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Safe Harbors related to Close Out of Complex Financial Instruments

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[1]—Introduction

"Derivatives," such as swaps, options, or futures, are risk-shifting agreements that derive their value from the value of an underlying asset. The underlying asset could be a physical commodity, an interest rate, a company's stock, a stock index, a currency, or virtually any other tradable instrument upon which two parties can agree.¹

Borrowers and lenders in financing structures are increasingly utilizing such financial instruments for a variety of purposes relating to a financing. For example, the borrower in a floating rate credit facility may separately enter into an interest rate swap agreement with the lender or a third party to hedge its exposure to interest rate fluctuations. Alternatively, if the borrower is borrowing money in one currency but conducts its operations in another currency, it may enter into a currency swap to hedge its exposure to currency fluctuations. Borrowers such as private investment funds also frequently use derivatives as a method of leveraging their investments and thus potentially increasing their returns (or magnifying

their losses). Lenders holding the debt of certain obligors frequently purchase credit protection with respect to such obligors by entering into credit default swap agreements.

The Bankruptcy Code treats these agreements similarly to other, more traditional, transactions, such as transactions relating to the purchase or sale of securities or commodities.

In particular, the Bankruptcy Code contains a number of inter-related provisions that provide special rights and safe harbors to non-debtor counterparties to certain categories of financial transactions. This section will review the safe harbors in the Bankruptcy Code relating to the close out, liquidation, acceleration, termination, netting and set off of obligations and the use of collateral to satisfy obligations, in each case, with respect to such financial contracts under the Bankruptcy Code. These contracts include commodity contracts, securities contracts, forward contracts, repurchase agreements, swap agreements and master netting agreements.

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[2]—Statutory History

Parties to financial transactions frequently rely upon a complex chain of guarantees and accounts involving several layers of financial intermediation. At some point in this chain, two intermediaries “clear” their respective obligations through a central clearing organization. For example, in the context of a securities transaction between a buying broker and a selling broker, both parties may arrange for their counterparty to be a central clearing organization. After the trade is executed, the clearing agency would be responsible for the transfer of the securities and funds, and generally guarantee settlement. To guarantee settlement, the clearing agency would interpose itself between the counterparties and become the buyer to the selling broker and the seller to the buying broker.² In this context, “[e]ach participant in the chain guarantees that he or she will make good on his or her obligation. The buying broker guarantees that he or she will deliver funds in exchange for the securities. The selling broker guarantees he will deliver the security in exchange for funds. Because the comparison and settlement process is not instantaneous, however, the clearing agency must guarantee to the seller that it will deliver the funds, and it must also guarantee to the buyer that it will deliver the securities. In the event of a default by any party in the chain, the clearing agency must still make good on its guarantee, which it can do by calling on a backup clearing fund provided by its members. Brokers and other intermediaries require collateralization of their respective risks by means of various types of margin payments. This system depends upon the availability of the respective guarantees to the clearing agency; without them, the potential exposure is tremendous.”³

Because of the interdependent nature of this system, if a financial institution that is party to a large

volume of commodities or securities transactions files for bankruptcy and its counterparties were subject to the automatic stay, the avoidance powers of the trustee and certain other limitations to which a creditor would otherwise be subject under the Bankruptcy Code, the bankruptcy of the financial institution could threaten the solvency of its counterparties as well as any central clearing organization standing in the middle of these trades. This, in turn, could affect the stability of the relevant market as a whole. Therefore, when Congress initially enacted the Bankruptcy Code in 1978, it provided certain protections to parties engaged in commodities transactions to prevent the insolvency of one commodity firm from spreading to other financial institutions or clearing agencies and possibly threatening the collapse of the relevant market.⁴

In 1982, due to concerns about the scope of these safe harbors in the context of securities and forward transactions, similar protections for those types of transactions were added so that the prompt closing out and liquidation of securities contracts and forward contracts would minimize the potential for chain reactions to occur in the securities market.⁵ In 1984, the Bankruptcy Code was further revised to add certain protections to counterparties to repurchase agreements.⁶

The development and widespread use of “derivatives” was arguably the most significant event in finance in the 1990s.⁷ Financial institutions increasingly large exposures in connection with these financial instruments prompted further reform of the Bankruptcy Code. In order to ensure that the financial markets for swap agreements and forward contracts were not destabilized by uncertainties regarding the treatment of those financial instruments, the Bankruptcy Code was revised in 1990 to add similar protections for counterparties to swap agreements and to revise certain definitions pertinent to forward contracts.⁸

This statutory framework was further revised and expanded by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the BAPCPA). The financial contract provisions in that statute were implemented by Congress partially in response to the Russian financial crisis and the near collapse of the hedge fund Long-Term Capital Management, L.P. (LTCM) in 1998. The President's Working Group on Financial Markets found that the ability to enforce contractual provisions permitting the termination of certain financial contracts and the netting of the amounts due upon the insolvency of a counterparty allowed LTCM's counterparties to reduce their individual credit and market risk by immediately closing out their positions with LTCM.⁹ The President's Working Group concluded that the availability of such close-out netting enhances market stability by limiting losses to solvent counterparties, by reducing precipitous terminations of contracts, and by preserving liquidity for the solvent counterparties.¹⁰ In a separate report, The President's Working Group noted its support for then pending proposals in Congress that would improve the netting regime under the Bankruptcy Code by expanding and clarifying definitions of the financial contracts eligible for netting and by explicitly allowing eligible counterparties to net across different types of contracts, such as swaps, security contracts, repurchase agreements and forward contracts.¹¹ Those proposals were eventually incorporated into the BAPCPA.

In 2006, in further response to the findings of The Presidents Working Group, the financial contracts provisions were again revised by the Financial Netting Improvements Act of 2006 (the FNIA). The FNIA made further technical changes to the BAPCPA by strengthening and clarifying the enforceability of early termination and close-out netting provisions and related collateral arrangements in US insolvency proceedings,¹² as well as providing

enhanced protections from certain avoidance powers.

[3]—General

The financial contract provisions of the Bankruptcy Code are generally intended to permit non-debtor parties to take action that is otherwise prohibited by the Bankruptcy Code. In particular, a non-debtor party can use the commencement of a bankruptcy case as a basis for terminating the protected contract and accelerating obligations thereunder (notwithstanding the prohibition on *ipso facto* defaults in section 365(e) of the Bankruptcy Code) and a non-debtor party may apply any collateral pledged to it by the debtor to satisfy the debtor's obligations to the non-debtor party under the protected contract (notwithstanding the automatic stay of section 362(a) of the Bankruptcy Code). Furthermore, certain provisions of the Bankruptcy Code, as expanded by the provisions of the FNIA, are intended to insulate certain pre-petition transfers from post-petition avoidance.

However, the financial contract provisions of the Bankruptcy Code are only available to certain classes of *protected counterparties* exercising certain *protected rights* under certain types of *protected transactions* (though certain of the safe harbors do not include all three of these criteria). Any creditor seeking the benefit of the financial contract provisions should carefully review the relevant safe harbors and ensure that it falls under the definition of a *protected counterparty*, that the rights it intends to exercise are *protected rights* and that the relevant agreement falls under the definition of a *protected transaction*. See Table 1 below for a summary of protected counterparties, protected rights and protected transactions under the various safe harbors.

Non-debtor parties seeking the benefit of these safe harbors should also be keenly aware of the relevant versions of

the applicable safe harbor or definition of a protected transaction or protected counterparty. Furthermore, non-debtor parties should confirm the applicable version of the Bankruptcy Code safe harbors that will apply. The revisions to the Bankruptcy Code enacted by the BAPCPA are only effective in cases commenced on or after October 17, 2005. The revisions to the Bankruptcy Code enacted by the FNIA are only effective in cases commenced on or after December 12, 2006.

Table 1: Protected Counterparties, Protected Transactions and Protected Rights

Safe Harbor	Protected Counterparty	Protected Transaction	Protected Rights
555	stockbroker, financial institution, financial participant, securities clearing agency	securities contract	contractual right to cause liquidation, termination or acceleration because of a condition of the kind specified in section 365(e)(1)
556	commodity broker, financial participant, forward contract merchant	commodity contract, forward contract	contractual right to cause liquidation, termination or acceleration because of a condition of the kind specified in section 365(e)(1) and the right to a variation or maintenance margin payment received from a trustee with respect to open commodity contracts or forward contracts
559	repo participant, financial participant	repurchase agreement	contractual right to cause liquidation, termination or acceleration because of a condition of the kind specified in section 365(e)(1)

560	swap participant, financial participant	swap agreement	contractual right to cause liquidation, termination or acceleration because of a condition of the kind specified in section 365(e)(1) or to offset or net out any termination values or payment amounts
561	not specified	securities contract, commodity contract, forward contract, repurchase agreement, swap agreement, master netting agreement	contractual right to cause the liquidation, termination or acceleration because of a condition of the kind specified in section 365(e)(1) or to offset or net termination values, payment amounts, or other transfer obligations
362(b)(6)	commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, securities clearing agency	commodity contract, forward contract, securities contract	any contractual right under any security agreement or arrangement or other credit enhancement or any contractual right to offset or net out any termination value, payment amount or other transfer obligation
362(b)(7)	repo participant, financial participant	repurchase agreement	
362(b)(17)	swap participant, financial participant	swap agreement	
362(b)(27)	master netting agreement participant	master netting agreement	
546(e)	commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, securities clearing agency	none specified	transfer that is a margin payment or settlement payment
		securities contract, forward contract, commodity contract	transfer in connection with a securities contract, commodity contract or forward contract

545(f)	repo participant, financial participant	repurchase agreements	transfer in connection with a repurchase agreement
546(g)	swap participant, financial participant	swap agreement	transfer under or in connection with any swap agreement
546(j)	master netting agreement participant	master netting agreement	transfer under or in connection with any master netting agreement or any individual contract covered thereby

[4]—Protected Transactions and Protected Counterparties

[4][a]—Protected Counterparties

Protected counterparties include commodity brokers,¹³ forward contract merchants,¹⁴ stockbrokers,¹⁵ securities clearing agencies,¹⁶ repo participants,¹⁷ swap participants¹⁸ and financial institutions.¹⁹ The BAPCPA added master netting agreement participants²⁰ as protected counterparties. The BAPCPA also added “financial participants” as a class of protected parties. Creditors should note that the definitions of these terms do not necessarily correspond to the trade usage of these terms. Furthermore, depending upon the type of protected transaction involved, only certain protected counterparties may get the benefit of the Bankruptcy Code safe harbor provisions.

Section 101(6) of the Bankruptcy Code states that a “commodity broker” is a “futures commission merchant, foreign futures commission merchant, clearing organization, leverage transaction merchant, or commodity options dealer” that has a “customer.”²¹ “Customers” are defined in section 761 of the Bankruptcy Code by reference to each of the aforementioned types of counterparties.

Section 101(26) of the Bankruptcy Code states that “forward contract merchant” is “a Federal reserve bank . . . 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)²² 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.”

Section 101(53A) of the Bankruptcy Code states that a “stockbroker” is a person who (1) has a “customer,” as defined in section 741 of the Bankruptcy Code, and (2) who is engaged in the business of effecting transactions in securities (i) for the account of others or (ii) with members of the general public, from or for such person’s own account.

Section 101(22) of the Bankruptcy Code defines “financial institution” as a Federal reserve bank, or an entity that is a commercial or savings bank, industrial savings bank, savings and loan association, trust company, federally-insured credit union, or receiver, liquidating agent, or conservator for such entity and, when any such Federal reserve bank, receiver, liquidating agent, conservator or entity is acting as agent or custodian for a customer (whether or not a “customer,” as defined in section 741) in connection with a

securities contract, such customer; or, in connection with a securities contract, an investment company registered under the Investment Company Act of 1940.²³

Section 101(48) of the Bankruptcy Code states that a “securities clearing agency” is a “person that is registered as a clearing agency under section 17A of the Securities Exchange Act of 1934, or exempt from such registration under such section pursuant to an order of the Securities and Exchange Commission or whose business is confined to the performance of functions of a clearing agency with respect to exempted securities, as defined in section 3(a)(12) of such Act for the purposes of such section 17A.”

Section 101(38B) of the Bankruptcy Code defines a “master netting agreement participant” as “an entity that, at any time before the date of the filing of the petition, is a party to an outstanding master netting agreement with the debtor.”

Section 101(46) of the Bankruptcy Code defines a “repo participant” as “an entity that, at any time before the filing of the petition, has an outstanding repurchase agreement with the debtor.”

The BAPCPA added financial participants as protected counterparties in order to limit the potential impact of insolvencies upon major market participants that do not otherwise fall into the categories above.²⁴ Section 101(22A) of the Bankruptcy Code provides that a “financial participant” is either an entity that at the time it enters into “a securities contract, commodity contract, swap agreement, repurchase agreement, or forward contract, or at the time of the date of the filing of the petition, has one or more agreements or transactions (securities contracts, as defined in section 741(7), commodity contracts, as defined in section 761(4), forward contracts, repurchase agreements, swap agreements, or master netting agreements) with the debtor or any other entity (other than an affiliate) of a total gross dollar value of

not less than \$1,000,000,000 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 has gross mark-to-market positions of not less than \$100,000,000 (aggregated across counterparties) in one or more such agreements or transactions with the debtor or any other entity (other than an affiliate) at such time or on any day during the previous 15-month period preceding the date of the filing of the petition; or a clearing organization as defined in section 402 of the Federal Deposit Insurance Corporation Improvement Act of 1991.” Clearing organizations are included to further the goal of promoting the clearing of derivatives and other transactions as a way to reduce systemic risk.²⁵

[4][b]—Protected Transactions

Protected agreements include securities contracts, commodities contracts, forward contracts, repurchase agreements and swap agreements. The BAPCPA also added master netting agreements. Creditors should note that the definitions of these terms do not necessarily correspond to the trade usage of these terms.

[4][b][1]—Securities Contracts

Pursuant to section 741(7) of the Bankruptcy Code, a “securities contract”:

(A) means—

(i) a contract for the purchase, sale, or loan of a security,²⁶ 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 transaction 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);²⁷

(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;²⁸

(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; and

(B) does not include any purchase, sale, or repurchase obligation under a participation²⁹ in a commercial mortgage loan[.]³⁰

[4][b][2]—Commodity Contracts

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

(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) any other agreement or transaction that is similar to an agreement or transaction referred to in this paragraph;

(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[.]³¹

[4][b][3]—Forward Contracts

Pursuant to section 101(25) of the Bankruptcy Code:

[t]he term “forward contract” means—

(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 562.³²

[4][b][4]—Repurchase Agreement

Under Section 101(47) of the Bankruptcy Code, the term “repurchase agreement” (which definition also applies to a reverse repurchase agreement)

(A) means—

(i) an agreement, including related terms,³³ 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 participation³⁴ in a commercial mortgage loan.³⁵

[4][b][5]—Swap Agreement

Under Section 101(53B) of the Bankruptcy Code, the term “swap agreement”—

(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;

(IX) 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;³⁶

(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 Commodity Exchange Act.³⁷

[4][b][6]—Master Netting Agreement
Under Section 101(38A) of the Bankruptcy Code, the term “master netting agreement”—

(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).³⁸

[5]—Liquidation and Termination; Ipso Facto Clauses

Financial contracts frequently include *ipso facto* clauses which provide that an event of default shall occur thereunder if certain bankruptcy related events occur to the debtor. For example, the 2002 ISDA Master Agreement provides that an event of default shall occur with respect to a counterparty if, among other things, the counterparty becomes

insolvent, makes a general assignment for the benefit of creditors, institutes bankruptcy proceedings or has such proceedings instituted against it.³⁹ Such *ipso facto* clauses are intended to allow the non-defaulting to terminate the agreement, accelerate the indebtedness and take remedial action without the borrower’s acquiescence. Frequently, such events of default are deemed to automatically occur under the terms of the contract, without any declaration of an event of default by the non-defaulting party.

The Bankruptcy Code generally prevents the enforcement of such *ipso facto* clauses by the non-defaulting party because such provisions “hamper rehabilitation efforts by depriving the chapter 11 estate of valuable property interests at the very time the debtor and estate need them most.”⁴⁰ Section 365(e)(1) of the Bankruptcy Code provides that notwithstanding a provision in an executory contract or unexpired lease, such agreements of the debtor may not be terminated or modified at any time after the commencement of the case solely because of a provision in such agreements that is conditioned on (A) the insolvency or financial condition of the debtor at any time before the closing of the case, (B) the commencement of a case under the Bankruptcy Code or (C) the appointment of or taking possession by a trustee in a case under the Bankruptcy Code or a custodian before such commencement.

However, “because financial markets can change significantly in a manner of days, or even hours, a non-bankrupt party to ongoing securities transactions and other financial transactions could face heavy losses unless the transactions are resolved promptly and with finality.”⁴¹ For example, upon the termination of a natural gas swap contract, the parties calculate termination payments owed based upon prevailing natural gas costs and the loss of the benefits of the contract.

Since energy prices fluctuate on a day to day basis, a delay in termination could change the size of termination payments payable by one party to the other party and, in certain circumstances, could even affect the party required to make a termination payment.⁴²

Accordingly, to promote the prompt resolution of protected transactions, sections 555, 556, 559, 560 and 561 of the Bankruptcy Code provide certain exceptions to section 365(e)(1). Each of the provisions applies to one or more protected transactions, but collectively they allow every protected counterparty to such protected transactions to exercise its contractual rights under the relevant protected transactions based upon the ipso facto default. For example, section 555 provides that the exercise of a contractual right of a stockbroker, financial institution, financial participant, or securities clearing agency to cause the liquidation, termination, or acceleration of a securities contract because of a condition of the kind specified in section 365(e)(1) of the Bankruptcy Code shall not be stayed, avoided, or otherwise limited by operation of any provision of the Bankruptcy Code or by order of a court or administrative agency in any proceeding under the Bankruptcy Code unless such order is authorized under the provisions of the SIPA or any statute administered by the SEC.⁴³

Section 556 of the Bankruptcy Code provides similar protections to commodity brokers, financial participants or forward contract merchants exercising such contractual rights under commodity contracts or forward contracts.⁴⁴ Section 559 of the Bankruptcy Code provides similar protections to repo participants or financial participants exercising such contractual rights under repurchase agreements.⁴⁵ Section 560 of the Bankruptcy Code include similar provisions for swap participants and financial participants exercising similar rights under swap agreements.⁴⁶

Section 561, addressing master netting agreements, is discussed further below.

A threshold concern for the non-defaulting party in this context is whether the protected contract at issue includes any such ipso facto clauses which provide a contractual right to liquidate, terminate or accelerate. Sections 555, 556, 559, 560 and 561 merely protect any pre-existing contractual right. It should be noted that the definition of contractual right includes rights that arise outside of the four corners of the contract. For example, in the context of section 555, contractual right is defined broadly to include a right set forth in a rule or bylaw of a derivatives clearing organization, a multilateral clearing organization, 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.⁴⁷

The non-defaulting party should also confirm whether any such ipso facto clauses provide that the right to liquidate, terminate or accelerate applies *because of a condition of the kind specified under section 365(e)(1)*. A right to terminate because of a payment default or any other conditions outside of such scope will not be protected. Furthermore, non-defaulting parties should be mindful that courts have looked to whether the non-defaulting party exercised the contractual right to terminate *because of a condition of the kind specified in section 365(e)(1) or because of some other reason*.⁴⁸

[5][a]—Master Netting Agreements and Cross-Product Netting

Section 561 of the Bankruptcy Code was added by the BAPCPA. Like sections 555, 556, 559 and 560, section 561 provides that the exercise of any contractual right to cause the termination, liquidation or acceleration of certain protected contracts because of a condition of the kind specified in section 365(e)(1) shall not be stayed, avoided or otherwise limited by operation of any provision of the Bankruptcy Code or by order of a court or administrative agency in any proceeding under the Bankruptcy Code. However, this provision is not limited to certain protected counterparties. Furthermore, the enumerated protected contracts include both master netting agreements and all of the protected contracts in the predecessor provisions (securities contracts, commodity contracts, forward contracts, repurchase agreements and swap agreements). Unlike the predecessor provisions, section 561 *explicitly* protects the exercise of any contractual right to offset or net termination values, payment amounts or other transfer obligations arising under or in connection with one or more protected contracts.

This provision clearly protects the exercise of any contractual right arising under a master netting agreement to liquidate, terminate or accelerate such agreement or any of such other protected contracts covered by such master netting agreement. However, since “contractual right” is not defined by reference to the four corners of any of the specified protected contracts, and no protected counterparties are specified, a party that is not necessarily a “master netting agreement participant” may seek the benefits of this safe harbor so long as they have a contractual right to do so, including a contractual right arising under rules or bylaws of derivatives clearing organizations,

multilateral clearing organizations, national securities exchanges, rights arising under common law, under law merchant, by reason of normal business practice, etc.⁴⁹

However, section 561(b) clarifies that a party may only exercise the contractual right to the extent that such could party exercise such right under sections 555, 556, 559 or 560 for each individual contract covered by the master netting agreement in issue. Accordingly, contracts that are not protected contracts cannot be liquidated, terminated or accelerated simply because they are covered by a master netting agreement. Furthermore, the party exercising such rights should otherwise be categorized as a protected counterparty under those sections. To the extent the contractual right to liquidate, terminate or accelerate a securities contract or repurchase agreement is stayed by order under the provisions of the Securities Investor Protection Act of 1970 or any statute administered by the SEC, such agreements could not be terminated under a master netting agreement pursuant to section 561.

Section 561 also includes certain limitations to the exercise of netting rights where the debtor is a commodity broker subject to liquidation under Subchapter IV of Chapter 7 of the Bankruptcy Code. Under section 561(b)(2)(A), a party may not net or offset obligations to the debtor arising under, or in connection with, commodity contracts traded on or subject to the rules of a contract market designated under the Commodity Exchange Act or a derivatives transaction execution facility registered under the Commodity Exchange Act except to the extent that the party has positive net equity in the commodity accounts at the debtor. Under section 561(b)(2)(B), if the debtor is also a customer of another commodity broker and the commodity contracts are of the kind specified above, the other commodity broker may not net out or offset obligations to the debtor arising under, or in connection with,

such commodity contracts. However, these provisions will not prevent any offsets of claims and obligations arising under cross-margining agreements approved by the Commodities Futures Trading Commission or any other netting agreements between clearing organizations and other entities approved by the Commodities Futures Trading Association.⁵⁰

[5][b]—Chapter 15 proceedings

The BAPCPA added new section 561(d), which provides that the provisions of the Bankruptcy Code relating to protected contracts also apply in foreign proceedings under chapter 15. The enforcement of contractual provisions of such contracts and agreements in accordance with their terms will not be stayed or otherwise limited by operation of any provision of the Bankruptcy Code or by order of a court in any case under the Bankruptcy Code. Avoidance powers will apply to the same extent as in a proceeding under Chapter 7 or Chapter 11 and such enforcement shall not be limited based on the presence or absence of assets of the debtor in the United States.

[6]—Setoff, Application of Collateral and Netting: Exceptions from the Automatic Stay

Section 553 of the Bankruptcy Code preserves a creditor's pre-existing right to setoff mutual debts and claims.⁵¹ However, as discussed in further detail in ¶ 3.02 *infra*, the filing of any petition for relief under the Bankruptcy Code automatically stays virtually all creditor actions against the debtor, including the setoff of any debt owing to the debtor that arose before the commencement of the case against any claim against the debtor.⁵² Nonetheless, sections 362(b)(6), (b)(7), (b)(17) and (b)(27) of the Bankruptcy Code set forth certain exceptions that allow certain protected

counterparties to setoff such pre-petition debts to the debtor against claims against the debtor notwithstanding the automatic stay.

[6][a]—Application of Collateral: Sections 362(b)(6), 362(b)(6) and 362(b)(17)

Under the pre-BAPCPA version of section 362(b)(6), a petition in bankruptcy would not stay the right of certain protected counterparties to setoff any mutual debt and claim under or in connection with a protected transaction that constitutes setoff of a claim against the debtor for a margin payment or settlement payment arising out of such agreements against cash, securities, or other property held by or due from such protected party to margin, guarantee, secure or settle such transactions.⁵³ While there is scant legal precedent interpreting this prior provision, it is clear, for example, that it protects the right of a stockbroker to liquidate securities in a debtor's margin account in order to satisfy margin calls without any need to seek relief from the automatic stay.⁵⁴ This is because Congress found it "essential that stockbrokers . . . 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 market 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."⁵⁵ The pre-BAPCPA versions of sections 362(b)(7) and 362(b)(17) included similar protections for setoffs of debts arising out of repurchase agreements and swap agreements.

Over time, the rights of protected counterparties to take and apply collateral to satisfy obligations under protected transactions have been expanded. Section 362(b)(6), as revised by the BAPCPA and the FNIA, now provides that a petition in bankruptcy "shall not stay the exercise by a

commodity broker, forward contract merchant, stock broker, financial institution, financial participant or securities clearing agency of any contractual right under any security agreement or arrangement or other credit enhancement forming a part of or related to any commodity contract, forward contract or securities contract, or of any contractual right to offset or net out any termination value, payment amount or other transfer obligation arising under or in connection with 1 or more such contracts, including any master agreement for such contracts.” Sections 362(b)(7)⁵⁶ and 362(b)(17),⁵⁷ as revised by the BAPCPA and the FNIA, include similar provisions for repurchase agreements and swap agreements.

The new safe harbors now explicitly state that the exercise of certain “contractual rights,” which are defined by reference to sections 555, 556, 559 and 560, as applicable, are protected. As discuss infra in ¶[5] above, sections 555, 556, 559 and 560 provide that such contractual rights need not arise under the four corners of the contracts themselves but can arise under rules or bylaws of trade associations, clearing organizations and the like. Furthermore, as sections 362(b)(6),(7) and (17) also make clear, the offset and netting rights may arise from any master agreement for such contracts. The first clause of the provision also states that contractual rights arising under any security agreement or arrangement or other credit enhancement forming a part of or related to a protected transaction are also protected.

The new safe harbors’ reference to “any contractual rights under any security agreement....” and to the ability to “offset or net out any termination value, payment amount or other transfer obligation” are presumably broader than their respective predecessors, which only referred to setoff of margin and settlement payments.⁵⁸ Congress has stated that it intended the new safe harbor to exempt from the automatic stay “self-help foreclosure-on-collateral

rights, setoff rights and netting rights (including foreclosure on, and setoff against, cash and securities held to margin or secure claims for margin payments and settlement payments, title transfer arrangements and the right to offset obligations owed against collateral pledged to the debtor).”⁵⁹

[6][b]—Master Netting Agreements: Section 362(b)(27)

Master netting agreements are agreements that provide for exercise of rights, including netting, setoff, liquidation, termination, acceleration, or close out, under or in connection with securities contracts, commodities contracts, forward contracts, repurchase agreements or swap agreements. Such agreements permit two parties who have entered into multiple agreements to offset or net out their obligations to each other across such agreements. Since sections 362(b)(6),(7) and (17) only permit “single product” netting, if two parties to a master netting agreement owe obligations of the kind otherwise permitted to be offset and net out under those safe harbors but each owes such obligation to the other under a separate agreement, those safe harbors would not prevent the stay of any offset or net out of those two separate obligations through a master netting agreement.⁶⁰ However, if such cross-product netting is subject to the stay, the insolvency of the debtor could presumably have the same ripple effect that the safe harbors were designed to prevent. New section 362(b)(27) of the Bankruptcy Code was enacted to further the policy of increasing legal certainty and reducing systemic risks in the case of an insolvency of a large financial participant by extending the safe harbors to cross-product netting.⁶¹

Pursuant to section 362(b)(27), as revised by the BAPCPA and the FNIA,⁶² a petition in bankruptcy shall not stay the exercise by a master netting agreement participant of any contractual right under any security agreement or arrangement or other

credit enhancement forming a part of or related to any master netting agreement, or of any contractual right to offset or net out any termination value, payment amount or other transfer obligation arising under or in connection with 1 or more such master netting agreements to the extent that such participant is eligible to exercise such rights under sections 362(b)(6), (7) or (17). "Contractual right" is defined inclusively by reference to each of sections 555, 556, 559 or 560.

It should be noted that if the master netting agreement contains provisions relating to agreements or transactions that are not securities contracts, commodities contracts, forward contracts, repurchase agreements or swap agreements, the benefits of section 362(b)(27) shall only apply with respect to such protected transactions. For example, if a master netting agreement also allows for netting and setoff with respect to obligations under a credit agreement, a master netting agreement participant's netting and setoff of obligations thereunder against obligations arising under a protected transaction will not be exempt from the automatic stay.

[6][c]—Setoff: Section 553(a), 553(b) and 362(o)

While section 553(a) of the Bankruptcy Code generally protects a creditor's right to offset a mutual debt of the debtor to the creditor against a claim of such creditor against the debtor, sections 553(a)(2) and (3) include certain exceptions for the period after 90 days before the commencement of the case while the debtor was insolvent.⁶³ Section 553(a)(2) prevents setoff to the extent the claim of such creditor is transferred by an entity other than the debtor to such creditor. Therefore, for example, if an affiliate of the creditor transferred a claim against the debtor to the creditor, any setoffs in respect of such claim would not be protected by section 553(a). However, the BAPCPA has revised section 553(a)(2) to allow such

setoffs to the extent they are of the kind described in sections 362(b)(6), 362(b)(7), 362(b)(17), 362(b)(27), 555, 556, 559, 560 or 561.

Section 553(a)(3) also provides that section 553(a)'s general protection does not apply to the extent the debt owed to the debtor by such creditor was incurred by such creditor for the purpose of obtaining a right of setoff against the debtor. However, the BAPCPA has revised section 553(a)(3) to clarify that to the extent the debt was incurred for purposes of obtaining a right of setoff of the kind described in sections 362(b)(6), 362(b)(7), 362(b)(17), 362(b)(27), 555, 559, 560 or 561, section 553(a)'s general protections will apply. Therefore, if a creditor enters into a protected contract (such as a master netting agreement) with the debtor for purposes of acquiring certain setoff rights, such setoff rights will be preserved by section 553(a).

Under section 553(b) of the Bankruptcy Code, to the extent a creditor offsets a mutual debt owing to the debtor against a claim against the debtor on or within 90 days before the date of filing of the petition, the trustee has the power to recover from the creditor a certain amount of such offset.⁶⁴ Prior to the BAPCPA, setoffs of the kind described in sections 362(b)(6) and 362(b)(7) could not be recovered under section 553(b). As revised by the BAPCPA, setoffs of the kind described in sections 362(b)(17), 362(b)(27), 555, 556, 559, 560 and 561 are also protected from recovery.

While most of the protections for setoffs in section 362 apply to the automatic stay, the BAPCPA further expanded the protections to make clear that such setoffs would not be subject to any stay, including stays imposed using the equitable powers of a court. Section 362(o) of the Bankruptcy Code provides that the exercise of rights not subject to the stay arising under section 362(a) pursuant to sections 362(b)(6), (7), (17) or (27) shall not be stayed by any order of a court or administrative agency in any proceeding under the Bankruptcy Code.

[7]—Preferences, Fraudulent Transfers and Limitations of Trustee's Avoidance Powers

Sections 544, 545, 547 and 548 of the Bankruptcy Code give the trustee certain blanket avoidance powers in connection with pre-petition transfers of property by the debtor, including with respect to preferential transfers, statutory liens and fraudulent transfers. These avoidances power are generally intended to prevent fraud and ensure the equality of distribution to creditors holding claims of equal priority.⁶⁵ However, because of Congress's concern that the bankruptcy of a protected counterparty could cause a ripple effect in the financial markets, section 546(b)(e),(f),(g) and (j) of the Bankruptcy Code limit the Trustee's avoidance power in the context of certain protected transactions.

[7][a]—§ 546(e)

Section 546(e), which is often referred to as the stockholder's defense, provides that notwithstanding the trustee's avoidance powers under sections 544, 545, 547, 548(a)(1)(B) and 548(b), the trustee may not avoid a transfer that is a margin payment or settlement payment made by or to or for the benefit of a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant or securities clearing agency or that is a transfer made by or to or for the benefit of a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant or securities clearing agency in connection with a securities contract, commodity contract or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of the Bankruptcy Code, which is the avoidance power related to intentional fraud.⁶⁶

[7][a][1] Settlement Payments

Section 741(8) of the Bankruptcy Code, which applies in stockbroker liquidation cases, defines a settlement payment as a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade. Section 101(51A) of the Bankruptcy Code includes a similar but not identical definition for purposes of the forward contract provisions of the Bankruptcy Code.

There is general agreement that the term "settlement payment" is intended to refer to a payment or transfer of cash and securities made upon completion of a securities transaction.⁶⁷ However, because the term is defined circularly by reference to use of such terms in the forward contract trade and securities trade, the scope of such term has been the subject of some dispute.

Court generally interpret the term broadly.⁶⁸ Courts have held that the payments include all transfers that occur during the settlement process.⁶⁹ However, the term is not boundless⁷⁰ and, in determining the scope of the term, courts have looked to the whether the payment can be characterized as a payment "commonly used in the securities trade" or "commonly used in the forward contract trade."⁷¹ One line of cases restricts the term to payments involving the public securities markets because transactions not involving the public securities markets cannot be characterized as "payments commonly used in the securities trade."⁷² Accordingly, some courts have held that payments in connection with nonpublic securities are not settlement payments.⁷³ There remain conflicting views on whether or not transfers made between parties that are not cleared through a clearing agency should be considered settlement payments. Some courts have found that the term is broad enough to include transfers of cash and stock in connection with leveraged buyouts.⁷⁴

Other courts have argued that since such payments do not affect the chain of guarantees in the securities market, the payments are not protected settlement payments.⁷⁵

Some courts have also held that where the payment itself is otherwise illegal, it could not properly be characterized as a payment commonly used in the securities trade, and therefore, should not be characterized as a settlement payment.⁷⁶

[7][a][2]—Margin Payments

Section 741(5) on the Bankruptcy Code, which applies in stockbroker liquidation cases, provides that a margin payment means payment or deposit of cash, a security or other property, that is commonly known to the securities trade as original margin, initial margin, maintenance margin, or variation margin, or as a mark-to-market payment, or that secures an obligation of a participant in a securities clearing agency. Section 101(38) of the Bankruptcy Code includes a similar but not identical definition for purposes of the forward contract provisions of the Bankruptcy Code. Section 761(15) of the Bankruptcy Code includes a similar but not identical provision for purposes of commodity broker liquidations. Like settlement payments, the term is interpreted broadly and has been interpreted to include any payment by the debtor which was used to reduce a deficiency in a margin account.⁷⁸

[7][a][3]—Expansion by the FNIA

The FNIA has expanded the scope of the safe harbor to also prevent from avoidance “transfers made by or to or for the benefit of a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant or securities clearing agency in connection with a securities contract, commodity contract or forward contract.” Accordingly, certain transfers in connection with such contracts that were previously avoidable because they

could not be characterized as margin payments or settlement payments may now no longer be avoidable.

[7][b]—§ 546(f) and 546(g)

Section 546(f) of the Bankruptcy Code provides that notwithstanding the trustee’s avoidance powers under sections 544, 545, 547, 548(a)(1)(B) and 548(b), the trustee may not avoid a transfer made by or to or for the benefit of a repo participant or financial participant, in connection with a repurchase agreement and that is made before the commencement of the case, except under section 548(a)(1)(A) (*i.e.*, where intentional fraud was involved).⁷⁹

It should be noted that, unlike section 546(e), this provision exempts from avoidance all transfers made by or to or for the benefit of a protected counterparty. Prior to the enactment of the FNIA, this provision only prevented avoidance of a transfer that is a margin payment or settlement payment. Congress intended this revision in order to conform the provision to the broader safe harbor for swap agreements in section 546(g).⁸⁰

That section provides that notwithstanding the trustee’s avoidance powers under sections 544, 545, 547, 548(a)(1)(B) and 548(b), the trustee may not avoid a transfer made by or to or for the benefit of a swap participant or financial participant, under or in connection with any swap agreement and that is made before the commencement of the case, except under section 548(a)(1)(A) (*i.e.*, where intentional fraud was involved).⁸¹

[7][c]—§ 546(j) Master Netting Agreements

As discussed above in ¶[6][b], master netting agreements allow the parties thereto to setoff and net out their respective obligations under any agreements covered thereby. Such an agreement might provide for the determination of a net amount payable by one of the parties thereto to the other

party thereto and require a payment of such net amount. However, sections 546(e), (f) and (g) will not exempt from avoidance any such transfer since the transfer would not otherwise qualify as an exempt transfer under a securities contract, commodity contract, forward contract, repurchase agreement or swap agreement.

Therefore, the FNIA added new section 546(j)⁸² of the Bankruptcy Code which provides that notwithstanding the trustee's avoidance powers under sections 544, 545, 547, 548(a)(1)(B) and 548(b), the trustee may not avoid a transfer made by or to (or for the benefit of) a master netting agreement participant under or in connection with any master netting agreement or any individual contract covered thereby that is made before the commencement of the case, except under section 548(a)(1)(A) and except to the extent that the trustee could otherwise avoid such a transfer made under an individual contract covered by such master netting agreement.

As noted in the final exception to this safe harbor, if all or a portion of the transfer at issue under the master netting agreement were made under an individual contract covered by the agreement and such individual contract was not otherwise protected by a safe harbor preventing avoidance, then section 546(g) will not prevent the trustee from avoiding such transfer or the relevant portion of such transfer.

[8]—§ 562 Timing of Damage Measurement for Protected Contracts

New section 562 of the Bankruptcy Code was added by the BAPCPA. Under section 365 of the Bankruptcy Code, the trustee has the power to assume or reject executory contracts of the debtor. To the extent the trustee rejects a swap agreement, securities contract, forward contract, commodity contract,

repurchase agreement or master netting agreement, or if certain counterparties exercise their rights to liquidate, terminate or accelerate such contracts or agreements, section 562 provides that damages shall be measured as of the earlier of the date of such rejection or the date of such liquidation, termination or acceleration.

To the extent there are no "commercially reasonable determinants of value" as of the relevant date, damages shall be measured as of the earliest subsequent date or dates on which there are commercially reasonable determinants of value.⁸³ Congress has noted although it is expected that in most circumstances damages would be measured as of the date or dates of either rejection or liquidation, termination or acceleration, in certain unusual circumstances, such as dysfunctional markets or liquidation of very large portfolios, there may be no commercially reasonable determinants of value for liquidating any such agreements or contracts or for liquidating all such agreements and contracts in a large portfolio on a single day.⁸⁴

To the extent damages are determined on such a subsequent date and one of the parties to the contract or agreement object to the timing of the measurement of damages, the other party has the burden of proving that there were no commercially reasonable determinants of value as of such date.⁸⁵

Endnotes

¹ See (2008) <http://www.isda.org>.

² See Report of the President's Working Group on Financial Markets, *Hedge Funds, Leverage and the Lessons of Long Term Capital Management*, at B-12 (April 28, 1999), <http://www.ustreas.gov/press/releases/reports/hedfund.pdf>.

³ *Wieboldt Stores, Inc. v. Schottenstein*, 131 B.R. 655, 664 n.10 (N.D. Ill. 1991), (citing Neil M. Garfinkel, Note, *No Way Out: Section 546(e) Is No Escape for the Public Shareholder of a Failed LBO*, 1991 COLUM. BUS. L. REV. 51, 64-65 (1991) (referring to *Bankruptcy of Commodity and Securities Brokers: Hearings Before the Subcomm. on Monopolies and*

Commercial Law of the House Comm. on the Judiciary, 97th Cong., 1st Sess. 203 (1981).

⁴ See H.R. REP. NO. 97-420, at 2 (1982), reprinted in 1982 U.S.C.C.A.N. 583, 583-84; The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005), effective in cases commenced on or after October 17, 2005.

⁵ See H.R. REP. NO. 97-420, at 2 (1982), reprinted in 1982 U.S.C.C.A.N. 583; Bankruptcy Act Amendments, Pub. L. No. 97-222, 96 Stat 235 (1982).

⁶ See Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (1984).

⁷ See Alan Greenspan, *Financial Derivatives—Remarks Before the Futures Industry Association*, The Federal Reserve Board (March 19, 1999), <http://www.federalreserve.gov/boarddocs/speeches/1999/19990319.htm>.

⁸ See H.R. REP. NO. 101-484, at 1, 1990 U.S.C.C.A.N. 233, 233-34 (1990); Bankruptcy: Swap Agreements and Forward Contracts, Pub. L. 101-311, 104 Stat. 267 (1990).

⁹ See Report of the President's Working Group on Financial Markets, *Hedge Funds, Leverage and the Lessons of Long Term Capital Management*, at E-1 (April 28, 1999), <http://www.ustreas.gov/press/releases/reports/hedfund.pdf>.

¹⁰ *Id.*

¹¹ See Report of the President's Working Group on Financial Markets, *Over-the-Counter Derivatives Markets and the Commodity Exchange Act*, at 34 (November 9, 1999), <http://www.ustreas.gov/press/releases/reports/otcact.pdf>.

¹² See Financial Netting Improvements Act of 2006, P.L. 109-390, H.R. REP. NO. 648, 109th Cong., 2nd Sess. (2006).

¹³ See 11 U.S.C. § 101(6) and related definitions under 11 U.S.C. § 761.

¹⁴ See 11 U.S.C. § 101(26).

¹⁵ See 11 U.S.C. § 101(53A) and related definition of "customer" under 11 U.S.C. § 741.

¹⁶ See 11 U.S.C. § 101(48).

¹⁷ See 11 U.S.C. § 101(46).

¹⁸ See 11 U.S.C. § 101(53C).

¹⁹ See 11 U.S.C. § 101(22).

²⁰ See 11 U.S.C. § 101(38B).

²¹ 11 U.S.C. § 761 applies to commodity broker liquidations of subchapter §§ 761 et seq.

of title 11 of the United States Code (the Bankruptcy Code).

²² 11 U.S.C. § 761 states that a "commodity" has the meaning assigned to it in the Commodity Exchange Act.

²³ See ¶ [4][b][1] *infra*.

²⁴ See *House Comm. on Judiciary, Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Report to Accompany S. 256*, H.R. REP. NO. 109-31, 109th Congress 1st Sess. 131 (2005).

²⁵ *Id.*

²⁶ The reference to a "loan" of a security in the definition is intended to apply to loans of securities, whether or not for a "permitted purpose" under margin regulations. See *House Comm. on Judiciary, Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Report to Accompany S. 256*, H.R. REP. NO. 109-31, at 119, 109th Congress 1st Sess. 131 (2005).

²⁷ Note that the scope of repurchase agreement and reverse repurchase agreement is broader than the Bankruptcy Code's definition of such terms. Congress has noted that repurchase and reverse repurchase transactions on all securities (including, for example, equity securities, asset-backed securities, corporate bonds and commercial paper) are included under the definition. See *id.* at 120.

²⁸ Congress noted that this term "is intended to encompass only those loans commonly known in the securities industry as "margin loans," such as credit permitted in a margin account under the Federal Reserve Board's Regulation T (whether or not effected in that account) or arrangements where a financial intermediary—a stockbroker, financial institution, financial participant, or securities agency—extends credit in connection with the purchase, sale, carrying, or trading of securities. "Margin loans" do not include, however, other loans that happen to be secured by securities collateral." See *House Comm. on Judiciary, Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Report to Accompany S. 256*, H.R. REP. NO. 109-31, at 119, 109th Congress 1st Sess. 131 (2005).

²⁹ While a contract for the purchase, sale or repurchase of a participation may constitute a "securities contract," the purchase, sale or repurchase obligation embedded in a participation agreement does not make that agreement a securities contract. See *House Comm. on Judiciary, Bankruptcy Abuse Prevention and Consumer Protection Act of*

- 2005, *Report to Accompany S. 256*, H.R. REP. NO. 109-31, at 120, 109th Congress 1st Sess. 131 (2005).
- ³⁰ 11 U.S.C. § 741(7).
- ³¹ 11 U.S.C. § 761(4).
- ³² 11 U.S.C. § 101(25).
- ³³ *But see In re American Home Mortgage, Inc.*, 379 B.R. 503 (Bankr. D.Del. 2008) (in a contract providing for sale and repurchase of mortgage loans with a separate and severable portion of the contract providing for servicing of the mortgage loans, the servicing portion is neither a repurchase agreement nor a securities contract under the Bankruptcy Code).
- ³⁴ Repurchase obligations embedded in participations in commercial loans (such as recourse obligations) do not constitute a "repurchase agreement." A repurchase agreement involving the transfer of participations in commercial mortgage loans with a simultaneous agreement to repurchase the participation on demand or at a date certain one year or less after such transfer, however, would constitute a "repurchase agreement." *See House Comm. on Judiciary, Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Report to Accompany S. 256*, H.R. REP. NO. 109-31, at 120, 109th Congress 1st Sess. 131 (2005).
- ³⁵ 11 U.S.C. § 101(47).
- ³⁶ Congress has noted that this provision is intended to provide sufficient flexibility to avoid the need to amend the definition as the nature and uses of swap transactions matured and that the phrase "or any similar agreement" has been added to the definitions of "forward contract," "commodity contract," "repurchase agreement" and "securities contract" for the same reason. *See House Comm. on Judiciary, Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Report to Accompany S. 256*, H.R. REP. NO. 109-31, at 121, 109th Congress 1st Sess. 131 (2005).
- ³⁷ 11 U.S.C. § 101(53B).
- ³⁸ 11 U.S.C. § 101(38A).
- ³⁹ *E.g.*, 2002 ISDA Master Agreement, Section 5(a)(vii).
- ⁴⁰ *Summit Inv. & Dev. Corp. v. Leroux*, 69 F.2d 608, 610 (1st Cir. 1995).
- ⁴¹ *See In re Enron Corp.*, 306 B.R. 465, 472 (Bankr. S.D.N.Y. 2004).
- ⁴² *Id.*
- ⁴³ The exception relating to authorizations under SIPA or statutes administered by the SEC is only included in sections 555 and 559.
- ⁴⁴ Section 556 also protects the exercise of a right to a variation or maintenance margin payment received from a trustee with respect to open commodity contracts or forward contracts. As used therein, the terms variation and maintenance margin should be construed in conformity with their use in the definition of the term "margin payment" in section 761 of the Bankruptcy Code. *See H.R. REP. NO. 97-420*, 97th Congress, 2nd Sess. 4 (1982).
- ⁴⁵ Section 559 separately clarifies that if a repo participant or financial participant liquidates a repurchase agreement and liquidates securities in its positions in connection therewith to satisfy its obligations, any excess of the market prices received on liquidation of such assets over the sum of the stated repurchase prices and all expenses in connection with the liquidation shall be deemed property of the estate, subject to available rights of setoff. *See also, In re American Home Mortgage, Inc.*, 379 B.R. 503 (Bankr. D.Del. 2008) (in a contract providing for the sale and repurchase of mortgage loans, the portion of the contract relating to servicing of mortgage loans is not protected under Section 555 and 559 of the Bankruptcy Code because it is severable from the portion of the contract providing for the sale and repurchase of mortgage loans and the servicing portion is neither a repurchase agreement nor a securities contract).
- ⁴⁶ Section 560 also protects the right of a swap participant or financial participant to offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation or acceleration of one or more swap agreements.
- ⁴⁷ In the context of section 556, *see In re Cordova*, 77 B.R. 441 (Bankr. D.N.J. 1987) (bankruptcy termination clause in trading rules of trade association effectively closed out commodity contracts with debtor).
- ⁴⁸ *In re Amcor Funding Corporation*, 117 B.R. 549 (D.Ariz. 1990) (section 555 does not provide a safe harbor for broker's proposed liquidation of securities positions with debtor since broker's liquidation was precipitated exclusively by the bankruptcy of broker's parent rather than any condition of debtor); *In re Enron Corp.*, 306 B.R. 465 (Bankr. S.D.N.Y. 2004) (section 560 does not exempt from the automatic stay a state court action seeking a declaratory judgment with respect to termination of a swap agreement

because counterparty was not requesting the declaratory judgment for any of the reasons set forth in section 365(e)(1)). *But see, In re Mirant Corp.*, 314 B.R. 347 (Bankr. N.D.Tex. 2004) (swap counterparty's delay in terminating a swap agreement after debtor's filing of a petition did not waive its protections under section 560 because swap counterparty relied on an interim order stating that it was a protected counterparty).

⁴⁹ See 11 U.S.C. § 561(c) of the Bankruptcy Code.

⁵⁰ See 11 U.S.C. § 561(b)(3) of the Bankruptcy Code.

⁵¹ See ¶ 3.04 *infra* for a further discussion of setoff.

⁵² See 11 U.S.C. § 362(a)(7).

⁵³ See Pre-BAPCPA section 362(b)(6) of the Bankruptcy Code for full provision. This provision was revised by the BAPCPA and further substantially revised by the FNIA.

⁵⁴ See *In re Weisberg v. Shearson Lehman Bros., Inc.*, 136 F.3d 655 (9th Cir. 1998)

⁵⁵ *Id.* at 659 (citing the legislative history of section 362(b)(6), 128 Cong. Rec. § 15981, (daily ed. July 13, 1982) (remarks of Sen. Dole)).

⁵⁶ Section 362(b)(7), as revised by the BAPCPA and the FNIA, provides that a petition in bankruptcy will not stay the exercise by a repo participant or financial participant of any contractual right under any security agreement or arrangement or other credit enhancement forming a part of or related to any repurchase agreement, or any contractual right to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such agreements, including any master agreement for such agreements. Contractual rights are defined by reference to section 559 of the Bankruptcy Code.

⁵⁷ Section 362(b)(17), as revised by the BAPCPA and the FNIA, provides that the exercise by a swap participant or financial participant of any contractual right under any security agreement or arrangement or other credit enhancement forming a part of or related to any swap agreement, or of any contractual right to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such agreements, including any master agreement for such agreements. Contractual rights are defined by reference to section 560 of the Bankruptcy Code.

⁵⁸ The scope of those terms have been the subject of some dispute. See ¶ [7][a] below. It should also be noted that the pre-FNIA version of section 362(b)(6) referred only to the setoff of margin payments. However, the pre-FNIA version of section 362(b)(17) referred to the setoff "of any payment or other transfer of property."

⁵⁹ See H.R. REP. NO. 109-648, at 7 (2006), 109th Cong., 2nd Sess. (2006).

⁶⁰ See ¶ [4][b][6].

⁶¹ Subcomm. Hearing on H.R. 833, Part III at 21 (statement of Hon. James A. Leach).

⁶² The BAPCPA created the safe harbor for master netting agreements and it is not available cases commenced prior to October 17, 2005. The FNIA further broadened the exemption.

⁶³ For further discussion of section 553(a)(2) and (3), see ¶ 3.04.

⁶⁴ For further discussion of section 553(b), see ¶ 3.04.

⁶⁵ See ¶ 3.05, 3.06 and 3.07 for a general discussion of avoidance powers.

⁶⁶ This provision was modified by the BAPCPA and the FNIA. See older Bankruptcy Code for cases effective prior to October 17, 2005 or December 12, 2006, as applicable.

⁶⁷ *In re Comark*, 971 F.2d 322 (9th Cir. 1992) (settlement payment clearly includes a transfer of securities that completes a securities transaction); *Kaiser Steel vs. Charles Schwab (Kaiser I)*, 913 F.2d 846 (10th Cir. 1990) (settlement is the completion of a securities transaction); *Kaiser Steel Corp. v. Pearl Brewing Co. (In re Kaiser Steel Corp) (Kaiser II)*, 952 F.2d 1230 (10th Cir. 1991), cert. denied, 505 U.S. 1213, 112 S. Ct. 3015 (1992) (same); *Lowenschuss v. Resorts Int'l (In re Resorts Int'l, Inc.)*, 181 F.3d 505, 515 (3d Cir. 1999), cert. denied, 528 U.S. 1021 (1999) (in the securities industry, a settlement payment is generally the transfer of cash or securities made to complete a securities transaction); *Bevill, Bresler & Schulman Asset Mgmt. Corp. v. Spencer S&L Ass'n*, 878 F.2d, 743 (3d Cir. 1989) (settlement payment includes a "deposit of cash by the purchaser or the deposit or transfer of the securities by the dealer, and that it includes transfers which are normally regarded as part of the settlement process").

⁶⁸ *Kaiser II*, 952 F.2d 1230 (natural reading of the term suggests the term settlement payment should be interpreted very broadly); *Williams v. Morgan Stanley Capital Group (In re Olympic Gas)*, 294 F.3d 737 (5th Cir. 2002) (citing the same); *In re Enron Corp.*,

323 B.R. 857, 864 (Bankr. S.D.N.Y. 2005) (notwithstanding the circular definition of the term, term is extremely broad and includes anything which may be considered a settlement payment); *In re Resorts Int'l*, 181 F.3d 505 (3d Cir. 1999) (the term includes almost all securities transactions); *Bevill, Bresler*, 878 F.2d at 743 (Settlement payment term is "extremely broad."); *Hamilton Taft & Co. v. Howard, Weil, Labouisse, Freidrichs Inc.*, 114 F.3d 991 (9th Cir. 1997); *Jonas v. Resolution Trust Corp.*, 971 F.2d 322, 326 (9th Cir. 1992) ("We now join with the Third and Tenth Circuits and broadly define the term settlement payment."); *Official Comm. of Unsecured Creditors of The IT Group, Inc. v. Acres of Diamonds, L.P.*, (*In re The IT Group, Inc.*), 359 B.R. 97, 101 (Bankr. D.Del. 2006) ("The analysis performed . . . in *Resorts* makes it abundantly clear that the term settlement payment is to be applied broadly to any transfer of stock or cash to pay for stock."); *QSI Holdings, Inc. v. Alford (In re Quality Stores, Inc.)*, 355 B.R. 629, 633 (W.D. Mich. 2007) ("This court reluctantly agrees . . . and joins those courts that have adopted a broad definition of 'settlement payment.'"); *Official Comm. of Unsecured Creditors of Nat'l Forge Co. v. Clark (In re National Forge Co.)*, 344 B.R. 340 (W.D. Pa. 2006); *BCP Liquidating LLC v. Bridgeline Gas Mktg., LLC (In re Borden Chems. & Plastics Operating Ltd. P'ship)*, 336 B.R. 214 (Bankr. D. Del. 2006).

⁶⁹ *Comark*, 971 F.2d at 322; *Bevil, Bressler*, 878 F.2d at 742 (settlement payment includes transfers which are normally regarded as part of the settlement process, whether they occur on the trade date, the scheduled settlement day, or any other date in the settlement process for the particular type of transaction at hand).

⁷⁰ *Enron Corp.*; 323 B.R. 857 (Bankr. S.D.N.Y. 2005); *In re Adler Coleman Clearing Corp.*, 263 B.R. 406 (S.D.N.Y. 2001); *Official Comm. of Unsecured Creditors of Norstan Apparel Shops, Inc. v. Lattman (In re Norstan Apparel Shops, Inc.)*, 367 B.R. 68, 75-76 (Bankr. E.D.N.Y. 2007).

⁷¹ 11 U.S.C. § 741(8); *Enron Corp.*, 323 B.R. at 865; *Kipperman v. Circle Trust F.B.O. (In re Grafton Partners, L.P.)*, 321 B.R. 527, 538 (9th Cir. BAP 2005) ("Whatever else a settlement payment may be, it is restricted to the securities trade and must be 'commonly used.'"); *Official Comm. of Unsecured Creditors v. ASEA Brown Boveri, Inc. (In re Grand Eagle Cos., Inc.)*, 288 B.R. 484, 492

(Bankr. N.D. Ohio 2003); *Jackson v. Mishkin (In re Adler, Coleman Clearing Corp.)*, 263 B.R. 406, 475 (S.D.N.Y. 2001) (" . . . in ascertaining the meaning of 'settlement payment,' as the term relates to both § 546(e) and companion provisions in § 546(f), Congress made clear that the provisions are to be defined with reference to the common understanding, practice and usage in the securities industry.").

⁷² *In re Norstan*, 367 B.R. 68 (Bankr. E.D.N.Y. 2007) (in order to be encompassed in the statutory definition of settlement payment, a transaction must involve the public securities markets); *Grafton*, 321 B.R. 527 (9th Cir. B.A.P. 2005) (common elements in finding that there is not a protected settlement payment are that the securities involved are not publicly traded and public markets are not utilized).

⁷³ *Norstan*, 367 B.R. 68 (Bankr. E.D.N.Y. 2007) (payment made by closely held corporation to its shareholders in connection with a leveraged buyout did not fall under the definition of settlement payment because it did not involve publicly traded securities or otherwise implicate public securities markets); *Grafton*, 321 B.R. 527 (9th Cir. B.A.P. 2005) (limited liability company's payment to an investor withdrawing its capital in a non-public non-market transaction was not a settlement payment; common elements in decisions finding that there is not a protected "settlement payment" pursuant to §546(e) are that the securities involved are not publicly traded and public markets are not utilized).

⁷⁴ See *Kaiser I*, 913 F.2d 846 (10th Cir. 1990); *Kaiser II*, 952 F.2d 1230 (10th Cir. 1991); see also, *QSI Holdings, Inc. v. Alford*, 355 B.R. at 633 (following the Tenth Circuit's adoption of a broad definition of "settlement payment" to include transfer of payments in connection with a LBO); *Official Comm. of Unsecured Creditors of The IT Group, Inc. v. Acres of Diamonds, L.P.*, 359 B.R. at 101; *In re Plassein Intern. Corp.*, 366 B.R. 318, 323 (Bankr. D.Del. 2007) (Payments made to shareholders for their stock in privately held corporations as part of LBO, which were made through bank via wire transfers, were "settlement payments" protected by § 546(e).).

⁷⁵ *Zahn v. Yukaipa Capital Fund*, 218 B.R. 656 (D.R.I. 1998) (transfers of nonpublic stock to a paying and escrow agent in connection with a leveraged buyout was not a settlement payment because system of intermediaries and guarantees was not used); *Jewel Recovery, L.P. v. Gordon*, 196 B.R. 348 (N.D. Tex. 1996) (tender by family shareholders of

closely held stock to a trust company acting as escrow agent was not a settlement payment because no stockbroker, clearing member or clearing agency participated in the transaction and no guarantees were made by third parties to facilitate the transaction); *In re Grand Eagle*, 288 B.R. 484 (Bankr. N.D. Ohio 2003) (payment to purchase privately held stock of corporation through use of bank financing was not a settlement payment simply because payment came from a financial institution). *But see, In re Munford*, 98 F.3d 604 (11th Cir. 1996) (even if leverage buyout payments are settlement payments, section 546(e) will apply unless transfer or settlement payment is made by or to a protected counterparty; since bank merely acted as an intermediary or conduit and never obtained beneficial interest in the funds or shares, payment was not a payment by or to a financial institution).

⁷⁶ *Grafton*, 321 B.R. 527 (9th Cir. B.A.P. 2005) (the fact that the transfer was a transaction in an illegally unregistered security can hardly be described as a payment commonly used in the securities trade); *Enron*, 323 B.R. 857 (Bankr. S.D.N.Y. 2005) (because corporation's repurchase of its shares was void under applicable state corporate law, repurchase could not be a payment commonly used in the securities trade and could not be characterized as a settlement payment).

⁷⁷ *Kaiser I*, 913 F.2d 846 (10th Cir. 1990); *Biggs v. Smith Barney, Inc.*, 193 B.R. 935 (Bankr. C.D. Cal. 1996) (the term margin payment also is interpreted very broadly).

⁷⁸ *Kaiser I*, 913 F.2d 846 (any payment by debtor which was used to reduce a deficiency in his margin account constituted either a margin or settlement payment for purposes of the exception under § 546(e)).

⁷⁹ 11 U.S.C. § 548 was amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, and further revised by the FNIA.

⁸⁰ H.R. REP. NO. 109-648, at 8, 109th Cong., 2nd Sess. (2006).

⁸¹ This provision was modified by the BAPCPA and further revised by the FNIA. *See* older Bankruptcy Code for cases effective prior to October 17, 2005 or December 12, 2006, as applicable.

⁸² This provision was added by the BAPCPA and does not apply to cases commenced prior to October 17, 2005. This provision was further modified by the FNIA. *See* older Bankruptcy Code for cases effective prior to October 17, 2005 or December 12, 2006, as applicable.

⁸³ *See* 11 U.S.C. § 562(b).

⁸⁴ *See House Comm. on Judiciary, Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Report to Accompany S. 256*, H.R. REP. NO. 109-31 at 135, 109th Congress 1st Sess. 131 (2005).

⁸⁵ *See* 11 U.S.C. § 562(c).

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