive shareholder distributions); AP Servs. LLP v. Silva, 483 B.R. 63, 70-71 (S.D.N.Y. 2012) (unjust enrichment claim); U.S. Bank Nat’l Ass’n v. Verizon Commc’ns Inc., 892 F. Supp. 2d 805 (N.D. Tex. 2012) (unlawful dividend claim); In re U.S. Mortgage Corp., 491 B.R. 642, 675-76 (Bankr. D.N.J. 2013) (conspiracy, aiding and abetting conspiracy, and conversion claims). To the extent, however, a state law claim seeks money damages as opposed to avoidance, recovery or disgorgement, a court may decline to apply Section 546(e) to preempt such a claim on the grounds that the payment of such damages would not implicate the unwinding of settled securities transactions and therefore would not frustrate the purpose of Section 546(e). See AP Servs. LLP v. Silva, 483 B.R. 63, 72 (S.D.N.Y. 2012) (breach of fiduciary duty and aiding and abetting breach of fiduciary duty claims). But see In re U.S. Mortgage Corp., 491 B.R. 642, 675-76 (Bankr. D.N.J. 2013) (finding Section 546(e) to preempt state common law claims seeking “damages...for the amount of the Property” because they were merely “re-labeled” avoidance actions). In addition, to the extent state law claims are brought by individual creditors, as opposed to the trustee or a litigation trust or committee serving in the capacity as the trustee, courts have declined to apply Section 546(e) to preempt such claims on the grounds that Section 546(e) applies only to the trustee. See In re Tribune Co. Fraudulent Conveyance Litig., 499 B.R. 310, 315-20 (S.D.N.Y. 2013)(appeal pending); In re Lyondell Chem. Co., 503 B.R. 348, 358-78 (Bankr. S.D.N.Y. 2014) and Section 546(e) which specifies that “the trustee may not avoid a transfer...” (emphasis added).
2. Section 546(f) (repurchase agreements) — unlike Section 546(e), prior language referring to margin payments and settlement payments was removed in the repurchase agreement context by FNIA, leaving protection only for prepetition transfers made by or to (or for the benefit of) a Protected Counterparty in connection with a repurchase agreement.

3. Section 546(g) (swap agreements) — this subsection differs from the Section 546(f) template in that it expressly includes prepetition transfers made “under or” in connection with any swap agreement. Moreover, language in prior versions of Section 546(g) requiring that the transfer be made “under” a swap agreement was removed in apparent response to In re Interbulk, Ltd., 240 B.R. 195 (Bankr. S.D.N.Y. 1999) (Protected Counterparty attached debtor’s receivable prepetition to collect on debtor’s swap agreement obligation; court declined to exempt attachment from preference challenge because it was “in connection with” but not “under” the swap agreement). See In re Casa de Cambio Majapara S.A. de C.V., 390 B.R. 595 (Bankr. N.D. Ill. 2008) (prepetition attachments of debtor’s bank accounts by a Protected Counterparty in aid of lawsuit to collect amount owing under a swap agreement are “in connection” with the swap agreement and, thus, exempted from avoidance by revised Section 546(g)).

   a. Section 546(g) has been found to protect payments made to swap counterparties that redeemed portions of their shares in the underlying reference fund in response to reductions of the collateral supporting the related swap agreements. See: Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 505 B.R. 135 (S.D.N.Y. 2013);

   b. In similar manner to the Section 546(e) opinions described in V.A.1.k above, at least one court has found Section 546(g) to preempt state fraudulent conveyance claims brought by a litigation trust formed to serve in the capacity of both the trustee and the representative of outside creditors. See: Whyte v. Barclays Bank PLC, 494 B.R. 196 (S.D.N.Y. 2013)(appeal pending).

4. Section 546(j) (master netting agreements) — this subsection follows the Section 546(g) template, but clarifies that Section 546(j) does not exempt a transfer under or in connection with an individual contract that was otherwise avoidable.

B. Taking for Value — Sections 548(d)(2)(B), (C), (D) and (E) supplement the Section 546(e), (f), (g) and (j) protections by providing that a Protected Counterparty that receives certain payments and transfers takes for value to the extent of such payments. This may assist a Protected Counterparty in demonstrating that it is entitled under Section 548(c) to a lien to the extent of such covered payments (assuming it acted in good faith), thereby affording at least
partial protection from recovery under Section 548(a)(1). See In re National Gas Distributors, 556 F.3d 247, 254 (4th Cir. 2009). The payments and transfers covered by the relevant clauses of Section 548(d)(2) are not uniform:

1. **Section 548(d)(2)(B) (securities, commodities and forward contract contexts)** — margin payments and settlement payments, as defined for the relevant context (note that there is no requirement that such margin payments or settlement payments be made in connection with a Protected Transaction)

2. **Section 548(d)(2)(C) (repurchase agreement context)** — margin payments and settlement payments, as defined in the securities contract or commodity contract contexts, in connection with a repurchase agreement

3. **Section 548(d)(2)(D) (swap agreement context)** — any transfer in connection with a swap agreement

4. **Section 548(d)(2)(E) (master netting agreement context)** — any transfer in connection with a master netting agreement (but excludes any transfers under individual contracts where the recipient did not take for value)

C. **Setoff protections – Sections 553(a)(2)(B)(ii), (a)(3)(C) and (b)(1)**

1. **Sections 553(a)(2)(B)(ii) and (a)(3)(C)** expressly exclude setoffs pursuant to Sections 362(b)(6), (7), (17) and (27) and 555, 556, 559, 560 and 561 ("Protected Setoffs") from challenge under Section 553(a)(2) (claims transferred during the 90 days prior to the petition date) and 553(a)(3) (incurrence of debt during such 90 days for the purpose of obtaining setoff rights).

2. **Section 553(b)(1)** expressly excludes Protected Setoffs from challenge under Section 553(b) (improvement of position during the 90 days prior to the petition date).

3. **Mutuality** — these exemptions afford broad protections for Protected Setoffs from the preference-like invalidation provisions of Section 553, but do not appear to relieve Protected Setoffs from the mutuality requirements inherent in Sections 553(a) and (b). It has been argued that (a) the protection of contractual rights under Section 560 may protect express contractual triangular setoff rights in a swap agreement and (b) the absence of mutuality language in the anti-stay protections contained in Sections 362(b)(6), (7), (17) and (27) implies that the mutuality requirements do not apply to Protected Setoffs. The court in In re SemCrude, L.P., 399 B.R. 388 (Bankr. D. Del. 2009), aff’d, 428 B.R. 590 (D. Del. 2010), rejected the argument that mutuality could be contractually created for purposes of Section 553, but the court does not appear to have considered special protections that might have been available with respect to the subject transactions under Section 560 or
362(b). The court in *In re Lehman Bros. Holdings Inc.*, 445 B.R. 130 (S.D.N.Y. 2011) ("Lehman/Swedbank"), however, held that Sections 560 and 561 do not allow a nondebtor counterparty to setoff pre-petition obligations against funds "fortuitously" deposited post-petition. Similarly, the courts in *In re Lehman Bros. Inc.*, 458 B.R. 134, 143 (Bankr. S.D.N.Y. 2011) ("Lehman/UBS"), and *In re American Home Mortgage Holdings, Inc.*, 501 B.R. 44, 58-60 (Bankr. D. Del. 2013) ("American Home"), rejected the argument that Section 561 permitted the exercise of a contractual right of triangular or cross-affiliate setoff, reasoning that because there was no mutuality between the parties, there was no offset right, and "nothing in section 561 of the Bankruptcy Code can be read to preserve or protect a right that does not otherwise exist." *Query* why a contractual setoff right is not a "contractual right ... to offset" and whether Lehman/UBS and American Home can be reconciled with other cases employing a "plain language" application of the safe harbor provisions? *Query* whether mutuality may be created by cross-guarantees by the relevant related companies?

VI. Other Relevant Non-Bankruptcy Laws

A. **12 U.S.C. §§ 4401-07 Payment System Risk Reduction (part of “FDICIA”)** – permits enforcement of "netting contracts" between "financial institutions" and by clearing organizations notwithstanding any contrary law.

B. **12 U.S.C. §§ 1821(e)(8)** – protections in the Federal Deposit Insurance Act analogous to Bankruptcy Code for "Qualified Financial Contracts" (which term includes all Bankruptcy Code protected transactions); all (but not less than all) Qualified Financial Contracts may be assigned promptly to a successor bank; no termination is permitted if based solely on the appointment of a conservator.