DERIVATIVES IN BANKRUPTCY

by Shmuel Vasser

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INTRODUCTION

Derivatives\(^1\) are highly complex financial instruments; so complex that even large, sophisticated companies sometimes fail to fully understand the risks asso-

* Partner, Edwards Angell Palmer & Dodge LLP, New York, New York. The views expressed herein are those of the author, not the Firm.
1. Derivatives is not a defined term. The SEC’s Chief Account in a report issued on June 15, 2005, defined it as “a financial instrument (or even more simply, an agreement between two people) which has a value determined by the price of something else.” Report and Recommendations Pursuant to Section 410(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers, at 72, available at http://www.sec.gov/news/studies/sxoffbalancerpt.pdf (quoting ROBERT L. MCDONALD, DERIVATIVES MARKETS (2003), at. 1) [hereinafter “SEC Report”]. There are essentially three definitions of the term: a descriptive
associated with them. The last decade provided some startling examples: Procter & Gamble’s 1994 loss of $102 million, Barings Bank’s 1995 loss of $1.3 billion and the Belgian government 1997 loss of $1.2 billion. As a leading commentator noted, “[t]his book is about the financial equivalent of fire.”  

But they are not of insignificant importance to our domestic or global economies. The threat of a ripple effect from the failure of Long Term Capital Management in 1998 resulted in a $3.6 billion bailout. The Federal Reserve Bank of New York reported that on June 28, 2001 the outstanding amount of repurchase agreements for United States government and agency securities entered into by primary dealers exceeded $1.74 trillion and the amount of reverse repos for these securities exceeded $1.35 trillion. The outstanding notional amount of privately negotiated interest rate swaps, currency swaps and interest rate options at the end of June 2000, was estimated by the International Swaps and Derivatives Association, Inc. (“ISDA”) to exceed $60.3 trillion. In 1996 that amount was estimated to exceed $25 trillion, pointing to the rapid growth of these instruments.

On March 26, 2003, the Federal Deposit Insurance Corporation reported that the total notional amount of derivatives held by commercial banks as of December 31, 2002 exceeded $56 trillion; almost a year later, the Office of the Comptroller of the Currency reported that amount at $71.1 trillion. The Bank for International Settlements announced that the total notional amount of outstanding over the counter derivatives increased 15% from the end of December 2001 to the end of June 2002, and stood at almost $128 trillion.


3. JOHNSON, DERIVATIVES, supra note 2, at xi.

4. JOHNSON, DERIVATIVES, supra note 2, at 42.


6. The notional amount of a derivative, does not represent the “amount at risk.” The risk of loss, or potential for gain is based on changes in value of the physical or financial assets represented by the notional amount. See Derivatives Risk in Commercial Banking (March 26, 2003), available at http://www.fdic.gov/bank/analytical/fyi/2003/032603fyi.html.


8. JOHNSON, DERIVATIVES, supra note 2, at 23-4.


11. “Over the counter” or OTC derivatives mean “off exchange” instruments. The OTC market is essentially an electronic network for trading commodities not listed on an exchange. See Ramdhanie, Derivatives Contracts, supra note 1, at 272 n.28.

These instruments are also becoming common financial tools. An ISDA study released in April 2003 reported that of the world’s largest 500 companies, 92% use derivative instruments; 85% use them to manage interest rate risk; 78% use them to manage currency risk; 23.5% use them to manage commodity prices and 11% use them to manage equity price risk. Of the 196 U.S. companies included in the study, 94% use derivatives; as do “91% of the 89 Japanese companies” included in the study, “92% of the 37 French companies, 100% of the 35 U.K. companies, and 94% of the 34 German companies.”

While the risks associated with derivatives are many, and include, systemic risk, counterparty credit risk, volatility risk, operational risk (fraud, human error, inadequate control systems), legal risks (e.g., unenforceability) and liquidity risk, they are given deferential treatment in bankruptcy. Specifically, Congress attempted to favor derivatives in three main areas: (i) allowing the enforceability of bankruptcy termination or ipso facto clauses, (ii) exempting close-outs, setoffs and foreclosure on collateral from the automatic stay, and (iii) exempting payments made under them from preference and constructive (but not actual) fraudulent transfer causes of action.

The significant expansion in protections and special treatment given to derivative type transactions in the 2005 amendments to the Bankruptcy Code, provides a good opportunity to examine the treatment of these instruments in a bankruptcy of a counterparty.

I. PUBLIC POLICY UNDERLYING THE SAFE HARBOR PROVISIONS

The legislative history to the various provisions of the Bankruptcy Code dealing with derivative and financial contracts, referred to herein as the “safe harbor

13. Mark A. Guynn and William L. Harvey, Taking OTC Derivative Contracts as Collateral, 57 BUS. LAW. 1127, 1127 (2002) (“Derivative contracts, once viewed as arcane and exotic financial instruments, have become commonplace tools utilized by companies of all sizes to hedge or otherwise reallocate market risks associated with their businesses.”); SEC Report, supra note 1, at 81–86 (presenting empirical data on the use of derivatives by U.S. filers).


15. As described by one author:

There are six basic risks associated with derivatives contracts. First, derivatives may involve systemic risk, where a problem in one market has the potential of affecting the entire financial system, even on a global scale. Second, the default by one party to meet its financial obligations creates counterparty credit risk. Third, the volatility of the market and the exposure to significant losses from unfavorable price movements creates market risk. Fourth, potential failure of each party's internal control systems, human error, or fraud, increases operational risks. Fifth, the losses suffered by major institutions and others from derivatives contracts give rise to legal risks. Finally, there is a market/product liquidity risk when one party is unable to close out its position either because of insufficient activity in the market or because of too great a price spread.

Ramdhanie, Derivative Contracts, supra note 1, at 281–82; see also JOHNSON, DERIVATIVES, supra note 2, at 43–61.

16. This article is limited to a bankruptcy of an entity that is eligible to become a debtor in a case under the Bankruptcy Code. 11 U.S.C.A.§ 109 (2004).

provisions" and the transactions subject to them as "safe harbor transactions," indicates a strong Congressional policy to protect American financial markets and institutions from the ripple effects resulting from a bankruptcy filing by a major participant in the financial markets. These provisions are designed to protect the financial markets from systemic risks:

It is essential that stockbrokers and securities clearing agencies be protected from the issuance of a court or administrative agency order which would stay the prompt liquidation of an insolvent's positions, because market fluctuations in the securities markets create an inordinate risk that the insolvency of one party could trigger a chain reaction of insolvencies of the others who carry accounts for that party and undermine the integrity of those markets.18

The legislative history to the Act to Amend Title 11 of the United States Code Regarding Swap Agreements and Forward Contracts,19 is similarly a testament to the public policy behind the safe harbor provisions.20 These amendments were supported by the Federal Reserve Board, Securities Industry Association, Public Securities Association, New York Clearinghouse Association, International Swap Dealers Association (now known as ISDA), and others with no opposition.21

One of the most illuminating paragraphs contained in the legislative history states:

As new financial instruments have been developed, Congress has recognized the need to amend certain aspects of the Bankruptcy Code in order to continue to provide the necessary speed and certainty in complex financial transactions. In 1982 and again in 1984 Congress amended section 362 to exempt the termination and setoff of mutual debts and claims arising under securities contracts, forward contracts, commodity contracts and repurchase agreements. The 1982 amendments were "intended to minimize the displacement caused in the commodities and securities markets in the event of a bankruptcy affecting these industries," recognizing the "potential volatile nature of the markets." 128 Cong. Rec. H261 (daily ed. Feb. 9, 1982). The same rationale supported the 1984 amendments. These protections should be extended to the swap and forward foreign exchange agreements for the same reasons. ... 22

Congress has clearly focused on the differences between potential losses in the ordinary, garden variety executory contracts and derivatives:

As Congress recognized at the time of the 1982 and 1984 amendments, counterparties could be faced with substantial losses if forced to await bankruptcy court decision on assumption or rejection of financial transaction

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21. Id. at S1415.
22. Id. at S1416.
agreements. Unlike ordinary leases or executory contracts, where the markets change only gradually, the financial markets can move significantly in a manner of minutes. The markets will not wait for a court decision. . . . There is a clear need for Congress to assure counterparties that they will be able to terminate these agreements and exercise contractual liquidation and netting rights if a party to the agreement files for bankruptcy relief.23

Congress also focused on the unique nature of the financial markets and their volatility: “The commodities and securities markets operate through a complex system of accounts and guarantees. Because of the structure of the clearing systems in these industries and the sometimes volatile nature of the markets, certain protections are necessary to prevent the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market.”24

Consistent with the legislative history, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, signed into law on April 20, 2005, amends the Bankruptcy Code for cases commenced on or after October 17, 200525 and contains provisions expanding the protections for derivative and financial contract transactions.

II. Repurchase Agreements

A “repurchase agreement” (commonly known as a repo) is defined in Bankruptcy Code section 101(47) as:26

1. an agreement, including related terms, that
   • provides for a transfer,
   • of 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,27 qualified foreign government securities (representing a direct obligation of, or that is fully guaranteed by, the

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23. Id. at S1416.
central government of a member of the organization for Economic Cooperation and Development),

- securities that are direct obligations of, or are fully guaranteed by the U.S. or U.S. agency,\textsuperscript{28}
- against transfer of funds by the transferee,
- with simultaneous agreement by transferee to transfer the instruments back,
- at a date certain not later than one year after the transfer, or on demand, against transfer of fund;

ii. any combination of agreements or transactions described in (i) and (iii);
iii. an option to enter into an agreement or transaction described in (i) or (ii);

iv. a master agreement that provides for an agreement or transaction referred to above, "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 above; 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 the Bankruptcy Code;

- but, "does not include a repurchase obligation under a participation in a commercial mortgage loan."\textsuperscript{29}

\textsuperscript{28} The term "U.S. agency" is not defined in the Bankruptcy Code. The legislative history to the 2005 Bankruptcy Amendments states that the intent is to cover obligations issued or guaranteed by Fannie Mae and Freddie Mac "as well as all obligations eligible for purchase by Federal Reserve banks under the similar language of section 14(b) of the Federal Reserve Act." See H.R. Rep. No. 109-31, at 127 (2005), reprinted in 2005 U.S.C.C.A.N. 88, 188. Federal Reserve Board regulation, 12 C.F.R. § 201.108 (2005), lists 20 principal type obligations that qualify, including Federal Home Loan Bank notes and bonds, Federal National Mortgage Association notes, debentures and guaranteed certificates of participation, Government National Mortgage Association obligations or obligations fully guaranteed by it and Export-Import Bank notes and guaranteed participation certificates.

\textsuperscript{29} The legislative history provides that

that repurchase obligations under a participation in a commercial mortgage loan do not make the participation agreement a "repurchase agreement." These repurchase obligations embedded in participations in commercial loans (such as recourse obligations) do not constitute a "repurchase agreement." However, a repurchase agreement involving the transfer of participations in commercial mortgage loans with simultaneous agreement to repurchase the participations on demand or at a date certain one year or less after such transfer would constitute a "repurchase agreement" (as well as a "securities contract").

The protected parties for the application of the special treatment afforded to repos are repo participants and financial participants. A repo participant is defined in Bankruptcy Code section 101(46)\textsuperscript{30} as:

- any entity,
- at any time before bankruptcy,
- has outstanding repo with the debtor.

A financial participant is defined in new Bankruptcy Code section 101(22A)\textsuperscript{31} as:

(A) 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 [securities contracts, commodities contracts, forward contracts, repurchase contracts, 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 on any day during the previous 15-month period, 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) on any day during the previous 15-month period; or

(B) a clearing organization (as defined in section 402 of the Federal Deposit Insurance Corporation Improvement Act of 1991).

A repo is essentially a current sale and a forward contract. Economically, however, it is hard to distinguish a repo from a secured loan where the underlying securities serve as collateral, since the repurchase price includes interest on the imputed loan created by the repo.\textsuperscript{32}

Prior to the 2005 amendments, only a narrow set of securities could have been used for the repo to qualify as a safe harbor transaction.\textsuperscript{33} As to repos involving other securities, courts are split on whether non-qualified repos are sales\textsuperscript{34} or loans.\textsuperscript{35}


\textsuperscript{31} 2005 Bankruptcy Amendments, supra note 25, § 907(b), 119 Stat. at 175 (codified at 11 U.S.C. § 101(22A)).


\textsuperscript{33} These were certificates of deposit, eligible bankers' acceptances, or securities representing direct obligations of, or that are fully guaranteed by the U.S. or a U.S. agency. 11 U.S.C.A. § 101(46) (2004).


III. Forward Contracts

A forward contract is defined in Bankruptcy Code section 101(25) as:

- a contract (not a commodity contract),
- for purchase, sale or transfer,
- of a commodity, including any similar good, article, service or interest "which is presently, or in the future becomes, the subject of dealing with in the forward contract trade, or product or byproduct thereof,"
- with a maturity date of more than 2 days after the contract is entered into,
- including, but not limited to: reverse repos, consignment, lease, swap, hedge, deposit, loan, option, allocated or unallocated transaction, or any other similar agreement.

Similar to the repo definition, a forward contract includes any combination of agreements or transactions, any option to enter into these agreements or transactions, master agreements, and security and credit enhancement agreements, with damages measured pursuant to Bankruptcy Code section 562.

The new definition contains some inartful drafting carried over from the prior definition. The definition uses the term "swap," not a "swap agreement;" "repurchase transaction" and "reverse repurchase transaction" are used, not "repurchase agreement," and the commodity contract carve-out does not specifically refer to commodity contract as defined in Bankruptcy Code section 761(4).

Many forward contracts are "mixed" in nature, i.e., contracts whereby Party A purchases gas from Party B, processes it and sells the processed product back to Party B. A valid question seems to be whether such contracts are forward contracts covered by the safe harbor provisions, or service contracts governed by the regular rules applicable to non-safe harbor transactions. Courts may apply the primary purpose test, or the integral element test used in other contexts.

40. In re UAL, Corp., 293 B.R. 183, 187–88 (Bankr. N.D. Ill. 2003) (agreements that have the extension of credit as their primary purpose, as distinguished from ordinary transactions where payments are made over time, qualify as financial accommodations), aff’d, 368 F.3d 720 (7th Cir. 2004). The Seventh Circuit noted, however, that courts should not look at the parties’ subjective intent or purpose; they should “determine the nature of the entire transaction rather than hunt for factors that look like loans or guaranties.” 368 F.3d at 724.
41. See In re Matusalem, 158 B.R. 514 (Bankr. S.D. Fla. 1993) (not stating this test by name but holding a franchise agreement containing a license to manufacture rum covering both trade secrets
Protected parties for the special treatment afforded to forward contracts are forward contract merchants and financial participants. Forward contract merchants are defined in Bankruptcy Code section 101(26) as:

- Federal Reserve banks, or
- an entity whose business consists in whole or in part of entering into forward contracts, as a merchant or with merchants, in commodities or other similar good, service or interests, which presently or in the future becomes part of the forward contract trade.

Other than the reference to Federal reserve banks, the definition of a forward contract merchant is descriptive, and thus, leaving room for judicial interpretation. One court, for example held that a forward contract merchant is a person that, in order to profit, engages in forward contract trade as a merchant, or with merchants. A merchant is not one acting as the end-user or producer; it buys, sell or trades in the market. Another held that a forward contract merchant engaging in collection activities for gas it sold may not qualify as a forward contract merchant for settlement payment protections.

The legislative history suggests that it is a commercial trading firm that offers producers, users of commodities and other traders opportunity to buy and sell commodities on a forward basis. While the term “forward contract trade” is part of the definitions of forward contract and forward contract merchants, it is not defined. Thus, it is not clear what constitutes trade as far as required volume or number of transactions. As a result, unless a counter-party relies on the forward contract safe harbor provisions with respect to goods that are indisputably actively dealt with in forward con-

(defined as intellectual property under the Bankruptcy Code section 101(35A)) and trademarks, not considered intellectual property under the Bankruptcy Code definition, to be an intellectual property license under Bankruptcy Code section 365(n)).

43. The definition was added by 2005 Bankruptcy Amendments, supra note 25, § 907(b), 119 Stat at 175 (codified at 11 U.S.C § 101(22A)).
44. Appears to overrule In re Mirant Corp., 303 B.R. 319, 326–27 (Bankr. N.D. Tex. 2003) (holding that governmental entities are not protected; old definition of forward contract merchant used “person” which excludes governmental entities).
45. The language “in whole or in part” raises some interpretational issues. Does a person having only one asset/contract, which is a forward qualify as forward contract merchant? Does a person that has only one forward contract but is otherwise a very large business qualify? Mirant, 310 B.R. at 567–70, seems to suggest that the answer to both questions is negative. Note, however, that an entity may qualify for protection, even if it is not a forward contract merchant, if it is a financial participant.
46. Mirant, 310 B.R. at 567.
47. Newhouse v Texas Eastern Transmission Corp. (In re Aurora Natural Gas, LLC), 316 B.R. 481,484 (Bankr. N.D. Tex. 2004) (“There is a genuine issue of material fact concerning whether DEFS has been acting as a debt collector on a delinquent obligation ... and not as a forward contract merchant.”).
48. See 124 Cong. Rec. S14724 (daily ed. Sept. 7, 1978) (remarks of Senator Mathias) (“Forward contract merchants are commercial trading firms which offer to commercial customers the ability to buy or sell commodities in the physicals market on a forward basis.”).
tracts, the utility of these provisions may be limited, as the court may stay the non-debtor counter-party from exercising its rights under the safe harbor provisions, pending a court's determination that the contract is in fact a forward contract. 

IV. SECURITIES CONTRACTS

A securities contract is defined in Bankruptcy Code section 741(7) as:

- a contract, for purchase, sale or loan, "of a security, a certificate of deposit, a mortgage loan or any interest in a mortgage loan, group or index of securities, certificates of deposit, or mortgage loans or interest therein (including an interest therein or based on the value thereof)," or any option to purchase or sell any of the foregoing and any repo or reverse repo on the foregoing,
- an option entered on a national securities exchange relating to foreign currencies,
- "the guarantee by or to a 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,"
- "any margin loan," and
- "any other agreement or transaction that is similar to an agreement or transaction referred to in this subparagraph."

Similarly to forwards and repos, the definition includes any combination of agreements or transactions, option to enter into these agreements or transactions, master agreements with all supplements and security and credit enhancement agreements, with damages measured pursuant to Bankruptcy Code section 562, but

49. For example, there is an active forward contract market in electricity, see generally Duke Energy Trading and Marketing, L.L.C. v. Davis, 267 F.3d 1042 (9th Cir. 2001), cert. denied, 535 U.S. 1112 (2002) and California Power Exchange Corp. v. FERC (In re California Power Exchange Corp.), 245 F.3d 1110 (9th Cir. 2001), and in natural gas, see generally Mirant, 310 B.R. 548.


51. 2005 Bankruptcy Amendments, supra note 25, § 907(a)(2), 119 Stat. at 173–74 (codified at 11 U.S.C. § 741(7)). The section is not part of the regular chapter 7 provisions but is part of the subchapter applicable to stockbroker liquidations. 11 U.S.C. Chapter 7, Subchapter III. The 2005 amendments significantly expanded this section. Prior to the 2005 amendments only a security, certificates of deposit, a group or index of securities and an option entered on a national securities exchange could have been the subject of a securities contract. 11 U.S.C.A. § 741(7) (2004).
"does not include any purchase, sale or repurchase obligation under a participation in a commercial mortgage loan."\footnote{52}

At the heart of the definition is the existence of a contract for the "purchase, sale or loan" of a security. An interesting question arises when an issuer of debt instruments prepays, redeems or repurchases them; does the transaction qualify as a purchase by the issuer of the debt instruments or is it merely a payment of the outstanding debt which does not qualify as a purchase. In denying a motion to dismiss, the bankruptcy court in \textit{Enron}, suggested that such a transaction may not constitute a purchase.\footnote{53}

Security is defined in Bankruptcy Code section 101(49)\footnote{54} to include:

- "note,"
- "stock,"
- "treasury stock,"
- "bond,"
- "debenture,"
- "collateral trust certificate,"
- "pre-organization certificate or subscription,"
- "transferable share,"
- "voting trust certificate,"
- "certificate of deposit,"
- "certificate of deposit of a security,"
- "investment contract or certificate of interest or participation in a profit-sharing agreement or in an oil, gas or mineral royalty or lease," it if is required to be registered under the Securities Act of 1933 or is exempt from registration under § 3(b) of the 1933 Act,
- "interest in a limited partnership,"
- "other claim or interest commonly known as [a] ‘security,’" or
- "certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase or sell, a security."

Excluded from the definition of security in Bankruptcy Code section 101(49) are:

- "currency, check, draft, bill of exchange or bank letter of credit,"
- "leverage transaction" as defined in Bankruptcy Code section 761,
- "commodity futures contract,"
- "forward contract,"


\footnote{54}{11 U.S.C.A. § 101(49) (2004).}
Limited liability company interests constitute a security of the debtor.\textsuperscript{56} Securities exempt from registration under any exemption other than section 3(b) of the Securities Act of 1933 are not securities within the Bankruptcy Code's definition.\textsuperscript{57} Margin contracts, where a stockbroker advances loans against pledged securities in a margin account, qualify as securities contracts.\textsuperscript{58} The 2005 Bankruptcy Amendments specifically include margin loans in the definition of a securities contract.\textsuperscript{59} In a recent Enron decision, the bankruptcy court left for another day a ruling on whether short term commercial paper qualifies as a security, facing an argument by Enron that short term debt instruments issued for funding current operations rather than for investment purposes do not qualify as securities.\textsuperscript{60}

Repurchase agreements for "non-qualified" securities under the repurchase agreement definition, could still qualify as securities contracts.\textsuperscript{61} The legislative history to the 2005 Bankruptcy Amendments also states the same intent: "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 of 'securities contract.'"\textsuperscript{62}

The protected parties for the securities contract provisions of the Bankruptcy Code are a financial participant,\textsuperscript{63} stockbrokers,\textsuperscript{64} securities clearing agencies,\textsuperscript{65} and financial institutions.\textsuperscript{66}

\textsuperscript{55} Id.
\textsuperscript{58} Wolkowitz v. Shearson Lehman Bros., Inc. (In re Weissberg), 136 F.3d 655, 658-59 (9th Cir. 1998), cert. denied, 525 U.S. 826 (1998).
\textsuperscript{60} Enron, 325 B.R. at 682. Note, however, that the definition of security includes various debt instruments without qualifying their eligibility based on their business or economic purpose. 11 U.S.C.A. § 101(49) (2004).
\textsuperscript{61} Wyle v. Howard, Weil, Labouisse, Freidrichs, Inc. (In re Hamilton Taft & Co.), 114 F.3d 991, 992-3 (9th Cir. 1997) (citing the legislative history, S. Rep. No. 65, 98th Cong., 1st Sess. 45, 29 (1983), that the enactment of section 546(f) "was not intended . . . to affect the status of repos involving securities . . . as securities contracts."); Residential Resources, 98 B.R. at 23.
\textsuperscript{63} 2005 Bankruptcy Amendments, supra note 25, § 907(b)(2), 119 Stat. at 175 (codified at 11 U.S.C. § 101(22A)).
\textsuperscript{66} 2005 Bankruptcy Amendments, supra note 25, § 907(b)(1), 119 Stat. at 175 (codified at 11 U.S.C. § 101(22)).
Financial institutions are:

- Investment companies registered under the Investment Companies Act of 1940,
- banks, and
- when a bank acts as agent for a “customer” in connection with a securities contract, the customer.\(^\text{67}\)

The term customer is not defined. Arguably, therefore, the definition of the term in Bankruptcy Code section 741(2)\(^\text{68}\) could be applicable. Section 741(2) defines a customer essentially as a person with whom the stockbroker acts as principal or agent, and that has a claim against the stockbroker for a security received, held or acquired by the broker in its ordinary course of business as a broker from or for the account of the customer for “safekeeping, with a view to sale, . . . pursuant to a purchase,” or as collateral.\(^\text{69}\)

An interesting question arises whether a private securities transaction becomes subject of the safe-harbor provisions merely because a financial institution is inserted to act as an agent. The Eleventh Circuit held that it does not while a recent bankruptcy court disagreed.\(^\text{70}\)

V. SWAPS

A swap agreement is defined in Bankruptcy Code section 101(53B)(A)\(^\text{71}\) as any agreement (including terms and conditions incorporated by reference therein in such an agreement) which is:

1. an interest rate swap, option, future, or forward agreement, including a rate floor, rate cap, rate collar, cross-currency rate swap, and basis swap;
2. a spot, same day-tomorrow, tomorrow-next, forward, or other foreign exchange or precious metals agreement;
3. a currency swap, option, future, or forward agreement;
4. an equity index or equity swap, option, future, or forward agreement;
5. a debt index or debt swap, option, future, or forward agreement;

\(^\text{67}\) Id.
\(^\text{69}\) Id.
\(^\text{70}\) Munford v. Valuation Research Corp. (Matter of Munford, Inc.), 98 F.3d 604, 610 (11th Cir. 1996) (per curiam), cert. denied, 522 U.S. 1068 (1998) (LBO transaction, acknowledging the involvement of a financial institution, but noting that it acted as a mere intermediary or conduit so that even if the payments were “settlement payments,” the payments were not made to the entity listed in Bankruptcy Code section 546(e), the payments were made to shareholders); contra Loranger Mfg. Corp. v. PNC Bank, 324 B.R. 575, 583–86 (Bankr. WD. Pa. 2005).
\(^\text{71}\) 2005 Bankruptcy Amendments, supra note 25, § 907(a)(1)(E), 119 Stat. at 172–73 (codified at 11 U.S.C. § 101(53B)). This definition applies only for Bankruptcy Code purposes and shall not be applied to challenge or affect the characterization or treatment of swaps under any other statute, regulation or rule. Id.
(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; or
(VIII) a weather swap, weather derivative, or weather options.

A swap agreement also means

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 markets (including terms and conditions incorporated by reference therein), and
(II) is a forward, swap, future, or option on one or more rates, currencies, commodities, equity securities, or other equity instruments, debt securities or other debt instruments, 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.

Similarly to the other financial contracts’ definitions, the swap agreement definition includes any combination of these agreements or transactions, any option thereon, any master agreement, supplements and any security or credit enhancement agreement, with damages measured pursuant to Bankruptcy Code section 552.72

The 2005 Bankruptcy Amendments significantly expanded the definition to specifically cover, among other things, equity and credit derivatives.73 The legislative history notes that the original definition, which included “any other similar agreements,” was intended to provide sufficient flexibility to avoid the need to amend the definition as the nature and uses of swaps mature. The amended definition is designed to clarify such intent.74

The protected parties for swap agreements are “swap participants”75 and financial participants.76 “Swap participant” is defined as an entity that, at any time before the bankruptcy filing, has an outstanding swap agreement with the debtor (no timing limitations).77

72. Id. (codified at 11 U.S.C. § 101(53B)(A)(iii)-(vi)).
73. Prior to the 2005 Bankruptcy Amendments, swap agreements listed in 11 U.S.C. § 101(53B) (2004) were “a rate swap agreement, basis swap, forward rate agreement, commodity swap, interest rate option, forward foreign exchange agreement, spot foreign exchange agreement, rate cap agreement, rate floor agreement, rate collar agreement, currency swap agreement, cross-currency swap agreement, currency option, [and] any other similar agreement.”
The legislative history to the 2005 Bankruptcy Amendments states that agreements are not protected just because they are documented as swaps, and that a forward transaction could qualify as a swap even if not qualified as a forward.

VI. Commodity Contracts

The term commodity contract is defined in Bankruptcy Code section 761(4) and contained in the sub-chapter dealing with commodity broker liquidation. Because section 761 provides that the definitions are limited only to that chapter, one could question whether these definitions apply in other chapters of the Bankruptcy Code where the term is used but not defined. The Fifth Circuit held that they do.

Commodity is defined in Bankruptcy Code section 761(8) through cross-reference to the Commodity Exchange Act ("CEA"). The CEA defines "commodity" to include a list of agricultural products "and all other goods and articles, except onions as provided in section 13-1 of this title, and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in."

The quoted phrase above was added to CEA in 1974 and was intended by Congress to expand "the definition of commodity to encompass virtually anything that is or becomes the subject of futures trading, intangible as well as tangible," except for onions.

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;

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81. 11 U.S.C. Chapter 7, Subchapter IV.
86. 1 PHILIP McBRIDE JOHNSON & THOMAS LEE HAZEN, DERIVATIVES REGULATION, § 1.02[1], at 9 (2004) (emphasis omitted).
88. "Futures commission merchant" is defined in the CEA, which definition is incorporated by 11 U.S.C.A. § 761(8) (2004), as an individual, association, partnership, corporation, or trust that—(A) is engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market or derivatives transaction execution facility; and (B) in or in
(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.

The 2005 Bankruptcy Amendments expanded the definition to cover combinations of agreements and transactions, options, master agreements and security and credit enhancement agreements, with damages measured pursuant to Bankruptcy Code section 562.

connection with such solicitation or acceptance of orders, accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom.

89. "Foreign futures commission merchant" is defined in 11 U.S.C.A. § 761(12) (2004) as an "entity engaged in soliciting or accepting orders for the purchase or sale of a foreign future or that, in connection with such a solicitation or acceptance, accepts cash, a security, or other property, or extends credit to margin, guarantee, or secure any trade or contract that results from such a solicitation or acceptance."
90. "Foreign future" is defined in 11 U.S.C.A. § 761(11) (2004) as a "contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a board of trade outside the United States."
92. "Leverage transaction" is defined in 11 U.S.C.A. § 761(13) (2004) as an "agreement that is subject to regulation under section 19 of the [CEA] [codified at 7 U.S.C. § 23 (2000)], and that is commonly known as the commodities trade as a margin account, margin account, or leverage account."
93. "Commodity options dealer" is defined in 11 U.S.C.A. § 761(6) (2004) as a "person that extends credit to, or that accepts cash, a security, or other property from, a customer of such person for the purchase or sale of an interest in a commodity option."
94. "Commodity option" is defined in 11 U.S.C.A. § 761(5) (2004) as an "agreement or transaction subject to regulation under section 4c(b) of the [CEA] [codified as 7 U.S.C. § 6c(b) (2000)]." Section 4c(b) of the CEA regulates option trading: "No person shall offer to enter into, enter into or confirm the execution of, any transaction involving any commodity regulated under this chapter which is of the character of, or is commonly known to the trade as, an 'option,' 'privilege,' 'indemnity,' 'bid,' 'offer,' 'put,' 'call,' 'advance guaranty,' or 'decline guaranty,' contrary to any rule, regulation or order of the [CFTC]. ..." 7 U.S.C. § 6c(b) (2000).
VII. DISTINCTION BETWEEN FORWARDS AND COMMODITIES CONTRACTS

The terms forward contracts and commodity contracts, taken together, cover the entirety of transactions in the commodity and forward contract markets. The distinction is essentially between forwards, which are private, non-regulated contracts, and futures (or "commodity" contracts), which are regulated by the CFTC. The jurisdictional focus of the CEA is not on what is a commodity, almost everything is a commodity, but on whether the contract is a futures contract. Subject to the exceptions listed therein and the preservation of the Securities and Exchange Commission’s authority, CEA section 2 grants to the CFTC exclusive jurisdiction over, among other things, “transactions involving contracts of sale of a commodity for future delivery.” The term “contract of sale” is defined to include “sales, agreements of sale, and agreements to sell.” The “future delivery” component, however, is defined in the CEA only by way of exclusion: “[T]he term ‘future delivery’ does not include any sale of any cash commodity for deferred shipment or delivery.” As a leading commentator notes:

[T]he phrase future delivery eliminates transactions where an immediate sale occurs but where, for the convenience of the parties or otherwise, the actual transfer of the commodity is deferred. The primary focus of this exclusion, in historical context, was on a common practice in agricultural trade of making binding sales with postponed delivery; these arrangements frequently are referred to as forward contracts.

There is no fixed definition for a futures contract. When the contract contemplates actual delivery, but the obligation is deferred the forward contract ex-


98. *Olympic Natural Gas*, 294 F.3d at 741 (“The term ‘commodity contract’ encompasses purchases and sales of commodities for future delivery on, or subject to the rules of, a contract market or board of trade...” In contrast, ‘forward contracts’ are ‘contracts for the future purchase or sale of commodities that are not subject to the rules of a contract market or board of trade.’) (citations omitted), aff’d, 258 B.R. 161, 163, 165 (Bankr. S.D. Tex. 2001) (referring to “on-exchange transactions” as futures and to “off-exchange transactions” as forwards; “contracts for the purchase and sale of a certain, specified quantity of natural gas to be delivered at some certain, specified future date... are indeed forward contracts.”).


100. 7 U.S.C. § 1a(7) (2000).


102. JOHNSON & HAZEN, DERIVATIVES REGULATION, supra note 86, § 1.02[3], at 23–24 (emphasis omitted).

ception applies. The differences and similarities between forwards and futures were explained in Abrams v. Oppenheimer Government Securities, Inc.:105

- forwards are privately negotiated transactions while futures are traded on an exchange,
- both are designed to shift risks,
- both in theory require actual delivery, but futures generally are not used to obtain actual delivery and are discharged by entering into offsetting transactions while forwards often contemplate actual delivery,
- the only open term to be negotiated in a futures is the price, in a forward all of the sale terms are negotiated including price, quantity, quality and date of delivery, and
- in futures a clearing house is required to effect the sale, in forwards the terms are negotiated directly among the parties.

The ultimate determination of whether a contract is a futures contract is highly factual. The CFTC and the courts have developed certain criteria relevant to the determination:

- the designation of the contract as a futures or forward is not controlling,
- the use of standardized forms is significant in finding a futures contract to exist,
- in a futures contract actual delivery of the commodity is not expected to occur, and
- the customer generally has no business use for the commodity underlying a futures contract.106

The lack of expectation of delivery is the most significant factor in finding a futures contract to exist. In reviewing the expectation of delivery element, courts examine the parties' objective ability to actually take delivery.107

The Seventh Circuit has refined the multi-factor test and held that if the following three factors exist, the contract is a forward contract not subject to CFTC's regulation:

104. Krommenhoek v. A-Mark Precious Metals, Inc. (In re Bybee), 945 F.2d 309, 315 (9th Cir. 1991); CFTC v. Noble Metals Intl., Inc., 67 F.3d 766, 772 (9th Cir. 1995) (forward contract exception did not apply because actual delivery was not contemplated).

105. 737 F.2d 582, 590–92 (7th Cir. 1984).

106. JOHNSON & HAZEN, DERIVATIVES REGULATION, supra note 86, § 1.02[5], at 32–33.

107. JOHNSON & HAZEN, DERIVATIVES REGULATION, supra note 86, § 1.02[5], at 33–34 & n.139 (citing Petro Mktg., 680 F.2d at 581 ("The contracts here represent speculative ventures in commodity futures which were marketed to those for whom delivery was not an expectation."); Bybee, 945 F.2d at 313–15; Andersons, Inc. v. Horton Farms, Inc., 166 F.3d 308, 318 (6th Cir. 1998); Noble Metals, 67 F.3d at 772–73; Olympic Gas, 294 F.3d at 741; CFTC v. Midland Rare Coin Exch., Inc., 71 F Supp. 2d 1257, 1262–63 (S.D. Fla. 1999)).

108. Salomon Forex, Inc. v. Tauber, 8 F.3d 966, 971 (4th Cir. 1993) ("These contracts ... are usually entered into between parties able to make and receive physical delivery of the subject goods."); CFTC v. IBS, Inc., 113 F. Supp. 2d 830, 846 (W.D.N.C. 2000), aff'd sub nom., CFTC v. Kimberlynn Creek Ranch, Inc., 276 F.3d 187 (4th Cir. 2002); Midland, 71 F. Supp. 2d at 1263.
• it has idiosyncratic terms regarding place of delivery, quantity or other terms, and is not fungible with other contracts for the sale of the commodity,
• the contract is among industry participants, not the general public, and
• delivery cannot be deferred forever.\textsuperscript{109}

VIII. IPSO FACTO PROVISIONS ENFORCEABLE

Generally, bankruptcy termination clauses, also known as ipso facto clauses, are unenforceable in bankruptcy.\textsuperscript{110} An exception to this general rule is provided for securities contracts (Bankruptcy Code section 555),\textsuperscript{111} forward and commodities contracts (Bankruptcy Code section 556),\textsuperscript{112} repos (Bankruptcy Code Section 559),\textsuperscript{113} swaps (Bankruptcy Code Section 560),\textsuperscript{114} and master netting agreements (new Bankruptcy Code section 561).\textsuperscript{115}

The exception applies to a “contractual right,” which includes rights provided for

in a rule or bylaw of a derivatives clearing organization (as defined in the [CEA]), a multilateral clearing organization (as defined in the [FDIC] Improvement Act of 1991), a national securities exchange, a national securities association, a securities clearing agency, a contract market designated under the [CEA], a derivatives transaction execution facility registered under the [CEA], or a board of trade (as defined in the [CEA]) or in a resolution of the governing board thereof and a right, whether or not evidenced in writing, arising under common law, under law merchant or by reason of normal business practice.\textsuperscript{116}

Only qualified protected counter-parties, which vary between the various types of covered contracts, enjoy the benefits of these provisions allowing termination upon bankruptcy of a counter-party.

Courts may interfere with enforcement of ipso facto clauses in securities contracts and repos, if authorized by the Securities Investor Protection Act of 1970,\textsuperscript{117}

\begin{footnotes}
\item 109. Nagel v. ADM Inv. Servs., Inc., 217 F.3d 436, 441 (7th Cir. 2000).
\item 116. 11 U.S.C.A. §§ 555, 556, 559, 560 (2004), as amended by 2005 Bankruptcy Amendments, supra note 25, § 907(g), (h), (i), (j), (o), 119 Stat. at 177–82; id, § 907(k), 119 Stat. at 179–80 (adding new section codified at 11 U.S.C. § 561). In Mirant, 310 B.R. at 559 n.16, decided prior to the 2005 Bankruptcy Amendments, the parties assumed that Southern California Gas Company was a clearing organization.
\end{footnotes}
administered by SIPC, or by any statute administered by the SEC.\textsuperscript{118} “At the commencement of a SIPA proceeding, [SIPC] generally seeks and obtains an order staying the close-out of at least some securities contracts, including securities loans”\textsuperscript{119} and repurchases agreements.

By letter dated August 29, 1988, Deputy General Counsel of SIPC advised counsel to The Public Securities Association (now known as The Bond Market Association) that SIPC would modify its standard from of order, while still barring the immediate close-out of securities lending transactions to permit close-out of securities lending transactions which would otherwise by protected under Section 555 upon written consent of SIPC and the trustee appointed in the case (thus eliminating the need for court relief). The letter indicates that it is expected that SIPC would consent (and would urge the trustee to consent) if it received an affidavit of the counterparty attesting that it has no knowledge of fraud in the transaction and, if it is the lender, that it has a perfected security interest in the collateral; that SIPC would act promptly to determine whether the subject securities are necessary to satisfy the claims of customers (stating 4 to 5 days after the initiation of the proceeding as a hoped-for time frame); and thereafter would lift the stay or perform the debtor's obligations under the transaction.\textsuperscript{120}

A similar letter addressing repos was issued on February 4, 1986, but it does not address the rights of a reverse repo participant.\textsuperscript{121}

In two major stockbroker failures, “Drexel Burnham and Thomson McKinnon, the stockbroker entities filed chapter 11 petitions (and did not become subject to SIPA proceedings) by transferring their customer accounts and giving up their broker/dealer licenses prepetition (thus ceasing to be stockbrokers).”\textsuperscript{122}

The 2005 Bankruptcy Amendments amend section 5(b)(2) of SIPA\textsuperscript{123} to block SIPC from seeking a stay of the exercise of contractual rights with respect to the various protected contracts, except that it may seek to stay the foreclosure on or disposal of “securities collateral pledged by the debtor, ... securities sold by the debtor under a repurchase agreement, or securities lent under a securities lending agreement.”\textsuperscript{124} Thus, a counterparty would be able to terminate or accelerate a securities contract (and reduce its exposure to market movements), but might be stayed from foreclosing on the related securities collateral.

Prior to the 2005 Bankruptcy Amendments, these sections exempted from the \textit{ipso facto} prohibition the right “to cause the liquidation of” the securities contracts,

\textsuperscript{118} 11 U.S.C §§ 555, 559 (2004), as amended by 2005 Bankruptcy Amendments, supra note 25, § 907(g), (i), (o), 119 Stat. at 177–78, 181–82.
\textsuperscript{119} Novikoff, \textit{supra} note 5, at 13–15.
\textsuperscript{120} \textit{Id.}
\textsuperscript{121} \textit{Id.} at 13–16.
\textsuperscript{122} \textit{Id.} at 13–16.
\textsuperscript{124} \textit{Id.}
forward contracts, commodities contracts and repos. As to swaps, the exception applied to the right "to cause the termination" of the swap. The "liquidation" term used was understood to mean, at a minimum, the termination of the contract. But, "the right to liquidate does not constitute the right to transfer cash, securities, or property held with respect to such contracts, except to the extent otherwise provided in [this] title." The 2005 Bankruptcy Amendments, modified these sections by allowing not only the liquidation, but also the "termination, or acceleration" of these contracts.

Unless a protected party exercises its right as soon as possible after the counterparty's bankruptcy, courts may refuse to apply the safe harbor provisions, thus, prohibiting termination. Courts may rely on the doctrine of waiver, finding that the protected party's continued post-petition performance and failure to enforce the event of default, constitutes a waiver. Courts may also refuse to allow termination of safe harbor contracts, for reasons wholly unrelated to the counterparty's bankruptcy.

In order to reduce non-debtors counterparties' incentive to terminate, counsel should consider seeking bankruptcy court approval for counter-party assurance programs designed to encourage counter-parties not to terminate. Programs may contain a variety of features such as a provision for collateral, allowing (super) administrative expense priority, and providing for guaranties or letters of credit. To protect the debtor, the order approving any such arrangement could provide that any participating party waives a termination right based on the bankruptcy filing.

IX. APPLICATION OF AUTOMATIC Stay TO Termination

Few courts have addressed the question whether the automatic stay applies to a nondebtor party's right to exercise its right to terminate a contact exempt from the ipso facto prohibition. Those that have are split.

The only court to address the safe harbor provisions, held the automatic stay not to stay termination. The Court of Appeals for the Ninth Circuit, in Computer

127. In re R.M. Cordova Int'l, Inc., 77 B.R. 441, 448 (Bankr. D.N.J. 1987) ("As the legislative history makes clear, the right to liquidate a commodity contract pursuant to Section 556, is the right to close out an open position.").
129. Supra notes 111-16.
132. See Mirant, 310 B.R. at 553-54.
Communications, Inc. v. Codex Corp., held that to effectuate a termination clause that is enforceable under Bankruptcy Code section 365(e)(2), which exempts *ipso facto* clauses in certain types of contracts from the general unenforceability of such clauses, the nondebtor party to the executory contract must first seek relief from the automatic stay of Bankruptcy Code section 362. The Court of Appeals for the Third Circuit, disagrees. In Watts v. Pennsylvania Housing Finance Co., a state agency that had agreed to lend the debtor money to avert foreclosure ceased advances upon commencement of case. The court held that the termination of advances did not violate the stay:

Section 365(e)(2)(B), unequivocally and without qualification, provides for the termination of a contract to make a loan after the commencement of a bankruptcy case. To hold that such termination is, at the same time, stayed under section 362 would be at worst anomalous, and at best an imposition of a pro forma requirement that the creditor must ask for what the Code plainly grants him.

The law in the other circuits is not clear.

It is not entirely clear whether the Ninth Circuit will apply the rationale of Computer Communications to the safe harbor contracts. Section 365(e)(2), which was the subject of that decision, provides for the enforceability of an *ipso facto* clause but does not specifically mention the term “stay.” The safe harbor provisions of the Bankruptcy Code, dealing with the enforceability of *ipso facto* clauses, specifically provide that the contractual right to liquidate, terminate or accelerate a


136. Watts, 876 F.2d at 1096.

safe harbor contract "shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by the order of a court." \(^{138}\)

X. SETOFF/NETTING

The legislative history teaches us that the focus is on stability of financial markets:

[T]he stay provisions of the Code are not construed to prevent brokers from closing out the open accounts of insolvent customers or brokers. The prompt closing out or liquidation of such open accounts freezes the status quo and minimizes the potentially massive losses and chain reactions that could occur if the market were to move sharply in the wrong direction. \(^{139}\)

Exercise of setoff rights are generally subject to the automatic stay. \(^{140}\) Recoupment is generally held to be exempt from the stay. \(^{141}\) Setoff allows parties to setoff obligations arising from various transactions among them; recoupment is limited to the same transaction. \(^{142}\) Recoupment does not apply to claims arising from post-rejection termination of the contracts. \(^{143}\)

Prior to the 2005 Bankruptcy Amendments, it was not necessarily clear whether various confirmations under a single master agreement constituted one transaction or several transactions. In Mirant, the parties assumed they constituted a single contract. \(^{144}\) The 2005 Bankruptcy Amendments specifically include in the definitions of the various financial contracts, master agreements with all supplements thereto. \(^{145}\) The 2005 Bankruptcy Amendments also amended section 553 of the Bankruptcy Code to provide that the exercise of a setoff under the safe harbor provisions may not be avoided as a preference, \(^{146}\) even if the debt was acquired for the purpose of obtaining a right of setoff. \(^{147}\)

The safe harbor provisions and certain sub-sections of Bankruptcy Code section 362 exempt certain setoffs from the automatic stay.

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\(^{138}\) See Mirant, 310 B.R. at 554. A related question is whether Computer Communications should be extended to contracts that require an advance termination notice. It seems inconceivable, however, that the rationale underlying the safe harbor provisions, could be vitiated by staying the technical step of sending a termination notice, where advance notice is required.


\(^{141}\) Holyoke Nursing Home, Inc. v. Health Care Fin. Admin. (In re Holyoke Nursing Home, Inc.), 372 F.3d 1, 3 (1st Cir. 2004).

\(^{142}\) Holyoke, 372 F.3d at 3.

\(^{143}\) Mirant, 310 B.R. at 560.

\(^{144}\) Id. at 560 n.19.

\(^{145}\) 2005 Bankruptcy Amendments, supra note 25, § 907(a), 119 Stat. at 170–75 (definitions of forward contract, repurchase agreement, swap agreement, commodity contract and securities contract).

\(^{146}\) Supra notes 111–16.


Securities contracts, forwards and commodity contracts are addressed by Bankruptcy Code section 362(b)(6) which exempts the setoff of mutual debts and claims under, or in connection with these contracts that constitutes a setoff against the debtor for a margin payment or settlement payment “against cash, securities or other property held by, pledged to, under the control of, or due to” a protected party “to margin, guarantee, secure or settle” these contracts.\textsuperscript{149} Forward and commodity contracts are also subject to the exemption of Bankruptcy Code section 556—protected parties “right to variation or maintenance margin payment received from a trustee” under those contracts “shall not be stayed, avoided or otherwise limited by operation of any provision of [Title 11] or by the order of a court in any proceeding under [Title 11].”\textsuperscript{150} Similar protections are extended to securities contracts by section 555.\textsuperscript{151} Repos are addressed in Bankruptcy Code sections 362(b)(7) and 559 in similar fashion to the safe harbor transactions governed by sections 362(b)(6) and 556.\textsuperscript{152}

Swaps are addressed in Bankruptcy Code section 362(b)(17) which exempts from the stay a setoff “of a mutual debt and claim under or in connection with one or more swap agreements that constitutes the setoff of a claim against the debtor for payment ... due from the debtor under or in connection with any swap against cash, securities or other property held by, pledged to, under the control of, or due from any swap or financial participant to margin, guarantee, secure or settle” the swap.\textsuperscript{153} The protection is supplemented by Bankruptcy Code section 560\textsuperscript{154} providing that a contractual right to “offset or net out any termination values or payment amounts ... shall not be stayed, avoided or limited by operation of any provision of [Title 11] or by the order of a court in any proceeding under [Title 11].”\textsuperscript{155} Bankruptcy Code section 560 seems broader than Bankruptcy Code section 362(b)(17) due to lack of limitation in its applicability to settlement or margin payments.

Setoff is allowed regardless of whether the post-petition termination of a safe harbor contract is deemed to give rise to a post-petition, or pre-petition claim, notwithstanding Bankruptcy Code section 553 requiring both claims to arise pre-petition.\textsuperscript{156}

\textsuperscript{153} 2005 Bankruptcy Amendments, supra note 25, § 907(d), 119 Stat. at 176.
\textsuperscript{154} It is not at all clear why section 560 (dealing with swaps) specifically preserves the right to exercise setoff free from any stay, while sections 555 (securities contracts), 556 (commodities and forward contracts) and 559 (repos) do not. This is even more curious with respect of repos, since section 559 specifically preserves any excess value generated by liquidation of the collateral as an asset of the bankruptcy estate subject to the right of setoff.
\textsuperscript{156} Wolkowitz v. Shearson Lehman Bros., Inc. (In re Weisberg), 136 F.3d 655, 657–59 (9th Cir.
Cross product netting did not appear to be covered by the safe harbor provisions prior to the 2005 Bankruptcy Amendments. New Bankruptcy Code section 561(a) specifically allows cross product netting and new Bankruptcy Code section 362(b)(27) exempts from the stay the setoff by a master netting participant of mutual debts or claims under master netting agreements or any contracts subject to master netting agreements, but only to the extent that the master netting participant is "eligible to exercise the offset rights under [Bankruptcy Code] section 362(b)(6), (7), or (17) for each individual contract covered by the master netting agreement." New Bankruptcy Code section 561(a) provides that the right to terminate, accelerate or liquidate, or "to offset or net termination values, payment amounts or other transfer obligations arising under or in connection with one or more" securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements or master netting agreements, "shall not be stayed, avoided or limited by operation of [Title 11] or by order of a court or administrative agency in any proceeding under [Title 11]."

The legislative history is clear: "The definition of 'master netting agreement' is designed to protect the termination and close-out netting provisions of cross-product master agreements between parties."

Prior to the 2005 Bankruptcy Amendments, Bankruptcy Code sections 362(b)(6), (7), (17) were drafted in terms of setoff, but their language was not

1998 (affirming application of section 362(b)(6) to liquidation of collateral posted pre-petition as margin to cover unanswered post-petition margin calls).


159. Master netting participant is defined as an entity, that at any time before the bankruptcy filing, "is a party to an outstanding master netting agreement with the debtor." 2005 Bankruptcy Amendments, supra note 25, § 907(c), 119 Stat. at 175–76 (codified at 11 U.S.C. § 101(38A)).

160. Master netting agreement is defined as

(A) 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 [securities contracts, commodity contracts, forward contracts, repurchase contracts or swap agreements], 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 one or more of the foregoing; and

(B) if the agreement contains provisions relating to agreements or transactions that are not [securities contracts, commodity contracts, forward contracts, repurchase contracts or swap agreements, it] shall be deemed to be a master netting agreement only with respect to those agreements or transactions that [qualify as such].


161. The legislative history makes clear that the intent was not to "disqualify" master netting agreements merely because they cover both safe harbor and non-safe harbor transactions; rather a master netting agreement that covers both safe harbor and non-safe harbor transactions would still be deemed a master netting agreement but the special treatment afforded to the safe harbor transactions would not be available to the non-safe harbor transactions. See H.R. Rep. No. 109-31, at 131–32 (2005), reprinted in 2005 U.S.C.C.A.N. 88, 192.


sufficiently clear as to whether realization on collateral was exempt from the automatic stay. The 2005 Bankruptcy Amendments specifically allow realization against pledged collateral.

The legislative history is also crystal clear on this point:

Subsection (d) amends section 362(b) of the Bankruptcy Code to protect enforcement, free from the automatic stay, of setoff or netting provisions in swap agreements and in master netting agreements and security agreements or arrangements related to one or more swap agreements or master netting agreements. This provision parallels the other provisions of the Bankruptcy Code that protect netting provisions of securities contracts, commodity contracts, forward contracts, and repurchase agreements. Because the relevant definitions include related security agreements, the references to ‘setoff’ in these provisions, as well as in section 362(b)(6) and (7) of the Bankruptcy Code, are intended to refer also to rights to foreclose on, and to set off against obligations to return, collateral securing swap agreements, master netting agreements, repurchase agreements, securities contracts, commodity contracts, or forward contracts. Collateral may be pledged to cover the cost of replacing the defaulted transactions in the relevant market, as well as other costs and expenses incurred or estimated to be incurred for the purpose of hedging or reducing the risks arising out of such termination. Enforcement of these agreements and arrangements free from the automatic stay is consistent with the policy goal of minimizing systemic risk.

Subsection (d) also clarifies that the provisions protecting setoff and foreclosure in relation to securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements, and master netting agreements free from the automatic stay apply to collateral pledged by the debtor but that cannot technically by "held by" the creditor, such as receivables and book-entry securities, and to collateral that has been repledged by the creditor and securities re-sold pursuant to repurchase agreements.

XI. DAMAGES

Prior to the 2005 Bankruptcy Amendments it was not clear whether the relevant date on which damages should be calculated is the petition date or the termination date. The 2005 Bankruptcy Amendments provide that the measure of damages

164. Wolkwitz, 136 F3d at 657–59 (11 U.S.C. § 362(b)(6) applies to liquidation of collateral posted pre-petition as margin to cover unanswered post-petition margin calls); but see Miranti, 310 B.R. at 559–60 (reversal of a wire, after the amount was deposited into the debtors’ account, violated the stay as it was not within the protection afforded by 11 U.S.C. § 556).

165. The 2005 Bankruptcy Amendments accomplished this result by inserting the language "pledged to, or under the control of," in sections 362(b)(7), (7) and (17). Similar language is also part of the newly added section 362(b)(27) dealing with setoffs under master netting agreements. 2005 Bankruptcy Amendments, supra note 25, § 907(d), 119 Stat. at 176.


is determined on the earlier of rejection of the agreement or the liquidation, termination or acceleration date.\textsuperscript{168} If there is no way to determine the values involved in a commercially reasonable manner, damages will be measured at the earliest subsequent date or dates on which values can be determined in a commercially reasonable manner.\textsuperscript{169} In any objection to timing, the objecting party carries the burden of proof.\textsuperscript{170}

The measure of damages is not provided for in the Bankruptcy Code, presumably leaving the parties the freedom to contract for the measures they believe are appropriate under the circumstances. One measure could be the cost to replace the derivative; another, the difference between derivative price and market value of the underlying security, index or other property.

In swap agreements, the practice, although no longer common, of denying a defaulting swap counterparty the termination value of a swap transaction, known as the “first method” under the 1992 ISDA Master Agreement (Multicurrency-Cross Border),\textsuperscript{171} was held enforceable in the Drexel case.\textsuperscript{172} The “first method” was eliminated altogether in the 2002 ISDA Master Agreement (Multicurrency-Cross Border).\textsuperscript{173}

The commonly used “market quotation” measure of damages under the 1992 ISDA Master Agreement does not use the lowest bid, but uses either (i) the average of the two middle bids obtained from four reference market makers or (ii) the middle bid of three bids so obtained.\textsuperscript{174} The other commonly used measure of damages under the 1992 ISDA Master Agreement—“loss”—expressly includes the cost of unwinding hedges related to the terminated swap agreement.\textsuperscript{175} The 2002 ISDA Master Agreement adopts a single measure of damages defined as the “Close-out Amount.” The Close-out Amount entails a determination as the losses or costs incurred or gains realized in replacing the terminated transactions or providing the economic equivalent of the material terms of these transactions. The calculation of the amount includes the payments or deliveries that have been required absent termination.\textsuperscript{176}

\textsuperscript{168} 2005 Bankruptcy Amendments, supra note 25, § 910(a), 119 Stat. at 184 (codified at 11 U.S.C. § 562(a)).

\textsuperscript{169} Id. (codified at 11 U.S.C. § 562(b)).

\textsuperscript{170} Id. (codified at 11 U.S.C. § 562(c)).

\textsuperscript{171} International Swap Dealers Association, 1992 ISDA Master Agreement, Payments on Early Termination Clause.


\textsuperscript{173} See International Swaps and Derivatives Association, 2002 ISDA Master Agreement, Payments on Early Termination Clause; International Swaps and Derivatives Association, USER'S GUIDE TO THE ISDA MASTER AGREEMENT 24 (2003 ed.).


\textsuperscript{175} 1992 ISDA Master Agreement, supra note 171.

\textsuperscript{176} For a more complete understanding see, 2002 ISDA Master Agreement, supra note 173, § 14 (definition of the term) and USER'S GUIDE TO THE ISDA 2002 MASTER AGREEMENT, supra note 173, at 24–28.
Damages under interest rate swap agreements are not subject to disallowance as unmatured interest under Bankruptcy Code section 502(b)(2).\textsuperscript{177}

What if the non-defaulting party under a swap in which the parties chose not to declare automatic termination upon bankruptcy event, refuses to designate an early termination event because it is “out of the money” at the time of bankruptcy (which prevents the debtor from getting the termination payment it would have been entitled to)? The New South Wales Supreme Court\textsuperscript{178} held the contract provisions enforceable, refused to compel TXU to designate an early termination date and refused to allow Enron to “disclaim” the swap because the effect of which would be to re-write the terms of the swap. We doubt that a U.S. court would reach the same result.\textsuperscript{179}

**XII. Avoidance Actions Exception**

Except for actual fraudulent transfers, Bankruptcy Code sections 546(e), (f), and (g), protect from avoidance transfers that constitute margin or settlement payments made by or to a protected party under the various safe harbor provisions.\textsuperscript{180} Note that Bankruptcy Code section 546(e), dealing with margin or settlement payments to a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant or securities clearing agencies, does not specifically require that payment be made under a qualified contract. Bankruptcy Code section 546(f), dealing with repos, does require the payment to be made “in connection with a repurchase agreement.” And Bankruptcy Code section 546(g), dealing with swaps, exempts a transfer under, or in connection with a swap agreement, but does not reference margin or settlement payments.

The 2005 Bankruptcy Amendments added new Bankruptcy Code section 546(j)\textsuperscript{181} protecting from avoidance a transfer “made by or to a master netting agreement participant,” except if the transfer is avoidable as an actual fraudulent transfer or avoidable under a contract covered by the master netting agreement, i.e., made under a non-safe harbor transaction that is nevertheless governed by the master netting agreement.\textsuperscript{182} Protection is supplemented by Bankruptcy Code sections 548(d)(2)(B), (C), (D) and (E)\textsuperscript{183} providing that protected parties that receive margin or settlement payments are deemed to have provided value.\textsuperscript{184}

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\textsuperscript{177} Thrifty Oil Co. v. Bank of America National Trust and Savings Assoc. (In re Thrifty Oil Co.), 249 B.R. 537, 543–51 (S.D. Cal. 2000), aff’d, 322 F.3d 1039 (9th Cir. 2003).


\textsuperscript{179} The safe harbor provisions enhance the rights of certain non-debtor counter parties; but nothing in them limits or otherwise denies a debtor the right to reject an executory contract. 11 U.S.C.A. § 365 (2004), as amended by 2005 Bankruptcy Amendments, supra note 25, §§ 309(b), 328(a), 404, 119 Stat. at 82, 100, 104–05.

\textsuperscript{180} 11 U.S.C.A. § 546(e), (f), (g) (2004) as amended by 2005 Bankruptcy Amendments, supra note 25, § 907(e), (o), 119 Stat. at 177, 182.

\textsuperscript{181} 2005 Bankruptcy Amendments, supra note 25, § 907(e), 119 Stat. at 177 (codified at 11 U.S.C. § 546(j)).

\textsuperscript{182} See supra note 161.


\textsuperscript{184} The legislative history on this point is clear: “[T]his provision exempts these types of customary setoff payments in the forward contract trade from scrutiny as to whether they are actually fair value for the amount used.” H.R. Rep. No. 101-484, at 7 (1990), reprinted in 1990 U.S.C.C.A.N. 223, 229.
In addition to Bankruptcy Code section 546, margin payments are at the heart of several of the safe harbor provisions. Margin payment for forward contract purposes is defined in section 101(38) of the Bankruptcy Code as a "payment or deposit of cash, a security or other property, that is commonly known in the forward contract trade as original margin, initial margin, maintenance margin, or variation margin, including mark-to-market payments, or variation payments." At least two courts suggested that an initial payment made to open a margin account, at a time when no trades took place and no deficiency exists, is not a margin payment.

Similarly, the term "settlement payment" is at the heart of various safe harbor provisions as well. "Settlement payment" is defined in Bankruptcy Code section 101(51A) for forward contract purposes as "a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, a net settlement payment, or any other similar payment commonly used in the forward contract trade." In the securities industry, the term is understood to mean any transfer of cash or securities to complete a securities transaction, it is essentially a payment made to discharge a settlement obligation.

Although the statutory definition is circular and not particularly illuminating, courts, in the securities context, have held that at a minimum the payment must involve the system of intermediaries and guarantees typical of the securities industry. Other cases refuse to deny protection simply because the transaction

187. Settler v. Farmer's Commodities Corp. (In re Yeagle), 220 B.R. 402, 405 (Bankr. D. Kan. 1998) ("The term 'margin payment' is not broad enough, however, to encompass payment made to open a margin account before any trading is conducted or any deficiency is incurred."); Biggs v. Smith Barney, Inc. (In re David), 193 B.R. 935, 940 (Bankr. C.D. Cal. 1996) ("[T]he terms 'margin payments' and 'settlement payment' do not include all payments into a margin account. For example, the court would be hard-pressed to find that a payment made to open an account with a stockbroker, prior to any trading, constituted a margin payment . . . ").
190. Enron, 325 B.R. at 684 (citations omitted).
191. Munford v. Valuation Research Corp., 98 F.3d 604, 609–10 (11th Cir. 1996) (LBO is essentially a private transaction; although the court assumed that the payments were settlement payments, and the payments were in fact made to a financial institution, no protection from avoidance because the financial institution was a mere conduit for the selling shareholders and thus, the payments were not made to protected parties), cert. denied, 522 U.S. 1068 (1998); Zahn v. Yucaipa Capital Fund, 218 B.R. 656, 675–76 (D.R.I. 1998) (court held that, even if interpreted broadly, to qualify as settlement payment for purposes of statute, payment must implicate the "system of intermediaries and guarantees" of the securities industry "wherein parties use intermediaries to make trades of public stock which are instantaneously credited, but in which the actual exchange of stock and consideration therefor take place at a later date"); Jewel Recovery, L.P. v. Gordon, 196 B.R. 348, 353 (N.D. Tex. 1996) (held, private stock sale not protected by the Bankruptcy Code because it "lack[s] the impact on the public market trading systems that Congress intended to protect"); Grand Eagle Cos. v. Boveri, Inc. (In re
does not impact the public markets.\textsuperscript{192} Transaction involving illegal securities law transactions or illegality under state law, were held not safe harbor transactions.\textsuperscript{193} In a recent \textit{Enron} litigation, Enron sought to avoid and recover transfers made to the defendants in prepayment of short term commercial paper notes. The prepayment, however, was contrary to the offering documents pursuant to which the notes were sold, and was alleged to be significantly above market value. Based on these facts the bankruptcy court denied the defendants’ motion to dismiss finding that there is a question of fact whether such payments are commonly used in the securities trade.\textsuperscript{194} In addition, the \textit{Enron} court infused some uncertainty as to whether payments made to retire debt qualify as a settlement payments: “If the payments were made to retire the debt, the Court would need to address the issue of whether such payments—which were not then for the purchase, sale or loan of securities but were to satisfy the underlying debt obligation—are nonetheless settlement payments for purposes of section 546(e).”\textsuperscript{195}

These authorities are probably inapplicable to forwards and swaps where these mechanisms do not exist. The Fifth Circuit expressly its agreement with precedents outside the securities area that the term should be interpreted broadly, and in the context of forward contracts, does not require the payment to be made under on-market transaction or to be cleared or settled through a centralized system.\textsuperscript{196} This view is supported by the literal wording of Bankruptcy Code section 101(51A) which states that, as to forward contracts, a settlement payment includes a “similar payment commonly used in the forward contract trade.”\textsuperscript{197}

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\textsuperscript{194} Kipperman v. Circle Trust F.B.O. (In re Grafton Partners, L.P.), 321 B.R. 527, 540–41 (B.A.P 9th Cir. 2005) (redemption of equity in an LLC run as a ponzi scheme not protected; not involving public markets and involving illegally unregistered securities); Enron Corp. v. Bear, Stearns & Co. Ltd. (In re Enron Corp.), 323 B.R. 857, 878 (Bankr. S.D.N.Y. 2005) (Oregon corporation’s redemption of securities that is invalid under Oregon law, is not a safe harbor transaction; “Where a transaction is rendered void by state law, it is a nullity” and section 546 is not implicated).

\textsuperscript{195} Enron, 325 B.R. at 685–86.

\textsuperscript{196} Olympic Gas, 294 F.3d at 742 (payments made under forward contracts were settlement payments for forward contract purposes); accord Mirant, 310 B.R. at 563 (setoff of claims arising from termination of forward contract is a settlement payment).

\textsuperscript{197} Olympic Gas, 258 B.R. at 166 (net payments exchanged monthly among the parties on account of forward contracts for natural gas, qualified as settlement payments under section 101(51A) as a “similar payment commonly used in the forward contracts trade”) (citation omitted); accord \textit{Hamilton}}
A payment obtained through attachment does not qualify as a settlement payment, the exercise of setoff to recover erroneous payments, may not qualify, and payment for gas purchased after initial failure to pay followed by collection activities by the seller, may not qualify either.

XIII. SECTION 105

Bankruptcy Code section 105(a) allows courts to issue any order necessary to carry out the provisions of the Bankruptcy Code. Section 105(a) should not be used to override the specific provisions protecting safe harbor transactions. Courts may, however, temporarily enforce the automatic stay or prevent closeouts of protected transactions to enable them to decide whether all of the necessary elements are satisfied.

XIV. RECHARACTERIZATION ISSUES

Courts generally have the power to recharacterize transactions based on their economic substance, rather than based on their form. Repos have the economics of a secured loan and carry a significant recharacterization risk.

Courts seem less than willing to recharacterize sophisticated financial products, based on a counter-party's post-hoc view as to their alleged economic substance. Courts in the Ninth Circuit refused to recharacterize a swap and floating rate loan as one transaction representing in substance a fixed rate loan.

Taft, 114 F.3d at 993 (reverse repo); Jonas v. Resolution Trust Corp. (In re Comark), 971 F.2d 322, 326 (9th Cir. 1992) (party's withdrawal from a repurchase transaction, and the return of additional margin posted in connection with the repo, is a settlement payment); Bevill, Bresler & Schulman Asset Mgmt., 878 F.2d at 751–53 (interpreting the term settlement payment to fit the settlement process applicable to repurchase agreements).

204. Reaves Brokerage Co. v. Sunbelt Fruit & Vegetable Co., 336 F.3d 410, 414 (5th Cir. 2003);
XV. MANDATORY SUBORDINATION ISSUES

Section 510(b) of the Bankruptcy Code requires mandatory subordination of damage claims arising from purchase or sale of a security of the debtor or its affiliates. This section may cause the subordination claims under forwards, swap, repos or securities contracts where the underlying security is a security of the debtor or its affiliates.

Section 510(b) subordinates claims for damages, but it is not entirely clear what the term means. Technically, the rejection of any agreement as well as a failure to pay, is a breach of the contract which gives rise to damages. If the term means damages related to a breach, any holder of a note issued by the debtor or an affiliate may be subordinated, a result that makes no sense. But, in In re Blondheim Real Estate, Inc., the investors filed claims based on the unpaid amounts outstanding on the debtor's notes. In other contexts, courts did apply the more comprehensive meaning of damages, i.e., losses suffered due to a failure to pay.

Section 510(b) does not mention the term "breach," but generally, damages can result either from a tort type claim or from a breach of contract. Thus, if the safe harbor contract by its terms refers to a bankruptcy filing as a credit event type default, the argument that the filing constitutes a breach and that the debtor is liable for the resulting damages, if any, is straightforward. But, if the contract refers to a bankruptcy filing as a termination event that does not constitute a breach, an argument can be made that the payment obligation triggered by the filing is not a payment on account of a breach of the safe harbor contract, but rather a payment due on account of its earlier maturity. Whether such drafting formulations would lead to different results, is yet to be seen.

Cases analyzing section 510(b) have focused on the nature of risk assumed by the claimants. Acknowledging that section 510(b) is not a model of clarity, it was held to be ambiguous. Relying on the legislative history, courts attempt to capture the risk associated with the transaction, i.e., did the claimant take an equity or creditor type risk.

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211. It should not be a complete surprise, however, if courts would refuse to treat these formulations differently, viewing the earlier maturity formulation as elevating form over substance.
213. Telegroup, 281 F.3d at 142 (dismissing claimants' argument that they didn't intend to retain
It is arguable, however, that when the debtor's or its affiliate's securities are used as the underlying property in swaps, forwards and securities contracts, the non-debtor counterparty is not intending to, and in effect is not taking a position of an equity investor, i.e., no rewards upon the stock's appreciation or loss upon failure; the non-debtor counterparty may take the risk of a creditor, except that the underlying property used in the transaction is debtor's or the debtor's affiliate's securities. That may be especially so if the debtor has a call against the put, or the re-sale of the security back to the debtor is mandatory through one mechanism or another. The literal language of section 510(b), however, is broad and the recent trend is to apply it liberally. 214

Furthermore, if the contract is deemed to be a contract for the debtor to purchase its own equity securities, in bankruptcy a debtor may not repurchase its own equity securities and thus the claim can be disallowed in its entirety under section 502(b)(1) of the Bankruptcy Code. 215

Corporate law principles could play an important role in this context. In determining the validity and legality of a corporation's obligation to purchase its own shares, some state laws inquire as to whether the obligation was legal and valid at the time the corporation entered into the transaction; others look to the time in which the corporation is required to perform its obligations under the contract, i.e., "outset" vs. "installment" tests. 216 In addition, one has to consider how do bankruptcy court apply these tests, as some did not engage in the analysis of state law, ignored it or added their judicial gloss onto it. 217

Section 510(b) applies whether the damages result from a purchase or sale of securities of the debtor or the debtor's affiliates. Very few cases have addressed the application of section 510(b) in such a situation. The In re VF Brands, Inc. court 218 subordinated claims against the parent resulting from the sale of its subsidiary stock to the claims of the unsecured creditors of the parent. The Lernout & Hauspie Speech Products, N.V. v. Baker court 219 subordinated claims of shareholders of the parent with respect of the subsidiary stock only to the subsidiary's creditors, not the parent's creditors.

It seems questionable whether the rationale underlying section 510(b), i.e., preventing equityholders from converting their equity type claim to a debt

claim,\textsuperscript{220} justifies the inclusion of affiliate’s securities within its scope. While the 
\textit{VF Brands} court gave this notion a short shrift, stating that section 510(b) makes 
no distinction between the debtor’s and affiliates’ stock,\textsuperscript{221} at least one commentator argues that the inclusion of affiliate’s securities was an error.\textsuperscript{222}

\textbf{XVI. PREEMPTION/CHAPTER 11 PLAN CONFLICT}

Case law is split on whether Bankruptcy Code section 546 preempts state law: 
whether a safe harbor transaction, made in violation of state corporate law, i.e., a 
prohibited distribution to shareholders, is nevertheless protected by section 546. 
Two Delaware cases held that state law is preempted.\textsuperscript{223} The Tenth Circuit suggested 
that state law may not be preempted.\textsuperscript{224} The bankruptcy court in Manhattan 
held that state law is not preempted.\textsuperscript{225}

Case law is also split on whether a Chapter 11 plan can avoid section 546, for 
example by assigning the claim to other parties. A Delaware district court held 
that it can.\textsuperscript{226} Case law in the Second Circuit suggests that the Delaware ruling is 
not free from doubt.\textsuperscript{227}

\textbf{XVII. APPLICABILITY TO CHAPTER 9/CROSS-BORDER 
PROCEEDINGS}

Prior to the 2005 Bankruptcy Amendments, Bankruptcy Code sections 555, 556, 
559 and 560 were not incorporated into chapter 9, governing municipal bank-
ruptcies, under Bankruptcy Code section 901(a).\textsuperscript{228} Section 901(a) was amended 
by the 2005 Bankruptcy Amendments to make these provisions, as well as new 
Bankruptcy Code sections 561 and 562, applicable.\textsuperscript{229}

\textsuperscript{220} Nicholas L. Georgakopoulos, \textit{Strange Subordinations: Correcting Bankruptcy’s § 510(b)}, 16 Bankr. 
\textsuperscript{221} 275 B.R. at 727–30.
\textsuperscript{222} Georgakopoulos, \textit{Strange Subordinations}, supra note 220, at 97–98.
\textsuperscript{223} PHP Liquidating, LLC v. Robbins, 291 B.R. 592, 596 (D. Del. 2003), ("[T]he Court concludes that 
if the avoidance action were brought by a trustee or a debtor-in-possession … the avoidance 
action would be barred by Section 546(e) of the Bankruptcy Code.") (illegal redemption), aff’d, 128 
\textsuperscript{224} Kaiser Steel, 952 F.2d at 1241 ("[W]e are not convinced [our decision] leaves the trustee 
remediless by way of suit for damages, or some similar device, against specific individuals or insti-
tutions for unlawful acts.").
\textsuperscript{225} Enron Corp. v. Bear, Sterns Int’l Ltd. (In re Enron Corp.), 323 B.R. 857, 876–78 (Bankr. 
S.D.N.Y. 2005) (when state law renders the obligation void).
\textsuperscript{226} PHP Liquidating, 291 B.R. 592, 596 (creditors assigned claims to liquidating trust; section 
546(e) is inapplicable as it applies to trustee/debtor in possession).
\textsuperscript{227} Breedon v. Kirkpatrick & Lockhart, LLP (In re Bennett Funding Group, Inc.), 336 F.3d 94, 
102 (2d Cir. 2003) (Trustee may not pursue claims belonging to creditors, even if creditors assigned 
the claims to the trustee giving rise to an argument that the assignee of an action that is barred by 
Bankruptcy Code section 546, may not have more rights than the assignor).
\textsuperscript{228} 11 U.S.C. § 901(a) (2004). In the Orange County bankruptcy case several counterparties 
closed-out positions; Orange County sued one debtor (Namura) as a test case but withdrew its com-
Prior to the 2005 Bankruptcy Amendments, it appeared that these sections were not applicable to an ancillary proceeding. Bankruptcy Code Section 103(a) provides that chapters 1, 3 and 5 apply in chapter 7, 11, 12 and 13 cases but did not mention ancillary proceedings which were governed by § 304.\textsuperscript{230}

The 2005 Bankruptcy amendments repealed Bankruptcy Code section 304\textsuperscript{231} and adopted new chapter 15 entitled “Ancillary and Other Cross-Border Cases.”\textsuperscript{232} Bankruptcy Code section 103 was amended to provide that Bankruptcy Code sections 555–557, and 559–562 apply to cases under chapter 15,\textsuperscript{233} and new sections 1519(f) and 1521(f) prohibit the stay of actions exempt from the automatic stay under sections 362(b)(6), (7), (17), or (27).\textsuperscript{234}

**CONCLUSION/POST-SCRIPT**

The safe harbor provisions seem to be the equivalent of a “get out of jail free” card; non-debtor counterparties can escape the most fearsome consequences of a bankruptcy filing since they can enforce bankruptcy termination clauses, foreclose on collateral and exercise setoff and netting rights free of the automatic stay and are immune from preference and constructive fraudulent transfer exposure. The Congressional rationale supporting these provisions, as shown in Part I, is laudable: Protecting financial markets from systemic risks. The question is whether this rationale is well founded. At least one leading figure seems to paint a different picture: Warren Buffett. Mr. Buffett has argued that derivatives are “financial weapons of mass destruction,” and that the “rapidly growing trade in derivatives posses a ‘mega-catastrophic risk’ for the economy.” Mr. Buffett has warned “that derivatives can push companies onto a ‘spiral that can lead to a corporate meltdown,’ like the demise of the notorious hedge fund Long-Term Capital Management in 1998,” and that they “pose a dangerous incentive for false accounting.”\textsuperscript{235}

It is also hard to miss the irony in the publication of the SEC Report\textsuperscript{236} within a few short weeks after the passage of the 2005 amendments to the Bankruptcy Code, in which the SEC, first, identifies the Enron scandal as an impetus to the wave of reforms that followed, including the passage of the Sarbanes-Oxley Act of 2002,\textsuperscript{237} and second, describes how Enron used hedging transactions in con-

\textsuperscript{230} 11 U.S.C.A. §§ 103, 304 (2004). Accord In re Bd. of Directors of Compañía General de Combustibles S.A., 269 B.R. 104, 111–13 (Bankr. S.D.N.Y. 2001) (motion by a swap counter-party to vacate an injunction issued in a section 304 proceeding was denied; “Congress was not seeking to protect a fundamental right of swap participants, but was seeking to ensure access to the swap market for United States borrowers and stabilize United States domestic markets.”).

\textsuperscript{231} 2005 Bankruptcy Amendments, supra note 25, § 802(d), 119 Stat. at 146.


\textsuperscript{233} 2005 Bankruptcy Amendments, supra note 25, § 802(a), 119 Stat. at 145.

\textsuperscript{234} 2005 Bankruptcy Amendments, supra note 25, § 801, 119 Stat. at 141–42.


\textsuperscript{236} SEC Report, supra note 1.

\textsuperscript{237} SEC Report, supra note 1, at 16.
junction with special purpose entities to conceal losses, reduce transparency, and disguise debt financing to create the impression of operating cash flow.  

But even if one accepts Congress's premise, naturally, not every bankruptcy of an entity that is a party to a safe harbor transaction carries with it the potential for a systemic risk. Rather, since these are privately negotiated transactions, in many derivative transactions the bankruptcy filing merely subjects the non-debtor counterparty (or the party to which the underlying risk was transferred by the original counterparty via mirror transactions) to a risk of loss, not an uncommon situation for parties with business relationships with a failed enterprise. The safe harbor provisions change all of that.

Assume that a debtor uses large amounts of metal in its manufacturing process and to protect itself from price fluctuations has entered into a long term forward for its metal requirements. At the time of its bankruptcy, metal prices are significantly higher thus making the forward a highly valuable estate asset, and potentially making its reorganization more likely. Not so; upon bankruptcy the seller can terminate the forward allowing it to obtain market prices for the metal. If, however, at the time of bankruptcy metal prices are lower than the contract price, the non-debtor counterparty has the option not to terminate the forward, and file rejection damage claim should the debtor decide to reject the forward. As this example makes clear, only the non-debtor counterparty obtains the upside of a derivative in a bankruptcy, not the debtor.  

On its face, the following scenario may be viewed as an isolated, private inequity that justifies the broader goal of maintaining the stability of financial markets. Now assume, however, that the debtor in the example above is a major corporation with tens of thousands of employees, tens of billions of dollars in debt securities outstanding, millions of public shareholders including pension funds and billions of dollars of notional amount of derivatives—will the application of the safe harbor provisions in such a case serve to protect financial markets from systemic risk or stress them even further? Time will tell.

APPENDIX: GLOSSARY OF COMMONLY USED TERMS

Basis Swap. A transaction in which one party pays periodic amounts of a given currency based on a floating rate and the other party pays periodic amounts of

238. SEC Report, supra note 1, at 17.
239. SEC Report, supra note 1, at 18.
240. The result may be different for swaps documented under the 2002 ISDA Master Agreement, for other derivatives documented in a manner not resulting in the loss by the breaching party, i.e. the debtor, of the value of the contract if the debtor is “in the money,” or if courts, contrary to Drexel, 1992 US Dist. Lexis 21223, refuse to enforce them as unenforceable ipso facto clauses under sections 541(c)(1) and 365(e)(1) of the Bankruptcy Code. The safe harbor provisions allow for the liquidation, termination and acceleration of safe harbor transactions, but do not speak to the enforceability of contractual provisions denying a debtor in bankruptcy of the value of an “in the money” contract.

the same currency based on another floating rate, with both rates reset periodically; all calculations are based on a notional amount of the given currency.

**Bond Option.** A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a bond of an issuer, . . . at a specified strike price. The bond option can be settled by physical delivery of the bonds in exchange for the strike price or may be cash settled based on the difference between the market price of the bonds on the exercise date and the strike price.

**Bullion Option.** A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the call of a call) or sell (in the case of a put) a specified number of ounces of Bullion at a specified strike price. The option may be settled by physical delivery of Bullion in exchange for the strike price or may be cash settled based on the difference between the market price of Bullion on the exercise date and the strike price.

**Bullion Swap.** A transaction in which one party pays periodic amounts of a given currency based on a fixed price or a fixed rate and the other party pays periodic amounts of the same currency or a different currency calculated by reference to a Bullion reference price (for example Gold-COMEX on the New York Commodity Exchange) or another method specified by the parties. Bullion swaps include cap, collar, or floor transactions in respect of Bullion.

**Bullion Trade.** A transaction in which one party agrees to buy from or sell to the other party a specified number of Ounces of Bullion at a specified price for settlement either on a “spot” or two-day basis or on a specified future date. A Bullion Trade may be settled by physical delivery of Bullion in exchange for a specified price or may be cash settled based on the difference between the market price of Bullion on the settlement date and the specified price. For purposes of Bullion Trades, Bullion Options and Bullion Swaps, “Bullion” means gold, silver, platinum or palladium and “Ounce” means, in the case of gold, a fine troy ounce, and in the case of silver, platinum and palladium, a troy ounce.

**Cap Transaction.** A transaction in which one party pays a single or periodic fixed amount and the other party pays periodic amounts of the same currency based on the excess, if any, of a specified floating rate (in the case of an interest rate cap) or commodity price (in the case of a commodity cap) in each case that is reset periodically over a specified per annum rate (in the case of an interest rate cap) or commodity price (in the case of a commodity cap).

**Collar Transaction.** A collar is a combination of a cap and a floor where one party is the floating rate or floating commodity price payer on the cap and the other party is the floating rate or floating commodity price payer on the floor.

**Commodity Forward.** A transaction in which one party agrees to purchase a specified quantity of a commodity at a future date at an agreed price and the other party agrees to pay a price for the same quantity to be set on a specified
date in the future. The payment calculation is based on the quantity of the commodity and is settled based, among other things, on the difference between the agreed forward price and the prevailing market price at the time of settlement.

Commodity Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to purchase (in the case of a call) or sell (in the case of a put) a specified quantity of a commodity at the specified strike price. The option can be settled either by physically delivering the quantity of the commodity in exchange for the strike price or by cash settling the option, in which case the seller of the option would pay to the buyer the difference between the market price of that quantity of the commodity on the exercise date and the strike price.

Commodity Swap. A transaction in which one party pays periodic amounts of a given currency based on a fixed price and the other party pays periodic amounts of the same currency based on the price of a commodity, such as natural gas or gold, or a futures contract on a commodity...; all calculations are based on a notional quantity of the commodity.

Credit Protection Transaction. Some market participants may refer to credit protection transactions as credit swaps, credit default swaps or credit default options. A transaction in which one party pays either a single fixed amount or periodic fixed amounts or floating amounts determined by reference to a specified notional amount, and the other party (the credit protection seller) pays either a fixed amount or an amount determined by reference to the value of one or more loans, debt securities or other financial instruments (each a “Reference Obligation”) issued, guaranteed or otherwise entered into by a third party (the “Reference Entity”) upon the occurrence of one or more specified credit events with respect to the Reference Entity (for example, bankruptcy or payment default). The amount payable by the credit protection seller is typically determined based upon the market value of one or more debt securities or other debt instruments issued, guaranteed or otherwise entered into by the Reference Entity. Credit protection transactions may also be physically settled by payment of a specified fixed amount by one party against delivery of specified Reference Obligations by the other party. A credit protection transaction may also refer to a “basket” or two or more Reference Entities.

Credit Spread Transaction. A transaction involving either a forward or an option where the value of the transaction is calculated based on the credit spread implicit in the price of the underlying instruments.

Cross Currency Rate Swap. A transaction in which one party pays periodic amounts in one currency based on a specified fixed rate (or a floating rate that is reset periodically) and the other party pays periodic amounts in another currency based on a floating rate that is reset periodically. All calculations are determined on predetermined notional amounts of the two currencies; often such swaps will involve initial and or final exchanges of amounts corresponding to the notional amounts.

Currency Option. A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to
purchase (in the case of a call) or sell (in the case of a put) a specified amount of a given currency at a specified strike price.

**Currency Swap.** A transaction in which one party pays fixed periodic amounts of one currency and the other party pays fixed periodic amounts of another currency. Payments are calculated on a notional amount. Such swaps may involve initial and or final payments that correspond to the notional amount.

**Equity Forward.** A transaction in which one party agrees to pay an agreed price for a specified quantity of shares of an issuer, a basket of shares of several issuers or an equity index at a future date and the other party agrees to pay a price for the same quantity of shares of an issuer to be set on a specified date in the future. The payment calculation is based on the number of shares and can be physically-settled (where delivery occurs in exchange for payment) or cash-settled (where settlement occurs based on the difference between the agreed forward price and the prevailing market price at the time of settlement).

**Equity Index Option.** A transaction in which one party grants to the other party (in consideration for a premium payment) the right to receive a payment equal to the amount by which an equity index either exceeds (in the case of a call) or is less than (in the case of a put) a specified strike price.

**Equity or Equity Index Swap.** A transaction in which one party pays periodic amounts of a given currency based on a fixed price or a fixed rate and the other party pays periodic amounts of the same currency or a different currency based on the performance of a share of an issuer, a basket of shares of several issuers or an equity index, such as the Standard and Poor's 500 Index.

**Floor Transaction.** A transaction in which one party pays a single or periodic amount and the other party pays periodic amounts of the same currency based on the excess, if any, of a specified per annum rate (in the case of an interest rate floor) or a specified price (in the case of a commodity floor) over a specified floating rate (in the case of an interest rate floor) or commodity price (in the case of a commodity floor).

**Foreign Exchange Transaction.** A transaction providing for the purchase of one currency with another currency providing for a settlement either on a “spot” or two-day basis or a specified future date.

**Forward Rate Transaction.** A transaction in which one party agrees to pay a fixed rate for a defined period and the other party agrees to pay a rate to be set on a specified date in the future. The payment calculation is based on a notional rate and is settled based, among other things, on the difference between the agreed forward rate and the prevailing market rate at the time of settlement.

**Interest Rate Option.** A transaction in which one party grants to the other party (in consideration for a premium payment) the right, but not the obligation, to receive a payment equal to the amount by which an interest rate either exceeds (in the case of a call option) or is less than (in the case of a put option) a specified strike rate.

**Interest Rate Swap.** A transaction in which one party pays periodic amounts of a given currency based on a specified fixed rate and the other party pays pe-
periodic amounts of the same currency based on a specified floating rate that is reset periodically, such as the London inter-bank offered rate; all calculations are based on a national amount of the chosen currency.

**Physical Commodity Transaction.** A transaction which provides for the purchase of an amount of a commodity, such as coal, electricity or gas, at a fixed or floating price for actual delivery on one or more dates.

**Repurchase Transaction.** A transaction in which one party agrees to sell securities to the other party and such party has the right to repurchase those securities from such other party at a future date.

**Securities Lending Transaction.** A transaction in which one party transfers securities to a party acting as the borrower in exchange for a payment or a series of payments from the borrower and the borrower’s obligation to replace the securities at a defined date with identical securities.

**Swap Option.** A transaction in which one party grants to the other party the right (in consideration for a premium payment), but not the obligation, to enter into a swap with certain specified terms. In some cases the swap option may be settled with a cash payment equal to the market value of the underlying swap at the time of the exercise.

**Total Return Swap.** A transaction in which one party pays either a single amount or periodic amounts based on the total return on one or more loans, debt securities or other financial instruments (each a “Reference Obligation”) issued, guaranteed or otherwise entered into by a third party (the “Reference Entity”), calculated by reference to interest, dividend and fee payments and any appreciation in the market value of each Reference Obligation, and the other party pays either a single amount or periodic amounts determined by reference to a specified notional amount and any depreciation in the market value of each Reference Obligation.

**Weather Index Transaction.** A transaction, structured in the form of a swap, cap, collar, floor or some combination thereof, between two parties in which the underlying value of the transaction is based on a rate or index pertaining to weather conditions, which may include measurements of heating, cooling, precipitation and wind.