

## FINANCIAL CONTRACTS UNDER THE U.S. BANKRUPTCY CODE

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The U.S. Bankruptcy Code has addressed so-called financial contracts by giving them special treatment under the Bankruptcy Code. Financial contracts consist of securities contracts, commodity and forward contracts, repurchase agreements and swap agreements. The special treatment has been, in the event of a debtor's bankruptcy, to immunize non-debtor counterparties to financial contracts with the debtor from the automatic stay, ipso facto clauses and most avoidance actions.

This paper<sup>1</sup> discusses the key financial contract provisions as they existed prior to the amendments made by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "*2005 Amendments*"), the changes to the financial contract provisions made by the 2005 Amendments, and the further changes to the financial contract provisions made in 2006 by the Financial Netting Improvements Act of 2006 (the "*2006 Amendments*").

### I. SECURITIES CONTRACTS

Background: A securities contract is generally a contract for the purchase, sale or loan of a security.

Before the 2005 Amendments: A "security" is defined broadly in § 101(49).<sup>2</sup> A "securities contract", as defined in § 741(7), included an option to purchase as well as a contract for the purchase or sale of not only a security but also a certificate of deposit. Section 555 permitted a stockbroker, financial institution (defined in § 101(22) to include not only a bank or savings and loan association but also a registered investment company) or clearing agency to cause the liquidation of a securities contract upon an "ipso facto" default otherwise rendered unenforceable under § 365(e)(1). The liquidation of the securities contract and, under § 362(b)(6), any setoff of a mutual debt or claim arising from the liquidation could be accomplished free of the automatic stay and without risk of avoidance. In addition, any prepetition "margin payment" or "settlement payment" could not under § 546(e) be avoided as a preference or as a constructive fraudulent transfer. The terms "margin payment" and "settlement payment" are defined in §§ 741(5) and (8) to include a broad array of payments commonly used in a securities trade.<sup>3</sup>

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<sup>1</sup> An earlier version of this paper was included in an October 2006 report to the National Bankruptcy Conference by its Capital Markets Committee chaired by the author.

<sup>2</sup> Section references, unless otherwise indicated, are to the Bankruptcy Code.

<sup>3</sup> The exchange of stock for a consideration in a leverage buyout transaction has been held to be a settlement payment insulating the payment from being challenged as a constructive fraudulent transfer. *See, e.g., In re Kaiser Steel Corp.*, 952 F.2d 1230 (10th Cir. 1991). There are, however, cases to the contrary.

The 2005 Amendments: The definition of “securities contract” was expanded to include (a) a contract for the purchase or sale, or an option on, a mortgage loan, (b) a repurchase transaction or reverse repurchase transaction for a security, certificate of deposit or mortgage loan, and (c) a margin loan. The class of non-debtor parties protected by § 555 was expanded to include a “financial participant” in addition to a stockbroker, financial institution or clearing agency. A financial participant, as defined in § 101(22A), is a “big boy player” with financial contracts with the debtor and others at any one time outstanding during the 15-month period prior to the debtor’s petition date of not less than \$1 billion on a gross notional or principal amount basis or \$100 million on a mark-to-market basis. Section 555 was also clarified to permit “termination” and “acceleration”, in addition to “liquidation”, of a securities contract upon the occurrence of an “ipso facto” default and to include for protection a default arising under an exchange or clearing house rule in addition to the contract itself. A new provision - § 561 - was added to permit so-called “cross-product” netting so that a payment due under any type of financial contract with the debtor may be netted against a payment owing under another type of financial contract so long as the netting was permitted by a so-called “master netting agreement” as defined in new § 101(38B). A new § 362(o) was added to eliminate the ability of a court affirmatively to enjoin enforcement by the non-debtor party of any type of financial contract.<sup>4</sup>

The 2006 Amendments: The 2006 Amendments have clarified that, for a repurchase transaction or reverse repurchase transaction for a security, certificate of deposit or mortgage loan to qualify as a “securities contract”, the repurchase transaction or reverse repurchase transaction need not also qualify as a “repurchase agreement” as defined in § 101(47).<sup>5</sup> The definition of “securities contract” has been expanded to include any loan transaction if coupled with a collar related to securities, any prepaid forward transaction related to securities, and any total return swap coupled with a sale transaction related to securities. The exception in § 362(b)(6) to the automatic stay has been clarified, or expanded beyond mere setoff,<sup>6</sup> to include any exercise of a contractual right by the non-debtor protected counterparty under any security agreement or arrangement or other credit enhancement associated with the securities contract to offset or net out any termination payment.<sup>7</sup> The limitations on avoiding powers in § 546 have

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<sup>4</sup> For example, new § 362(o) does not permit an injunction against enforcement by the non-debtor counterparty to be issued under § 105.

<sup>5</sup> The amendment is consistent with the legislative history to § 555 and with case law. Accordingly, a repurchase or reverse repurchase transaction could still qualify as a “securities contract” even if the purchase or sale back of the security, certificate of deposit or mortgage loan was to occur more than one year after the original sale. See § 101(47)(A)(i). However, the universe of non-debtor counterparties eligible for protection under § 555 with respect to “securities contracts” is narrower than the universe of non-debtor counterparties eligible of protection under § 559 with respect to “repurchase agreements.”

<sup>6</sup> The amendment is merely a clarification to the extent that § 555 was viewed already to include the exercise of a contractual right under a securities contract by the non-debtor protected counterparty. The exercise of a contractual right includes the right to enforce a contractual security interest in any collateral securing the debtor counterparty’s obligations under a securities contract.

<sup>7</sup> The amendment might be interpreted to permit contractual “cross-affiliate” netting (or clarify that it is already permitted).

been expanded to insulate from avoidance as a preference or constructive fraudulent any transfer made “for the benefit” of a member of the protected class.<sup>8</sup>

## II. COMMODITY AND FORWARD CONTRACTS

Background: A commodity contract is generally an exchange-traded contract entered into for the purchase or sale of a commodity at a future date. A forward contract is generally an over-the-counter contract for the purchase or sale of commodity or a like asset at a future date.

Before the 2005 Amendments: A “commodity” is defined in § 761(8) as a “commodity” as defined in the Commodity Exchange Act.<sup>9</sup> A “commodity contract”, as defined in § 761(4), generally involved a trade on a commodities exchange and a professional, such as a future commissions merchant, as defined in § 101(26), as a party to the trade. The term also included a commodity option with respect to a commodity options dealer. A “forward contract”, as defined in § 101(25), excluded a commodity contract and generally involved an over-the-counter transaction. If the contract was for the purchase, sale or transfer of a commodity or like asset at a future date of more than two days after the contract was entered into and was not a commodity contract, it was a forward contract. Section 556 permitted a commodity broker or forward contract merchant to cause the liquidation of a commodity contract or forward contract upon an “ipso facto” default otherwise rendered unenforceable under § 365(e)(1). The liquidation of the commodity contract or forward contract and, under § 362(b)(6), any setoff of a mutual debt or claim arising from the liquidation could be accomplished free of the automatic stay and without risk of avoidance. In addition, any prepetition “margin payment” or “settlement payment” could not under § 546(e) be avoided as a preference or as a constructive fraudulent transfer. A “margin payment is defined in § 101(38), 741(5) or 761(15) as any type of what the trade calls a margin payment (whether original, initial, maintenance or variation) or as any other payment that secures an obligation of a participant in a securities clearing agency. A “settlement payment” is defined in § 101(51A) as any payment commonly used in a forward trade.

The 2005 Amendments: The definitions of “commodity contract” and “forward contract” were expanded to include similar transactions and options to enter into commodity contracts or, as the case may be, forward contracts and similar transactions. The class of non-debtor parties protected by § 556 was expanded to include a “financial participant”. Section 556 was also clarified to permit “termination” and “acceleration”, in addition to “liquidation”, of a commodity contract or forward contract upon the occurrence of an “ipso facto” default and for the default to

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<sup>8</sup> For example, if the obligations of a debtor under a securities contract are supported by a letter of credit for which the issuer has obtained a secured reimbursement obligation, the letter of credit proceeds, to the extent of the collateral securing the reimbursement obligation, may not be subject to being returned to the debtor’s estate as a preference. See In re Compton Corp., 831 F.2d 586 (5th Cir. 1987), and In re Air Conditioning, Inc. of Stuart, 55 B.R. 157 (Bankr. S.D. Fla. 1985), rev’d in part, 72 B.R. 657 (S.D. Fla. 1987), aff’d, 845 F.2d 293 (11th Cir. 1988), cert. den. 488 U.S. 993 (1988).

<sup>9</sup> Section 1a of the Commodity Exchange Act defines a “commodity” generally as wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Irish potatoes, wool, wool tops, fats and oils, cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in.

arise under an exchange or clearing house rule in addition to the contract itself. A new provision - § 561 - was added to permit so-called “cross-product” netting so that a payment due under any type of financial contract with the debtor may be netted against a payment owing under another type of financial contract so long as the netting was permitted by a so-called “master netting agreement” as defined in new § 101(38B). A new § 362(o) was added to eliminate the ability of a court affirmatively to enjoin enforcement by the non-debtor party of any type of financial contract.

The 2006 Amendments: The exception in § 361(b)(6) to the automatic stay has been clarified, or expanded beyond mere setoff,<sup>10</sup> to include any exercise of a contractual right by the non-debtor protected counterparty under any security agreement or arrangement or other credit enhancement associated with the commodity contract or forward contract to offset or net out any termination payment. The limitations on avoiding powers in § 546 have been expanded to insulate from avoidance as a preference or constructive fraudulent any transfer made “for the benefit” of a member of the protected class.

### III. REPURCHASE AGREEMENTS

Background: A repurchase agreement (or “repo”) is generally a contract for the sale of a security or instrument with an obligation by the seller to buy back, and the buyer to resell, the security, instrument or an equivalent security or instrument at a higher price at a future date. The price increment represents a financing spread. A reverse repurchase agreement (or “reverse repo”) is the same transaction from the perspective of the other party. Market practice is to call a transaction a repo if the dealer is the seller and to call it a reverse repo if the dealer is the buyer. As described below, the Bankruptcy Code’s definition of “repurchase agreement” does not include all repos and reverse repos.

Before the 2005 Amendments: A “repurchase agreement”, as defined in § 101(47), included reverse repurchase agreements and was limited to transactions involving U.S. government and agency issued or guaranteed securities, certificates of deposit and eligible bankers’ acceptances where the sale or purchase back of the asset was to occur one year or less from the original transfer, including transactions terminable upon demand. Section 559 permitted a repo participant to cause the liquidation of a repurchase agreement upon an “ipso facto” default otherwise rendered unenforceable under § 365(e)(1). The liquidation of the repurchase agreement and, under § 362(b)(7), any setoff of a mutual debt or claim arising from the liquidation could be accomplished free of the automatic stay and without risk of avoidance. In addition, any prepetition “margin payment”, as defined in § 741(5) or 761(15), could not under § 546(f) be avoided as a preference or as a constructive fraudulent transfer.

The 2005 Amendments: The definition of “repurchase agreement” was expanded to include (a) a transaction in a mortgage loan or interest, (b) any option to enter into a repurchase

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<sup>10</sup> The amendment is merely a clarification to the extent that § 556 was viewed already to include the exercise of a contractual right under a commodity or forward contract by the non-debtor protected counterparty. The exercise of a contractual right includes the right to enforce a contractual security interest in any collateral securing the debtor counterparty’s obligations under a commodity or forward contract.

agreement or (c) any security agreement or arrangement or other credit enhancement in connection with a repurchase agreement. The class of non-debtor parties protected by § 559 was expanded to include a “financial participant”. Section 559 was also clarified to permit “termination” and “acceleration”, in addition to “liquidation”, of a repurchase agreement upon the occurrence of an “ipso facto” default and for the default to arise under an exchange or clearing house rule in addition to the contract itself. A new provision - § 561 - was added to permit so-called “cross-product” netting so that a payment due under any type of financial contract with the debtor may be netted against a payment owing under another type of financial contract so long as the netting was permitted by a so-called “master netting agreement” as defined in new § 101(38B). A new § 362(o) was added to eliminate the ability of a court affirmatively to enjoin enforcement by the non-debtor party of any type of financial contract.

The 2006 Amendments: The exception in § 361(b)(7) to the automatic stay has been clarified, or expanded beyond mere setoff,<sup>11</sup> to include any exercise of a contractual right by the non-debtor protected counterparty under any security agreement or arrangement or other credit enhancement associated with a repurchase agreement to offset or net out any termination payment. The limitations on avoiding powers in § 546 have been expanded to insulate from avoidance as a preference or constructive fraudulent any transfer made “for the benefit” of a member of the protected class.

#### IV. SWAP AGREEMENTS

Background: A swap agreement is generally a contract by which one party makes a payment to another party based on the performance of a notional security or an economic or financial index. A typical example would be an interest rate swap by which the first party periodically makes a payment to the second party calculated as the product of a specified variable interest rate and a notional amount, and the second party periodically makes a payment to the first party calculated as the product of a specified fixed rate and the same notional amount. The payments may be made on a gross or net basis depending upon the agreement of the parties.

Before the 2005 Amendments: A “swap agreement” was defined in § 101(53B) as a rate swap agreement, basis swap, forward rate agreement, commodity swap, interest rate option, forward agreement, rate floor, rate collar, cross-currency rate swap or any other similar agreement. Section 560 permitted a swap participant, defined in § 101(53C) as an entity that has a swap agreement with the debtor, to cause the liquidation of a swap agreement upon an “ipso facto” default otherwise rendered unenforceable under § 365(e)(1). The liquidation of the swap agreement and, under § 362(b)(17), any setoff of a mutual debt or claim arising from the liquidation could be accomplished free of the automatic stay and without risk of avoidance. In addition, any prepetition transfer to a swap participant under a swap agreement could not under § 546(g) be avoided as a preference or as a constructive fraudulent transfer.

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<sup>11</sup> The amendment is merely a clarification to the extent that § 559 was viewed already to include the exercise of a contractual right under a repurchase agreement by the non-debtor protected counterparty. The exercise of a contractual right includes the right to enforce a contractual security interest in any collateral securing the debtor counterparty’s obligations under a repurchase agreement.

The 2005 Amendments: The definition of “swap agreement” was expanded to include specific references to broad categories of transactions which the market customarily includes in the category of swap agreement including a foreign exchange or precious metals agreement (whether spot or future), a currency swap, an equity index agreement, a credit swap, a total return swap, a weather swap, any option to enter into a swap agreement and any security agreement or arrangement or credit enhancement of a swap agreement. In addition, the term includes any similar agreement that “presently, or in the future becomes, the subject of recurrent dealings in the swap markets” and is a forward, swap, future or option on a security or other financial instrument associated with an event or contingency relating to an economic or financial index or measurement or financial risk or value. The class of non-debtor parties protected by § 560 was expanded to include a “financial participant”. Section 560 was also clarified to permit “termination” and “acceleration”, in addition to “liquidation”, of a swap agreement upon the occurrence of an “ipso facto” default and for the default to arise under an exchange or clearing house rule in addition to the contract itself. A new provision - § 561 - was added to permit so-called “cross-product” netting so a payment due under any type of financial contract with the debtor may be netted against a payment owing under another type of financial contract so long as the netting was permitted by a so-called “master netting agreement” as defined in new § 101(38B). A new § 362(o) was added to eliminate the ability of a court affirmatively to enjoin enforcement by the non-debtor party of any type of financial contract.

The 2006 Amendments: The 2006 Amendments have added additional specific references to categories of swap transactions, such as emissions and inflation swaps, to the definition of “swap agreement”. The exception in § 361(b)(17) to the automatic stay has been clarified, and expanded beyond mere setoff,<sup>12</sup> to include any exercise of a contractual right by the non-debtor protected counterparty under any security agreement or arrangement or other credit enhancement associated with the swap agreement to offset or net out any termination payment. The limitations on avoiding powers in § 546 have been expanded to insulate from avoidance as a preference or constructive fraudulent any transfer made “for the benefit” of a member of the protected class.

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<sup>12</sup> The amendment is merely a clarification to the extent that § 560 was viewed already to include the exercise of a contractual right under a swap agreement by the non-debtor protected counterparty. The exercise of a contractual right includes the right to enforce a contractual security interest in any collateral securing the debtor counterparty’s obligations under a swap agreement.