

# Derivatives Provisions of the 2005 Bankruptcy Amendments

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## *Introduction*

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the “Act”)<sup>1</sup> is a sweeping overhaul of many provisions of the U.S. Bankruptcy Code (the “Code”), including refinement and changes to the safe harbor provisions (e.g., exemption from avoidance and the automatic stay, enforceability of bankruptcy default triggers and liquidation remedies) protecting certain derivatives contracts and counterparties in bankruptcy. This memorandum discusses the major derivatives-related provisions of the Act.<sup>2</sup>

## *Definitions*

Significant changes and additions to the definitional provisions of the Code include:

- The definitions of “Forward Contract,” “Forward Contract Merchant,” “Repurchase Agreement” and “Swap Agreement” have been broadened.

“Forward Contract” is expanded to add “any other similar agreement” to the nonexclusive list of examples in the current definition. This is consistent with the flexibility and deference to the forward contract trade already present in the definition. The term also includes: (i) options to enter into forward contracts, (ii) master agreements (without regard to whether the master agreement

covers transactions other than forward contracts, provided that such master agreement is only a “forward contract” to the extent it relates to a forward contract) and (iii) security agreements and credit enhancements relating to forward contracts.<sup>3</sup>

“Forward Contract Merchant” status is now obtainable by an “entity,” a broader category than that of “persons” formerly eligible. This change addresses the holding of *In re Mirant Corp.*, 303 B.R. 319 (Bankr. N.D. Ill. 2003), that governmental units are not “persons” under the Code, and therefore cannot be Forward Contract Merchants entitled to safe harbor protection.<sup>4</sup>

“Repurchase Agreement” is expanded to include (i) transfers of mortgage related securities, mortgage loans or interests in mortgage related securities or loans, (ii) securities that are a direct obligation/fully guaranteed by a foreign government that is an OECD member, (iii) options to enter into repurchase agreements, (iv) master agreements containing an agreement or transaction that would otherwise be defined as a Repurchase Agreement, and (v) any security agreement or credit enhancement related to any of the foregoing. The definition specifically excludes repurchase obligations under a participation in a commercial mortgage loan.<sup>5</sup>

“Swap Agreement” expressly includes a number of transactions whose status as safe harbor contracts had been questioned under prior law, including equity swaps, total return swaps, credit swaps, weather swaps, commodity indexes or commodity swaps, options, futures and forward agreements.<sup>6</sup>

- New definitions of “Financial Participant,” “Master Netting Agreement” and “Master Netting Agreement Participant.” Many of the safe harbor protections are extended to these new categories of protected parties and transactions.

A “Financial Participant” is any entity that has \$1 billion or more in notional or actual principal amount, or \$100 million or more in gross mark-to-market positions outstanding, on any day in the 15 month period prior to bankruptcy, under safe harbor contracts. The safe harbor protections are generally extended to Financial Participants, without regard to whether such parties would otherwise qualify (e.g., as forward contract merchants or as swap participants).<sup>7</sup>

“Master Netting Agreement” includes agreements providing for the exercise of rights, including netting, setoff, liquidation, termination, acceleration or closeout, under or in connection with one or more safe harbor contracts; and includes security agreements and credit enhancements.<sup>8</sup> A “Master Netting Agreement Participant” is any party to a prepetition Master Netting Agreement with the debtor.<sup>9</sup> The addition of Master Netting Agreement provisions to the Code favorably resolves any uncertainties that may have existed regarding the enforceability of bilateral cross-product netting agreements for safe harbor contracts and should result in a significant expansion of the use of such agreements.

- Expanded definitions in the stockbroker and commodity broker liquidation chapters.

The definition of “securities contract” is expanded to include mortgage loans, groups/indexes of certificates of deposit and mortgage loans, margin loans, or any similar agreement, including, a combination of securities con-

tracts, options to enter into securities contracts and master agreements containing a transaction that would otherwise be considered a securities contract. The definition also includes security agreements or credit enhancement related to a securities contract. The definition specifically excludes purchase, sale or repurchase obligations under a participation in a commercial mortgage loan.<sup>10</sup>

The definition of “commodity contract” is expanded to include similar agreements, combination agreements, master agreements, options, and/or security agreements involving transactions that would otherwise fall under the definition of commodities contract.<sup>11</sup>

### *The Automatic Stay*

Section 362 imposes an automatic stay, as of the time of commencement of the case, of virtually all acts and proceedings against the debtor or property of the bankruptcy estate, including the exercise of setoff rights. Under existing law, sections 362(b)(6), (b)(7) and (b)(17) exempt from the automatic stay certain setoffs by protected counterparties of margin or settlement payments under commodity, forward, securities, repurchase or swap agreements. The Act makes a number of changes to these sections as follows:

- Section 362(b)(6) and (7): The Act extends these setoff exceptions to the automatic stay to property “pledged to and under the control of” a party, in addition to property “held by” or “due from” such party, to margin, guarantee, secure or settle commodity, forward, securities or repurchase contracts. Additionally, the Act incorporates Financial Participants as protected parties under these sections.
- Section 362(b)(17): The setoff exception for swap agreements now extends to Financial Participants, applies to property “pledged to and under the control of” as well as “held by” or “due from” the counterparty, and clarifies that the stay exception will apply to setoff of mutual claims under “one or more” Swap Agreements.

- New section 362(b)(27) provides an exception to the stay for setoff by a Master Netting Agreement Participant under or in connection with one or more Master Netting Agreements or agreements subject to such Master Netting Agreements, but only to the extent such Master Netting Agreement Participant is otherwise eligible to exercise setoff rights under sections 362(b)(6), (7) or (17) for the individual contracts covered by the Master Netting Agreement.
- New section 362(o) provides that the exercise of rights excepted from the stay under (b)(6), (7), (17) or (27) may not be stayed by order of the court or an administrative agency in a case under the Bankruptcy Code. This brings the automatic stay provisions in line with similar existing protection for safe harbor liquidations or terminations under sections 555 through 560, by preventing the court from imposing a stay based on its general equity powers, notwithstanding the exception from the automatic stay.

### *Setoff--Section 553*

Section 553(a) governs setoff rights that have not been exercised prior to bankruptcy. Generally, such rights are preserved (albeit subject to the automatic stay unless an exception applies) where the debt and claim are mutual and both arose prepetition. Sections 553(a)(2) and (a)(3) disallow setoff rights where the creditor obtained its claim postpetition or within the 90 days prepetition and while the debtor was insolvent, or the debt owed to the debtor was incurred during this time period for the purpose of obtaining a right of setoff against the debtor. The Act clarifies that setoffs that fall within the scope of the safe harbor stay exceptions or the safe harbor termination provisions (sections 555, 556, 559, 560 and new section 561) are excluded from these provisions. A conforming change is also made to section 553(b), which permits avoidance of prepetition setoffs that led to an improvement in position by the creditor.

### *Protection from Avoidance--Sections 546 and 548*

The Code contains several means for the avoidance of transfers, including preferences (section 547), actual or constructive fraudulent conveyances (section 548)<sup>12</sup> and unauthorized postpetition transfers (section 549). Under current law, sections 546(e), (f) and (g) protect margin or settlement payments or other transfers to qualifying protected parties (e.g., forward contract merchants, swap participants) from all types of avoidance except in cases of actual intent to hinder, delay or defraud. The Act clarifies the scope of these provisions as follows:

- Sections 546(e) and (f) (protecting commodity brokers, forward contract merchants and repo participants, among others) now protect Financial Participants as well.
- Section 546(g) (protecting transfer to swap participants) is extended to Financial Participants, and amended to make clear that a transfer is not avoidable if it is either “under” or “in connection with” any swap agreement (the prior statute required that the transfer be both “under” and “in connection with” a swap agreement). This change addresses the holding of In re Interbulk, Ltd., 240 B.R. 195 (Bankr. S.D.N.Y. 1999). In Interbulk, the court refused to apply section 546(g) to protect the counterparty’s pre-petition attachment of an asset of the debtor, concluding that such transfer was at most “in connection with” but not “under” the swap agreement.
- New section 546(j) extends protection from avoidance to transfers made by or to a Master Netting Agreement Participant “under or in connection with” any Master Netting Agreement, except in cases of intentional fraud or to the extent the debtor or trustee could otherwise avoid any transfer under an individual contract covered thereby.
- §548(d)(2): conforming amendment to cover Financial Participants and Master Netting Agreement Participants (presumption of value for

fraudulent conveyance purposes). As with section 546(j), the intention is not to shield otherwise non-qualifying transactions through their inclusion under a master agreement.

## *Counterparty Rights Upon Bankruptcy Filing—Sections 555 Through 561*

- Sections 555, 556 and 559, which protect the right to “liquidate” a securities, commodity, forward or repurchase contract base on a solvency or bankruptcy-triggered event of default (so-called “ipso facto clauses”), are expanded to cover “termination” and “acceleration” as well as “liquidation” rights.
- Section 560, which permits ipso facto termination of a swap agreement, now covers “liquidation, termination, or acceleration of one or more swap agreements.”
- In addition, the protections of sections 555, 556, 559 and 560 are extended to Financial Participants.
- Lastly, new section 561 provides similar “safe harbor” protections for the exercise of ipso facto termination, liquidation, acceleration or offset rights under a Master Netting Agreement and across the various types of protected contracts thereunder. Such right is only exercisable to the extent that the individual contracts under such master agreement would give rise to such rights under sections 555, 556, 559 or 560.

## *Damages, Claims and Priorities—Sections 502, 562, 753 and 767*

New section 562 provides that damages following rejection by the debtor or trustee, or liquidation, termination or acceleration by the counterparty, are measured at earlier of: (i) the date of such rejection or (ii) the date of such liquidation, termination or acceleration (or, if lacking in either case, the earliest subsequent date where commercially reasonable determinants of value exist). New section 502(g)(2) provides that such damages are deemed a prepetition claim.

New sections 753 and 767 provide that the exercise of safe harbor rights in a stockbroker or commodity broker liquidation does not affect the priority of any remaining unsecured claim.

## *Municipal Bankruptcy*

- Chapter 9 of the Code governs the bankruptcy proceedings of municipalities. Section 901(a) of the Code lists particular provisions from other chapters of the Code that are applicable in a Chapter 9 case. In its Chapter 9 bankruptcy several years ago, Orange County, California took the position that certain safe harbor provisions did not apply, as they were not listed in section 901(a). The matter was settled prior to a court determination of the issue, however.
- Section 901(a) is amended by the Act to expressly apply these safe harbor provisions (sections 555, 556, 559, 560, 561 and 562) in a case under Chapter 9.

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1. Most provisions of the Act become effective 180 days after the date of its enactment (April 20, 2005), and generally do not apply to cases pending at the time the Act becomes effective. Act, §1501.
  2. Unless otherwise noted, all section references are to the Code, rather than to sections of the Act.
  3. Code §101(25).
  4. Code §101(26).
  5. Code §101(47).
  6. Code §101(53B).
  7. Code §101(22A).
  8. Code §101(38A).
  9. Code §101(38B).
  10. Code §741(7).
  11. Code §761(4).
  12. In addition, section 544 of the Code empowers the debtor or trustee with certain avoiding powers available under non-bankruptcy law, including state fraudulent conveyance statutes.

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