



CONTRIBUTOR

**McDermott
Will & Emery**

ARTICLE



Share



Follow



Question



Print



Translate

United States: The Effect of the new Bankruptcy Code on Safe Harbor Transactions

29 November 2005

by [Nathan F. Coco](#), [Kenneth Irvin](#) and [Peter Malyshev](#)

McDermott Will & Emery

Your [LinkedIn Connections](#)
with the authors

On October 17, 2005, the provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the 2005 act) became effective, amending various provisions of the U.S. Bankruptcy Code, 11 U.S.C. §§ 101-1532 (the bankruptcy code). All bankruptcy cases filed after October 17, 2005 are now governed by the amendments set forth in the 2005 act. Although the majority of the amendments address consumer bankruptcies, the 2005 act has far-reaching implications for business bankruptcies as well. Of particular significance are the provisions of the 2005 act that address the bankruptcy treatment of various "safe harbor" transactions, such as forward contracts, commodity contracts, repurchase agreements and securities contracts.

Prior to the enactment of the 2005 act, those safe harbor transactions were already granted special protections under the bankruptcy code. For example, a party deemed to be a "forward contract merchant" was entitled to enforce its contractual rights of setoff with respect to forward contracts, notwithstanding the bankruptcy filing by a counterparty. Likewise, a party deemed to be a "swap participant" was entitled to enforce its contractual rights of setoff with respect to swap agreements, notwithstanding the bankruptcy filing by a counterparty. Absent these safe harbor provisions, bankruptcy sections 362 and 365 would generally preclude a forward contract merchant or swap participant from liquidating its forward contract or swap agreement positions with a bankrupt counterparty, or from realizing against any property posted as collateral, without first obtaining relief from the automatic stay from the bankruptcy court. However, the protections for safe harbor transactions were further broadened and, in some cases, clarified under the 2005 act. Among other things, the 2005 act expands the category of contracts that qualify for the special protections under the bankruptcy code and provide express authorization for cross-product netting among protected transactions (*i.e.*, swap agreements, forward contracts, commodity contracts, repurchase agreements and securities contracts) under a "master netting agreement." As a result, the changes impact both how safe harbor transactions are structured, as well as how those contracts are drafted.

The implications for commodities, derivatives, swaps and forward contract merchants of the 2005 act are summarized below.

Cross-Product Netting

Prior to the enactment of the 2005 act, there was active debate among commentators and industry participants as to whether a proper construction of the then-existing safe harbor provisions permitted netting across various safe harbor transactions and contracts. Because "forward contracts" and "swap agreements" were subject to separate and distinct safe harbor provisions under the bankruptcy code, and those safe harbor provisions are worded differently from one another, there was uncertainty as to whether a non-debtor party may net and set off mutual obligations under both forward contracts and swap agreements, collectively, under a single master agreement. Title IX of the 2005 act, which made extensive revisions to the bankruptcy code, the Federal Deposit Insurance Act and the Federal Credit Union Act, resolved the issue of cross-product netting.

The 2005 act amended the bankruptcy code by adding a new section 561 that specifically preserves the contractual right to terminate, liquidate, accelerate or offset under a "master netting agreement" and across all species of safe harbor contracts. The new category of a "master netting agreement" is defined as "an agreement providing for the exercise of rights, including rights of netting, setoff, liquidation, termination, acceleration, or close out, under or in connection with one or more contracts . . .," including swap agreements, forward contracts and commodity contracts. The amendments under the 2005 act preserve the contractual right of a master netting agreement participant to terminate, liquidate, accelerate or set off among safe harbor transactions (*i.e.*, swap agreements, forward contracts, commodity contracts, repurchase agreements and securities contracts) and state that these rights "shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by any order court or administrative agency in any proceeding under this title."

Note that the 2005 act broadened the netting, setoff and close-out provisions with respect to each of these derivatives contracts by also authorizing termination, liquidation and acceleration of these agreements.

New Protected Category of Counterparty Consistent with FDICIA

Prior to the enactment of the 2005 act, parties typically negotiated the so-called FDICIA reps, *i.e.*, representations that both parties are "financial institutions" and therefore can rely on protections of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) section 403 that specifically authorizes cross-product bilateral netting of "qualified financial contracts" for such participants (*e.g.*, see the "Survey of Legal Landscape Applicable to the EEI Master Netting Agreements"). The standard for qualification as a "financial institution" is relatively high under FDICIA: at least \$1 billion in notional principal value of derivative contracts or not less than \$100 million in gross mark-to-market positions (aggregated across all counterparties) during the preceding 15 months with counterparties that are not its affiliates. In order to ensure consistency with FDICIA, the 2005 act amended the bankruptcy code to include "financial participant" as a new category of counterparty that can rely on the safe harbor provisions of the code in addition to the existing categories such as a "forward contract merchant" or "swap participant." The standard for qualification as a "financial participant" under the bankruptcy code essentially is the same as a "financial institution" under FDICIA.

Updated and Expanded Definitions

The definitions of various safe harbor contracts have been broadened in line with the recent developments in financial engineering to capture newly developed products and their combinations. For example, the term "swap agreement" includes many types of rate swaps, equity index or equity swaps, total return, credit spread or credit swaps, as well as weather derivatives. Any combination of these undertakings, or options on them, would also qualify under the expanded definition of "swap agreement."

In addition, a master agreement, a portion of a master agreement or a security arrangement under a swap agreement also qualifies as a "swap agreement" within the meaning of the bankruptcy code. As a result of this amendment, a broader range of products will qualify as safe harbor contracts. For example, an ISDA (International Swaps and Derivatives Association, Inc.) agreement with a power or a gas annex could be considered one "swap agreement."

Contractual Rights to Net, Setoff and Close-Out

As was the case before the 2005 act, the bankruptcy code does not grant any new rights with respect to safe harbor contracts (which are generally treated as executory contracts)—it merely allows counterparties to enforce existing contractual rights without regard to the automatic stay and other provisions of the bankruptcy code that would otherwise hinder the exercise of such rights. Thus, unless a safe harbor contract provides for a right to terminate, liquidate and close out the contract in the event of a bankruptcy, a counterparty will not be able to do so. The 2005 act recognizes as "contractual rights" under a master netting agreement the rules and bylaws of derivatives or securities clearing organizations, securities and commodities exchanges, national securities associations (*i.e.*, the National Association of Securities Dealers, or NASD), as well as rights under common law, law merchant and normal business practice. For instance, a person clearing a swap agreement on the New York Mercantile Exchange (NYMEX) that is documented under a short-form confirmation without a master netting agreement would be able to rely on the exchange's clearing rules as "contractual rights" under section 561 of the bankruptcy code.

Timing of Damage Measurement for Derivatives Contracts

Prior to the enactment of the 2005 act, the bankruptcy code did not specify the date as of which damages should be calculated if a safe harbor contract was terminated by a counterparty or rejected by the debtor. This created uncertainty, not to mention litigation, as to whether damages should be calculated as of the petition date for the bankruptcy case or the actual date of termination or rejection. (See, for example, *In re Enron Corp.*, 330 B.R. 387 (Bankr. S.D.N.Y. 2005) and *In re Mirant Corp.*, 303 B.R. 319 (Bankr. N.D. Tex. 2003)). The 2005 act added a new section 562, which clarifies that damages are to be calculated at the earlier of termination or rejection date of a derivative contract.

Forward Contract Merchant and Governmental Entities

The 2005 act revised the term "forward contract merchant" in the bankruptcy code by deleting the reference to a "person" and replacing it with an "entity." Note that the definitions of "repo participant" and "swap participant" already refer to "entities" and not "persons" and, likewise, the new definitions of "financial institution" and "financial participant" also refer to entities, not people. As a result, "governmental entities," such as a municipality or an interstate governmental authority, now qualifies as "forward contract merchants." (See *In re Mirant Corp.*) Further, the "new" bankruptcy code safe harbor provisions in sections on securities, commodities, forward

contracts, repurchase agreements and swaps apply to bankruptcies involving municipalities.

Cross-Border Cases

The 2005 act added a new chapter on cross-border cases. This new chapter 15 enables U.S. bankruptcy courts to recognize foreign insolvency proceedings.

Utilities and FERC

Prior to the 2005 act, there was much tension between bankruptcy and the federal energy regulatory laws, which typically trumped bankruptcy law due to the public interest nature of providing power to consumers. For example, if a utility attempted to terminate a wholesale power contract with the debtor or a debtor filed a motion in the bankruptcy court to reject such contract as an "executory contract," its customers would petition the Federal Energy Regulatory Commission (FERC) to enjoin the utility from ceasing to provide service. For example, in the case of *In re NRG Energy Inc.* (2003 U.S. Dist. LEXIS 11111 (S.D.N.Y. 2003)) the bankruptcy court declined to vacate a FERC order that ordered the bankrupt power marketer, NRG Energy, Inc., to continue to provide services to Connecticut Light & Power Company. (Also see *In The Matter Of: Mirant Corp.*, 378 F.3d 511 (5th Cir. 2004)).

The 2005 act amended section 366 of the bankruptcy code in three ways: first, it clarified that a utility may terminate its services to a debtor if such debtor does not provide adequate assurance of payment within 30 days of filing; second, it clarified what would and would not constitute "adequate assurance"; and finally, it specifically authorized utilities to set off any debtor's security deposit provided before filing for a petition.

Additional Conforming Amendments

The 2005 act made a number of conforming revisions to accommodate broader exemptions. Specifically, it clarified in section 362 that the automatic stay provisions do not apply to master netting agreements, and under section 546 a trustee cannot avoid a transfer by a financial participant in connection with a swap agreement. Further, section 548 adds a provision clarifying the meaning of "for value" with respect to a master netting agreement.

Conforming Amendments to Federal Deposit Insurance Act and Federal Credit Union Act

The 2005 act also amended the Federal Deposit Insurance Act and the Federal Credit Union Act. The 2005 act clarifies that "walk-away" clauses are ineffective under both these acts. The 2005 act also amended the Federal Deposit Insurance Act and the Federal Credit Union Act. The 2005 act clarifies that "walk-away" clauses are ineffective under both these acts (*i.e.*, clauses allowing the performing party to avoid paying to the defaulting party solely because that party is defaulting).

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

AUTHOR(S)



Nathan F. Coco
McDermott Will &
Emery



Kenneth Irvin
McDermott Will &
Emery



Peter Y. Malyshev
McDermott Will &
Emery



ARTICLE TAGS

[United States](#)[Accounting and Audit](#)[Consumer Protection](#)[Consumer Law](#)[Finance and Banking](#)[Commodities/Derivatives/Stock Exchanges](#)[Insolvency/Bankruptcy/Re-structuring](#)[Insolvency/Bankruptcy](#)

POPULAR ARTICLES ON: Finance and Banking from United States

[Social Security's Looming Crisis: Understanding The Problem And The Proposed Solutions](#)

ORBA

The future of Social Security is a topic of concern due to the program's impending insolvency. There are several proposals to address the issue, including increasing the payroll tax rate...

[Alternative Equity Offering Structures Provide Access To Capital As Markets Remain Challenged](#)

Katten Muchin Rosenman LLP

Global equity markets continue to navigate the dueling impacts of inflation, rising interest rates and a slowing economy. While the market for initial public offerings initially...

[Private Credit Insights: Exploring The Challenges Of Side Letters In Financing Transactions](#)

Akin Gump Strauss Hauer & Feld LLP

As private credit continues its rise as a key source of flexible capital for traditional private equity, there has been a growing focus by credit funds on the use and role of side letters in financing transactions.

[Know Your CEO? New York Proposes Character And Fitness Requirements](#)

Mayer Brown

On May 9, 2023, the New York Department of Financial Services ("NYDFS") issued proposed guidance that would, if finalized, require New York-regulated banking institutions and non-depository financial institutions...

[Investigations Involving Alleged Redlining](#)

Squire Patton Boggs LLP

Perhaps the signature initiative of the Department of Justice's Civil Rights Division under the current Administration has been its Combatting Redlining Initiative. By "redlin...

[SEC Adopts T+1 Settlement Cycle](#)

Katten Muchin Rosenman LLP

On February 15, 2023, the Securities and Exchange Commission (SEC) adopted amendments to Exchange Act Rule 15c6-1, including an amendment that decreased the standard settlement cycle...

[About](#) | [Blog](#) | [Contact Us](#) | [Contributors](#) | [Feedback](#) | [Free News Alerts](#) | [T&Cs](#) | [Your Privacy](#)

Powered by  Mondaq
© Mondaq® Ltd 1994 - 2023. All Rights Reserved.