US legal and regulatory developments

Financial Contract Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

Ian Cuillerier

Hunton & Williams, 200 Park Avenue, 53rd Floor, New York, NY 10166-0136, USA.
Tel: +1 212 309 1230; Fax: +1 212 309 1100; E-mail: icuillerier@hunton.com

Received: 8th July, 2005

Ian Cuillerier is counsel in the New York office of the law firm of Hunton & Williams LLP and is co-head of the firm's Derivative Group. He specialises in advising financial institutions, hedge funds and corporate users in a wide variety of derivative transactions with a particular focus on the application of derivatives to structured transactions. He has also advised users in a number of commodity swaps, rate swaps, total return swaps and credit default swaps.

INTRODUCTION

After more than ten years of effort to push through bankruptcy reform, legislation was finally enacted which clarifies the enforceability of certain rights of parties to financial contracts in insolvency proceedings in the US. These provisions are included in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005¹ (the '2005 Act'), signed into law on 20th April, 2005. The changes made by the 2005 Act to the US bankruptcy regime are possibly the most comprehensive since the enactment of title 11 of the US Code² (the 'Code' or 'Bankruptcy Code') in 1978. While attention to the 2005 Act focused most prominently on the impact it will have on individual debtors, the 2005 Act also has important provisions affecting debtors and creditors in corporate

bankruptcies. The focus of this paper is on the Financial Contract Provisions in Title IX of the 2005 Act, particularly those amending the Code.

Title IX of the 2005 Act amends the Bankruptcy Code as well as certain other statutes, including the Federal Deposit Insurance Act³ (FDIA).⁴ These amendments are designed to minimise the risk of disruption in financial markets upon the insolvency of one or more important participants in these markets. Industry associations and practitioners argued for many years that the amendments enacted by the 2005 Act were necessary to reduce systemic risk in financial markets and thus avoid the troubling effect of having a series of defaults cascade out of the bankruptcy of a single participant.⁵

To understand better how Title IX

**Derivatives Use,
Trading & Regulation,
Vol. 11 No. 2, 2005,
pp. 182-189
Henry Stewart
Publications,
1747-4426**

amends the prior law and affects the rights of the parties to financial contracts, some background on the existing regime will be reviewed and a few of its important facets highlighted. It will then be considered how the 2005 Act clarifies and broadens the protection afforded to financial transactions under the Bankruptcy Code.

BACKGROUND

In order to promote the fair and equitable treatment of creditors in an insolvency proceeding and to preserve the value of a bankrupt entity as a going concern, the Code: (i) grants broad powers to a bankruptcy trustee or to the debtor⁶ to avoid and recover certain transfers and payments made by the debtor prior to its bankruptcy as a preference or fraudulent conveyance; (ii) gives the trustee the right to accept or reject ongoing, or ‘executory’, contracts; and (iii) prevents the exercise of contractual liquidation and termination rights, and the taking of any action against the property of the debtor, through the imposition of an automatic stay. These powers further the Code’s overall policy of preserving value for stakeholders in a bankruptcy. Without these safeguards, creditors would run to realise on the debtor’s assets, helping themselves on a ‘first come, first served’ basis. Any going concern surplus of the bankrupt debtor would be lost on the courthouse steps, especially where firm-specific assets and ‘illiquid’ assets are sold at fire sale prices. The Code’s provisions establish the framework for a more orderly liquidation of the assets of a bankrupt debtor or, if the firm is worth

more as a going concern, for the reorganisation of its assets.

There are, however, certain limits on the trustee’s powers, and participants in the derivatives market benefit from some of these limitations.⁷ For financial contracts, these limits result partially from a balancing of two competing policy interests. The Bankruptcy Code’s policy objective of preserving asset value and providing for the orderly distribution of a firm’s assets or the reorganisation of a debtor is constrained (in a sense) by the important policy objective of allowing financial markets to function properly.

Without limits, the broad powers of the trustee would affect the right to terminate, liquidate or accelerate a financial contract; the right to settle outstanding amounts upon termination by the payment of a single net amount; the right to retain, apply or otherwise benefit from collateral or credit support; and the right to setoff amounts owing by a creditor of a bankrupt debtor against amounts owing to the creditor by such a debtor. Each of these directly affects the enforceability of the bargain that a creditor may have expected from a transaction. Allowing a trustee selectively to accept or reject a given transaction while preventing the close-out of a transaction places the creditor counterparty at risk of substantial loss without necessarily furthering the Bankruptcy Code’s policy objectives. Because a key component in the proper functioning of financial markets is ensuring the certainty of being able immediately to close-out a position upon a bankruptcy, the Code’s exceptions to the limits of the

trustee's powers further the policy objective of allowing financial markets to function properly.

The limits on the trustee's powers are imposed as exceptions to the rules outlined above that would otherwise apply, and it is in this context that these broad powers of the trustee, which affect the enforceability of negotiated rights in derivatives contracts, need to be analysed by participants in the derivatives market. Specifically, the Bankruptcy Code contains provisions that protect the rights of certain financial participants to terminate or liquidate certain financial contracts (such as swap agreements, forward contracts and commodity contracts), provided the agreement allows for the right to terminate. Other provisions of the Code protect the right to net payment obligations, setoff amounts owing and apply collateral. Still other provisions protect against the trustee's avoidance powers. The Bankruptcy Code's protections for financial contract participants, however, are applicable to specified categories of agreements and, in certain cases, are available only to creditors that are within an enumerated class.⁸

Understanding whether, as a creditor to a bankrupt debtor, a derivatives market participant can benefit from the exceptions to the trustee's power and thus be permitted to enforce negotiated rights upon a counterparty's bankruptcy is important to the evaluation of the risks of a transaction and, indeed, even whether to proceed with a transaction.

In certain respects, the need to expand and clarify the protections for financial contracts grew out of the evolution of the

derivatives markets and the rate of product development. The variety of derivatives contracts entered into today was not envisioned when the last amendments to the Bankruptcy Code's safe harbours were enacted in 1990. Also, many new categories of participants have entered the market. In addition, certain discrepancies crept into the provisions as a result of Congress' progressive expansion of the safe harbours through a series of changes to the Code over the years. The 2005 Act seeks to address these issues and thus bring more certainty to the business relationships of financial market participants and allow for better risk management. The amendments to the Bankruptcy Code and other insolvency legislation, including the FDIA, expand the scope of the limits on the trustee's powers, clarify the applicability of these limits and more closely harmonise the insolvency in regimes applicable to the different categories of insolvent debtors. They have also addressed many of the inconsistencies in the text applicable to the various specified categories of derivatives contracts.

MODIFICATIONS INTRODUCED BY THE 2005 ACT

Changes to definitions

The 2005 Act amends certain definitions of the Bankruptcy Code, including an expansion of the definitions of 'commodity contract', 'forward contract', 'repurchase agreement', 'swap agreement' and 'securities contract'.⁹ It adds protection for master netting agreements, a new category of

protected financial contracts. Likewise, protection is also added for financial participants and master netting agreement participants, two new enumerated categories of protected creditors.

As a result of the amendments to the 2005 Act, the definition of a swap agreement now explicitly covers a broader range of agreements. Debt index and debt swaps, total return, credit spread and credit swap, commodity index, equity index and equity swaps, weather swaps and weather derivatives have been added to the list as well as options, futures and forward agreements for each of these. The definition is also not limited to those products on the enumerated list and has the flexibility to cover new product developments as the market evolves in the years to come.

Prior to the 2005 Act, market participants were left to interpret the phrase ‘any other similar agreement’ when trying to determine, for example, whether a total return swap or equity swap fits within the definition of ‘swap agreement’. Although these two types of swaps are now explicitly covered by the definition of swap agreement, the 2005 Act has a more robust formulation for including new types of swap agreements that do not exist today. The provision brings more certainty in so far as the definition of swap agreement now includes any agreement or transaction that ‘is similar to any other agreement’ referred to in the definition that ‘is of a type that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap markets’. This is an important modification for the progressive

development of the swap market because, if a new type of transaction is not viewed as being a swap agreement, the creditor will not benefit from any of the protections of the Bankruptcy Code’s exceptions to the trustee’s powers.

The definition of a repurchase agreement at Section 101(47) of the Code has also been expanded to cover mortgage-related securities and mortgage loans, and interests in mortgage-related securities and mortgage loans. This change harmonises the Code with the FDIA’s definition of a repurchase agreement, which already covers mortgage loans and mortgage-related securities. Similarly, the changes to the definition of ‘securities contract’ broaden its scope and were made so that the definition in the Code conforms to that found within the FDIA.

Each of the definitions of ‘commodity contract’, ‘forward contract’, ‘repurchase agreement’, ‘swap agreement’ and ‘securities contract’ also now makes clear that the inclusion of a non-qualifying agreement or transaction under a master agreement does not prevent a party from losing the benefits of the Code’s limits on the trustee’s powers for the other qualifying agreements or transactions entered into under the same master agreement. Whereas, prior to the 2005 Act, market participants may have been concerned about a mix of transactions covered by a single master agreement, the new provisions alleviate this concern. It is likely that the effect of this provision will be for participants to document a greater variety of derivative transactions under one master agreement and to do so more often.

The definitions for each of these

protected contract categories have also been amended to include any security agreement or arrangement or other credit enhancement related to each of these contracts, including any guarantee or reimbursement obligation. This expansion will allow a creditor to setoff a claim against a debtor under a swap agreement; for example, against a claim owing to the debtor by such a creditor under a credit support document, such as a guarantee.

The 2005 Act has also established a new category of market participant which benefits from the exceptions to the trustee's powers. Specifically, the 2005 Act adds the definition of 'financial participant', which is defined to encompass most clearing organisations and any entity having agreements or transactions that have, in the aggregate, at least the specified minimum total gross dollar value in notional or actual principal amount outstanding or gross mark-to-market positions. As the participants that will be included within this category play a central role in the proper functioning of a large portion of the derivatives market, extending protected party status to them under the Code will clarify the contractual enforceability of their rights under financial contracts and reduce systemic risk in the market as a whole.

The Code will now extend the protection from the trustee's powers to include master netting agreement participants. Master netting agreements are a useful approach to managing counterparty risk. This addition addresses cross-product netting agreements providing for the netting of payments across differing product categories. These new provisions

complement and mirror the changes to the definitions of each of 'swap agreement', 'forward contract', 'commodities contract', 'repurchase agreement' and 'securities agreement' in respect of master agreements.

Automatic stay and the right to setoff

Without the exceptions to the automatic stay provisions of the Bankruptcy Code, parties would be prevented from setting off mutual debts and claims. These exceptions are set out in product-specific provisions at Section 362(b) of the Code¹⁰ and complement the rights to close-out and net settle outstanding payment obligations. The right to setoff is important, as it is generally understood that this right also extends to the right to setoff against the obligation to return posted collateral to the bankrupt debtor. The 2005 Act has expanded and clarified these provisions.

These provisions of the Code now include the new category of protected market participants, 'financial participants'.

In addition, the amendments introduced with the 2005 Act permit setoff against cash, securities or other property 'held by, pledged to, under the control of, or due from' a swap participant, repo participant, commodity broker or other protected market participant. This provision is expanded from the previous version which simply included cash, securities or other property 'held by' such participants and, thus, now reflects the various means through which parties may perfect security. This amendment also improves the position of the creditor who has repledged collateral received from the debtor.

Further, drafting discrepancies that existed

between the various provisions applicable to each type of financial contract have been eliminated. For example, Section 362(b)(17), which provides protection for swap participants from the automatic stay, did not include a reference to cash, securities or other property held to margin a swap agreement. Margin was, however, specifically included in the provisions applicable to commodity contracts, securities contracts, forward contracts and repurchase agreements. The text of this provision has now been harmonised with the provisions in this Section applicable to the other types of protected transactions.

The right to setoff is now not only enforceable against the debtor for ‘any payment due from’ the same but also against any ‘transfer of property due from’ the debtor. This clarifies the right of the parties where, for example, the debtor is required to return collateral to the creditor under applicable credit support.

Right to terminate, liquidate or accelerate

The right to close-out and net settle a financial contract notwithstanding, a filing in bankruptcy protects negotiated rights to terminate a contract, calculate amounts due and owing and settle such obligations on a net basis. These rights are set out at Sections 555, 556, 559 and 560 of the Code in respect of each category of protected contract. As mentioned above, the right to setoff claims and debts notwithstanding, the automatic stay complements these rights to close-out and net settle, together they are fundamental to improving predictability in the

enforceability of contract rights and in reducing systemic risk in financial markets.

The 2005 Act harmonises the provisions providing for the exercise of contractual rights to liquidate, terminate or accelerate enumerated contracts and to net settle amounts owing under one or more contracts. The amended provisions all now provide for the right to ‘liquidate, terminate or accelerate’, whereas the prior text sometimes provided only for the right to terminate (in the case of swap agreements) and at other times provided only for the right to liquidate (in the case of securities contracts, commodities contracts, forward contracts or repurchase agreements). Also, the new text provides that the benefits of these provisions are in each instance extended to ‘financial participants’.

A new Section 561 has been added to establish the ‘contractual right’ to terminate, liquidate or accelerate or offset or net termination values, payment amounts or other transfer obligations arising under or in connection with one or more securities contracts, commodities contracts, forward contracts, repurchase agreements, swap agreements or master netting agreements. The right to terminate and net across contract types is permitted only to the extent that the rights can be exercised in respect of each of the individual contracts covered by the master netting agreement in question.

Before these changes, parties could net payment obligations under securities contracts, commodities contracts and forward contracts, but uncertainty existed as to the ability of parties to net payment obligations under a swap agreement and a

forward contract. Section 561 brings the rights of the parties under the Bankruptcy Code in respect of cross-product netting closer to the rights under the FDIA.

Finally, the definition of ‘contractual right’ is expanded to include a right set forth in a rule or by-law of a derivatives clearing organisation, a multilateral clearing organisation, a national securities exchange, a national securities association, a securities clearing agency, a contract market, certain derivatives transaction execution facilities or a board of trade or in a resolution of the governing board thereof. This expanded definition is beneficial and reflects the reality that these entities sometimes have rights that are protected by Section 561 (the right to net payments, for example) that do not result from a contractual provision, but instead are permitted pursuant to the organisational documents of the entity.

Avoidance powers

The Code’s limitations on the trustee’s avoidance powers are set out in Section 546. Without these limitations, the trustee would have the right to avoid setoff of claims, ongoing and termination payments and other transfers of property, including transfers of collateral, by the bankrupt debtor. A trustee could thus have required the return of a payment pursuant to these provisions. These avoidance powers also apply to the period commencing 90 days prior to the date of a filing of a bankruptcy petition in addition to any time after such filing.

The amendments made to these provisions by the 2005 Act broaden their

scope to cover ‘financial participants’ and add an exception for master netting agreements. The protection applicable to swap agreements is also clarified. The revised text of Section 546(g) provides that the ‘trustee may not avoid a transfer, made by or to a swap participant or financial participant, under or in connection with any swap agreement’ and not merely ‘under a swap agreement’.

Note that these exceptions are not applicable to transfers made by the debtor with an ‘actual intent to hinder, delay, or defraud’. Such transfers remain subject to the trustee’s avoidance powers.

Timing of the measurement of damages

The 2005 Act adds a new provision to the Bankruptcy Code that addresses the timing of the determination of damages. Section 562 provides that following a rejection, liquidation, termination or acceleration of a swap agreement, securities contract, forward contract, commodities contract, repurchase agreement or master netting agreement, damages will be measured as of the earlier of the date of such rejection or the date of such liquidation, termination or acceleration. The new provision also provides that ‘if there are not any commercially reasonable determinants of value’ on the dates referred to above, ‘damages will be measured as of the earliest subsequent date or dates on which there are commercially reasonable determinants of value’.

Effectiveness

The amendments introduced by the 2005 Act will take effect on 17th October, 2005,

and will be applicable to cases filed on or after such date.

CONCLUSION

Until the 2005 Act, parties operated under some degree of legal uncertainty regarding the enforceability of certain contracts in insolvency proceedings. The safe harbours of the Code have now been expanded and clarified. Inconsistencies that existed within the Bankruptcy Code and *vis-à-vis* other insolvency legislation, such as the FDIA, have been addressed. Although some additional amendments, such as amendments addressing cross-affiliate netting, would have provided even more certainty, the recent changes do measurably improve the enforceability of financial contracts in bankruptcy and address, in large part, the concerns raised by market participants.

©Ian Cuillerier

This legal and regulatory round-up is not intended to be a comprehensive guide to the subject matter it covers, or to provide legal advice. For further information, please contact Ian Cuillerier at Hunton & Williams: icuillerier@hunton.com

References and notes

- 1 The US House of Representatives approved the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, S.256, 109th Cong. (2005) as passed by the US Senate on 10th March, 2005.

2 11 USC. 101 *et seq.*

3 12 USC. 1811 *et seq.*

4 The requirements of the Bankruptcy Code will apply to an insolvent debtor if it has a residence, domicile and place of business or property in the US. See Section 109 of the Code. There are exceptions to its applicability, however. For example, the list of excluded debtors includes domestic insurance companies, banks, savings banks, cooperative banks and credit unions. For some of these, the insolvency regime of the FDIA will apply.

5 See the position paper published on 2nd April, 1996, by the International Swaps and Derivatives Association, Inc (ISDA) and The Bond Market Association entitled 'Financial Transactions in Insolvency: Reducing Legal Risk Through Legislative Reform'.

6 To lighten the text, the paper generally refers to 'trustee' as opposed to 'trustee or debtor'. The Bankruptcy Code, however, in certain circumstances provides for the appointment of a trustee while, in other cases, a trustee may not be appointed, but instead the debtor remains in control of the company's assets.

7 In respect of the financial contracts, Sections 546(e), (f) and (g) of the Code are the safe harbours regarding avoidance actions. Sections 555, 556, 559 and 560 of the Code permit the liquidation of these contracts and the related collateral that would otherwise be prohibited pursuant to Section 365(e)(1) of the Code. Section 362 of the Code includes the exceptions regarding setoff from the automatic stay.

8 The Bankruptcy Code differs in its approach from that of the FDIA and the New York Banking Law. The latter two do not limit statutory protection to an enumerated list of protected participants.

9 Each of these terms is currently defined in the following Sections of the Code: 'commodity contract' at Section 761, 'forward contract' at Section 101(25), 'repurchase agreement' at Section 101(47), 'swap agreement' at Section 101(53B) and 'securities contract' at Section 741.

10 Commodity contracts, forward contracts and securities contracts are addressed in Section 362(6), repurchase agreements are dealt with in Section 362(7), swap agreements are addressed in Section 362(17) and the master netting agreements are addressed in a new section, Section 362(27).