The Safe Harbors for Swaps and Repurchase Agreements in Bankruptcy

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A. **Purpose of the Safe Harbors.**

The Bankruptcy Code contains certain “safe harbor” provisions which provide special treatment for certain types of financial and other contracts (i.e. swaps, repurchase agreements, forward contracts, securities contracts, and commodities contracts) that are designed to reduce systemic risk in the event that a counterparty becomes a debtor under the Bankruptcy Code. When enacting amendments to these “safe harbor” provisions in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, S.256, 109th Cong. (2005) (the “2005 Amendments”), Congress described “systemic risk” as

“the risk that the failure of a firm or disruption of a market or settlement system will cause widespread difficulties at other firms, in other market segments or in the financial system as a whole. If participants in certain financial activities are unable to enforce their rights to terminate financial contracts with an insolvent entity in a timely manner, or to offset or net their various contractual obligations, the resulting uncertainty and potential lack of liquidity could increase the risk of an inter-market disruption.”

In December 2006, Congress enacted the Financial Netting Improvements Act of 2006, which further amended certain definitions and safe harbor provisions. This paper focuses on the special protections afforded to swaps and repurchase agreements.

B. **Summary of 2005 and 2006 Amendments.**

The Amendments attempt to clarify and expand the existing policy of providing special treatment (the so-called “safe harbors”) for parties to certain types of financial and other contracts, including swaps and repurchase agreements. Congress intended that the Amendments:

1. Expand the types of transactions that are subject to the safe harbors.
2. Expand the safe harbors to include master netting agreements.
3. Expand the types of entities protected.
4. Clarify the remedies available.

C. **Without the Safe Harbors.**

Without the special protection afforded by the Bankruptcy Code, a party to a swap or repurchase agreement with a debtor would be vulnerable in several respects to loss of, or interference with, its rights and remedies by reason of the commencement of a bankruptcy case.

1. **Delay in enforcing rights - The Automatic Stay.** The automatic stay imposed pursuant to Section 362(a) of the Bankruptcy Code would, absent relief from the Bankruptcy Court, prevent the post petition exercise of (i) contractual rights to terminate a swap or

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repurchase agreement, accelerate the obligations of the parties thereunder, sell or recover the underlying securities, and set off the remaining mutual debts and claims under the repurchase agreement and (ii) secured party rights to liquidate and collect against any collateral held to secure the debtor's obligations under a swap or repurchase agreement.

2. **Inability to terminate the contract – The Anti-Ipso Facto Clause Provision.** Section 365(e)(1) of the Bankruptcy Code prohibits a non-debtor counterparty to an executory contract with the debtor from enforcing any contract provision that permits the termination or modification of the contract due to the bankruptcy, insolvency or financial condition of the debtor. The bankruptcy filing thus would not trigger a default or any termination or modification of the swap or repurchase agreement.

3. **Disgorgement of certain pre-petition transfers – Avoidance Actions.** The bankruptcy estate may recover transfers to parties made prior to the commencement of the bankruptcy case under various theories. For example, Section 547 of the Bankruptcy Code allows for the recovery of so-called “preferences” which are payments made to creditors on account of antecedent debt, *inter alia*, within 90 days of the bankruptcy filing while the debtor was insolvent. Section 548 of the Bankruptcy Code permits the recovery of transfers or the avoidance of debt obligations made two years before the bankruptcy filing where the debtor received less than reasonably equivalent value and the debtor was insolvent or was rendered insolvent by the transaction. The counterparty to a swap or repurchase agreement would face potential exposure on account of these types of avoidance claims.

D. **The Safe Harbors for Swaps and Repurchase Agreements.**

1. **Repurchase Agreements.** Section 559 of the Bankruptcy Code provides that, *inter alia*:

   “[t]he exercise of a contractual right of a repo participant or financial participant to cause the liquidation, termination or acceleration of a repurchase agreement because of a condition of the kind specified in section 365(e)(1) of this title shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title, unless, where the debtor is a stockbroker or securities clearing agency, such order is authorized under the provisions of the Securities Investor Protection Act of 1970 or any statute administered by the Securities and Exchange Commission.”

2. **Swaps.** Section 560 of the Bankruptcy Code provides that, *inter alia*:

   “[t]he exercise of a contractual right of any swap participant or financial participant to cause the liquidation, termination or acceleration of one or more swap agreements because of a condition of the kind specified in section 365(e)(1) of this title or to offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of one or
more swap agreements shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or agency in any proceeding under this title."

3. Master Netting Agreements. Section 561 of the Bankruptcy Code provides that, inter alia:

"(a) Subject to subsection (b), the exercise of any contractual right, because of a condition of the kind of specified in Section 365(e)(1), to cause the termination, liquidation, or acceleration of or to offset or not termination values, payment amounts, or other transfer obligations arising under or in connection with one or more (or termination, liquidation, or acceleration of one or more)

a. securities contracts, as defined in section 741(7);

b. commodity contracts, as defined in section 761(4);

c. forward contracts;

d. repurchase agreements;

e. swap agreements; or

f. master netting agreements,

shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by any order of a court or administrative agency in any proceeding under this title."

4. Actions or remedies within the safe harbor. The Amendments clarified that these safe harbor provisions of the Bankruptcy Code protect the rights of termination, liquidation, or acceleration under swap, repurchase agreements, and master agreements. Prior to the Amendments, the Bankruptcy Code was somewhat inconsistent in that it explicitly authorized only the "liquidation" of repurchase agreements and only the "termination" of swaps, which led to possible questions as to the extent of the safe harbor and whether there were differences between Sections 559 and 560. The prior Bankruptcy Code contained no provision concerning master netting agreements.

5. What types of repurchase transactions are covered? Prior to the Amendments, the definition of "repurchase agreements" was limited to repurchase transactions that involved certificates of deposit, eligible bankers' acceptances, and obligations of the United States. Under the Amendments, Section 101(47)(A)(i) expands the definition of "repurchase agreement" to include mortgage loans, mortgage related securities, interests in mortgage loans or mortgage related securities, and foreign government securities:

a. (47) The term repurchase agreement (which definition also applies to reverse repurchase agreements)
(A) means—

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

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

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

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

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

b. The scope is still limited to certain transactions. While broader in scope than the pre-2005 statute, Section 101(47) continues to limit the definition of the term "repurchase agreement" for purposes of the safe harbors to repurchase agreements (a) concerning specific types of securities or instruments and (b) that are terminable on demand or have a term of one year or less.

c. Master agreements and certain other related agreements are included. The Amendments clarified that master agreements, security agreements, guarantees, other credit enhancement arrangements and options related to a repurchase agreement are part of the protected repurchase agreements. However, a master agreement governing transactions of which only some of the agreements qualify as repurchase agreements is itself a repurchase agreement only to the transactions which qualify as repurchase agreements on their own. Thus, a protected party cannot obtain protection for a non-repurchase agreement simply by documenting it under a master agreement which governs repurchase agreements.

d. Expansion provides possible new bankruptcy protected financings. A repurchase agreement with respect to residential mortgages is now within the safe harbors for repurchase agreements. Thus, a repo involving mortgages is conferred protection, which could substitute for the usual special purpose entity structure with true sale/non-consolidation issues.

e. Commercial Mortgage Loans Excluded. Section 101(47)(B) excludes from the scope of the safe harbors "a repurchase obligation under a participation in a commercial mortgage loan."
(II) a spot, same day-tomorrow, tomorrow-next, forward or other foreign exchange, precious metals, or other commodity agreement;

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

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

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

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

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

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

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

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

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

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

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

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

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

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

b. Future Swap Products. The expanded definition attempts to include future products by covering similar agreements that become the subject of "recurrent dealings in the swap or other derivative markets." Issues nonetheless may arise as to what "recurrent dealings" mean.

c. Total Return and Other Credit Swaps. Can be used as credit support in a securitization or asset-backed commercial paper financing with added protections of the safe harbor. Lender should be able to realize on collateral without stay or avoidance risk. As with repos involving residential mortgages, this could provide a substitute for a special purpose entity structure.

7. What parties are protected? These safe harbors are available to a "repo participant," "swap participant" or "financial participant."

a. A "repo participant" is an entity that "at any time before the filing of the petition, has any outstanding repurchase agreement with the debtor." 11 U.S.C. § 101(46). Similarly, a "swap participant" is an entity that "at any time before the filing of the petition, has an outstanding swap agreement with the debtor." 11 U.S.C. § 101(53C). Thus, essentially any entity that is a party to a repurchase agreement or swap agreement with the debtor likely will have the protections of Sections 559 and 560.
b. A "financial participant" is defined in Section 101(22A) 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 agreements or transactions described in paragraph (1), (2), (3), (4), (5), or (6) of section 561(a) with the debtor or any other entity (other than an affiliate) of a total gross dollar value of not less than $1,000,000,000 in notional or actual principal amount outstanding (aggregated across counterparties) at such time or on any day during the 15-month period preceding the date of the filing of the petition, or has gross mark-to-market positions of not less than $100,000,000 (aggregated across counterparties) in one or more such agreements or transactions with the debtor or any other entity (other than an affiliate) at such time or on any day during the 15-month period preceding the date of the filing of the petition; or

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

c. Congress added "financial participants" as protected parties in order to limit the potential impact of insolvencies upon other major market participants. This definition will allow "financial participants" to close-out and net agreements with insolvent entities relating to those enumerated contracts and master netting agreements, even if the counterparty could not qualify under the old Bankruptcy Code's counterparty requirements that the entity qualify as a "swap participant," "repo participant," "forward contract merchant," "commodity broker," "stockbroker," "securities clearing agency" and/or "financial institution." H.R. Rep. No. 109-31 § 5907. Given the broad nature of the definition of a swap or repo participant, the inclusion of the financial participants in Sections 559 and 560 is not that significant. It does have significance with respect to commodities and forward contract transactions where the definition of market participants is narrower and geared to those that are in the commodities or forward contract business.

E. The Remedies Protected by the Safe Harbors.

1. Bankruptcy stay prevents termination of agreements. Absent the special protections afforded by Sections 559 and 560, post petition exercise of contractual rights would be stayed by the automatic stay imposed pursuant to Section 362(a). The stay would thus cause the party to a repurchase or swap agreement with a debtor to be exposed to potentially adverse market price movement and, in some cases, illiquidity. The situation from the perspective of such a party is worsened by the prospect that, inasmuch as the repurchase agreement is likely an
executory contract, the contract may be subject to assumption or rejection by the debtor pursuant to Section 365.

Consequently (a) the party does not know when and whether the debtor will choose to perform its obligations under the repurchase or swap agreement, thus making effective hedging of its position difficult or impossible (although it can predict that the debtor will assume if the market has moved in its favor and against the party’s, and vice versa); and (b) there is a risk that the debtor will attempt to exercise assumption and rejection selectively to assume the repurchase or swap agreements that have proven to be profitable to it and reject the others (thus exacerbating the party’s losses by depriving it of the right to set off amounts owing by it on the assumed trades profitable to the debtor against its claims for the rejected trades not profitable to the debtor).

2. The safe harbors allow termination of swap and repurchase agreements as well as the exercise of other rights. Sections 559 and 560 provide that the exercise by a protected party of a “contractual right” to liquidate, terminate and accelerate a repurchase or swap agreement that is triggered by a “condition of the kind specified in section 365(e)(1) of this title” cannot be stayed, avoided or otherwise limited by the automatic stay, any other provision of the Bankruptcy Code, or by order of the Bankruptcy Court. Most repurchase and swap agreements afford a non-defaulting party the right to “close-out” or “liquidate” the agreement upon the other party’s default. Such a close-out or liquidation typically entails terminating or cancelling the repurchase and swap agreement, fixing the damages suffered by the non-defaulting party based on market conditions at the time of the liquidation, and accelerating the required payment date of the net amount of the remaining obligations and damages. Sections 559 and 560 allow the non-debtor party to implement these contractual remedies.

3. Source of the rights and remedies. The source of repurchase and swap agreement liquidation, termination and acceleration rights will often be a written agreement or other document, such as a customer agreement, master agreement or the terms and conditions printed on a confirmation of the transaction. Sections 559 and 560 do not independently furnish such rights. In some instances, market custom and usage, exchange rules or clearing corporation rules will supply the rights. Sections 559 and 560 make clear that the term “contractual right” is not limited to a right contained in an actual written contract, but also includes a right from these other sources that may be applicable to the transaction. Nevertheless, it is good practice to include such a right in a written contract between the parties to avoid possible dispute as to the existence and terms thereof.

4. Counterparty must return excess property. Section 559 provides that any amount received upon the liquidation, termination and acceleration of a repurchase agreement that exceeds the sum of the repurchase price provided in the repurchase agreement and the expenses of liquidating such agreement are deemed property of the debtor’s estate (subject to any available rights of setoff). Thus, a protected party will have a duty to return to the debtor’s bankruptcy estate any sum in excess of the repurchase price for the benefit of creditors.
F. What kind of default allows the counterparty to act?

Sections 559 and 560 do not protect the exercise of liquidation, termination and acceleration rights contained in repurchase agreements for all kinds of defaults. Rather, they protect only rights triggered by "a condition of the kind specified in section 365(e)(1)" (i.e., so-called *ipso facto* clauses or bankruptcy defaults). Sections 559 and 560 allow protected parties to act based on *ipso facto* clauses. Accordingly, protected parties should include appropriate bankruptcy defaults in their repurchase and swap agreements to insure availability of the safe harbor protections.

G. Limitation to self-help remedies.

1. Although Sections 559 and 560 provide powerful protections enabling a protected party to enforce its remedies without interference, it does not require the debtor to cooperate or do anything. Thus, the remedies are effectively limited to various forms of self-help. If the remedy is dependent upon any action by the debtor, no matter how ministerial, the debtor is not required to act, and the protected party may be required to seek relief from the Bankruptcy Court to direct the debtor to act to effectuate the remedy (and the safe harbor provisions do not expressly require the court to grant such relief).

2. For example, if a protected party wants to sell securities to recover damages under a repurchase or swap agreement, it may be delayed or prevented from selling the securities if they remain in the possession or under the control of the debtor or the debtor’s cooperation is otherwise required.

H. Setoff Rights.

1. Sections 362(b)(7), (17) and (27) exempt from the effects of the automatic stay the contractual rights of a protected party to a repurchase agreement, swap, or master netting agreement.

2. The counterparty may exercise any of its contractual rights under its protected agreements including any security agreement or arrangement, or other credit enhancement, in addition to its rights to offset and net out payments.

3. Some believe that the purpose of Sections 362(b)(7), (17) and (27) is to permit a protected party to exercise whatever rights of setoff and rights as a secured party that it may have to recover its claims against the collateral. There is no express requirement that such property be liquid or marketable, although it is customary to have liquid collateral (e.g., cash and securities) in these types of transactions. For example, can a swap or repo participant foreclose liens on collateral such as real estate, equipment or receivables? The statutory language is not entirely clear and the courts have not yet spoken on this issue.

4. In the Amendments, Congress also added Section 362(o) which reinforces the point by providing that the Court may not affirmatively stay any exercise of rights that is not subject to automatic stay by virtue of Sections 362(b)(6), (7), (17), or (27).
I. Protection from Avoidance Powers.

1. Safe Harbors of Sections 546(f) and (g).
   
a. Repurchase Agreements. Section 546(f) of the Bankruptcy Code provides that the trustee may not avoid under Section 544, 547 or 548 a transfer to or for the benefit of a repo participant or financial participant under or in connection with a repurchase agreement, except for transfers that are actual fraudulent transfers made to hinder, delay or defraud creditors.

b. Swaps. Section 546(g) of the Bankruptcy Code provides that the trustee may not avoid under Section 544, 547 or 548 a transfer to or for the benefit of a swap participant or financial participant under or in connection with a swap agreement, except for transfers that are actual fraudulent transfers made to hinder, delay or defraud creditors.

c. Master Agreements. The Amendments added Section 546(j) which contains a similar safe harbor with respect to transfers under a master netting agreement.

2. Actual Fraudulent Transfers. Even in situations where the debtor may have made an actual fraudulent transfer, Section 548(d)(2) of the Bankruptcy Code contains further protection by deeming a transfer to a repo or swap participant in connection with a repurchase agreement or swap to be for value. Thus, if the repo or swap participant can show that it took the transfer in good faith, it will have a defense under Section 548(c) to the actual fraudulent transfer claim.

J. Safe Harbors Apply in Cross-Border Insolvency Cases.

The various safe harbor provisions concerning swaps and repurchase agreements also apply in a cross-border insolvency case. In that connection, Section 561(d) of the Bankruptcy Code (which was included in the 2005 Amendments) provides that any of the provisions:

"relating to securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements or master netting agreements shall apply in a case under chapter 15, so that enforcement of contractual provisions of such contracts and agreements in accordance with their terms will not be stayed or otherwise limited by operation of any provision of this title or by order of a court in any case under this title, and to limit avoidance powers to the same extent as in a proceeding under chapter 7 or 11 of this title (such enforcement not to be limited based on the presence or absence of assets of the debtor in the United States)."