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Derivatives and Bankruptcy: Where do the Safe Harbors Begin and End?

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Swaps. Repos. CDOs. CMOs. Commodity futures. Options. Currency hedges. Credit enhancements. Freight-forward contracts. Once the sole province of Wall Street investment banks and brokers, these and many other types of derivative instruments have become a common part of the everyday business strategy for enterprises such as airlines, utilities, manufacturers and retailers.

In fact, trading in derivatives has become a key method by which enterprises reliant on commodities like heating oil, jet fuel, corn or bauxite moderate or hedge their risk. Such commodities are subject to wide market price swings or trade globally, subjecting them to fluctuations in currency exchange.

In the United States, derivatives can be traded on national exchanges, such as the New York Mercantile Exchange or the New York Stock Exchange. This on-exchange-trading activity typically is accomplished through a broker or other professional.

Trades on a national exchange are made subject to the rules of the particular exchange and its self-regulating organization, as well as any applicable federal or state regulatory scheme.

Millions of derivative transactions are conducted privately, "off exchange" or "over the counter," with the trades negotiated directly between two counterparties.

In many cases, individual OTC transactions are conducted and made subject to master netting agreements between the trading parties that follow a form developed by the International Swaps and Dealers Association. The ISDA form contains the noneconomic terms such as termination, acceleration and liquidation rights, of each OTC trade. Meanwhile, the economic terms such as rate, price, term and volume are set forth in individual confirmations that can be generated electronically or on paper.

Although the ISDA form is widely used, in some cases the documentation may not be so formal or even complete. Often derivative trades are not closed and cashed out and are not settled in hard goods. Rather, the parties' obligations to each other are rolled over and the obligations netted out on a daily, weekly or other basis. The "out of the money" party makes a margin or net settlement payment or increases the collateral it posts to offset its liability to the counterparty.

The Bankruptcy Code's goals directly conflict with the proper functioning of the securities and commodities markets, which require parties to be able to timely close existing trades.

The ability to continually net, roll over and demand additional margin or collateral is key to the smooth functioning of the securities, commodities and derivative markets. Indeed, these trades are often done back-to-back so that a party is a seller in one instancand a buyer in the next.

What happens, however, when a party to one of these transactions files for protection under the U.S. Bankruptcy Code, 11 U.S.C. § 101? Does the music stop? If so, who has the power to stop it? Can a debtor continue to trade? When and under what circumstances would the debtor or a non-debtor counterparty want to do so?

The Bankruptcy Code

Filing a petition for relief under the Bankruptcy Code is a watershed event. Effective on the petition date, an estate composed of all the debtor's property rights and interests, including inchoate litigation, property and contract rights, is formed.

Actions against the debtor or its estate based on events occurring or contracts entered into pre-petition generally are stayed, and the commencement of a case even prohibits the setoff of mutual debts unless the Bankruptcy Court grants relief from the stay.

The filing of a bankruptcy case also vests the debtor in possession or trustee with certain rights and powers, such as a qualified right to assume, reject, or assume and assign executory contracts and unexpired leases. To facilitate a debtor's ability to retain and/or realize value from its pre-petition contractual rights, the Bankruptcy Code renders unenforceable certain types of contractual provisions, such as anti-assignment clauses and clauses that permit a party to terminate a contract based on a debtor's insolvency or bankruptcy filing (so-called *ipso facto* clauses).

A debtor even is permitted to bring litigation seeking to undo some property transfers and to recover monies paid out during the 90-day period prior to the petition date because of antecedent debts.

These provisions and many others like them in the Bankruptcy Code are intentionally designed to give the debtor breathing room to assess its situation, delay or prevent the forfeiture of valuable property and contract rights, collect its assets, and take the steps necessary to reorganize its liabilities.

However, these goals directly conflict with the proper functioning of the securities and commodities markets, which require parties to be able to timely close existing trades in order to engage in new ones.

Indeed, as was evident from the Federal Reserve's quick action to prop up Bear Stearns earlier this year and allow its trades to close, the insolvency of even one large market participant can have a calamitous effect on the market as a whole and might cause otherwise healthy counterparties to become insolvent very quickly.

Derivatives Safe Harbor

To prevent the policies underlying the Bankruptcy Code from disrupting the securities and commodities markets, the Bankruptcy Code contains numerous safe-harbor provisions that, taken together, are designed to neutralize the impact of a bankruptcy filing on non-debtor counterparties.

Among other things, these safe-harbor provisions permit the non-debtor counterparty to exercise set-off rights under securities contracts, commodities contracts, forward contracts, repurchase contracts, swap agreements, master netting agreements or similar instruments (collectively "derivatives"). The provisions further allow non-debtor counterparties to exercise contractual or exchange specific rights to liquidate, terminate or accelerate derivatives. They also exempt pre-petition settlement payments, margin payments and certain transfers made in connection with derivatives from avoidance as a preference or constructive fraudulent conveyance.

The derivatives safe harbor provisions render the automatic stay … and all the other special protections afforded to debtors automatically ineffective.

In other words, when they apply, the safe-harbor provisions render the automatic stay, the prohibition against the enforcement of *ipso facto* clauses and all other special protections afforded to debtors automatically ineffective when it comes to derivatives.

Sounds great, right? Yes, but the devil is always in the details.

To take advantage of any of these safe-harbor provisions, the non-debtor counterparty must ensure that the transaction at issue is a derivative within the various definitions set forth in the Bankruptcy Code.

In addition the non-debtor counterparty itself must be a stockbroker, commodities broker, forward-contract merchant, financial institution, financial participant, securities clearing agency, repo participant or a swap participant under the applicable Bankruptcy Code definitions to qualify for many of the protections discussed here.

Furthermore, the transfers at issue must be made by, to or on behalf of a qualifying entity and cannot be fraudulent or otherwise suspect. Also, the individual transaction must be shown to have been made pursuant to a master agreement that qualifies as a derivative.

The good news is the definitions in the Bankruptcy Code are very broad and recently were amended to further broaden their reach. For example, Section 546(e) of the Bankruptcy Code was amended in December 2006 to apply to "transfers made by or to (or for the benefit of) a commodity broker, forward-contract merchant, stockbroker, financial institution, financial participant or securities clearing agency" in connection with a securities, commodities or forward contract, as well as settlement and margin payments.

Before the 2006 amendment, transfers made in connection with securities or commodities contracts that did not qualify as a settlement or margin payment would not have been protected from avoidance as a preference, constructive fraudulent conveyance or being the subject of a turnover action.

This led to substantial litigation on whether a particular transfer was a settlement or margin payment and a split among the courts as to whether a payment that was not "common in the securities industry" could qualify as a settlement payment.

Now, Section 546(e) offers broader protection for "transfers," as long as they are made by, to or for the benefit of one of the listed entities and in connection with one of the enumerated derivatives contracts.

Limitations on the Safe Harbors

All that being said, there are instances when the Bankruptcy Code's safe harbors do not protect the non-debtor counterparty.

For example, the non-debtor party cannot exercise a set-off unless the debts at issue are mutual. This means an entity cannot set off amounts owed to an affiliate by the debtor against debt it owes to the debtor unless the same master netting agreement covers all the debts.

Similarly, a non-debtor cannot set off amounts a debtor owes it arising out of a pre-petition trade against amounts it owes the debtor based on a post-petition claim such as a preference.

The safe harbors also do not give the non-debtor counterparty any rights it does not already have under the parties' existing derivatives agreements or applicable law or regulations.

Moreover, even when a non-debtor counterparty might wish to let a pre-petition trade continue to its stated termination point, such as when it is out of the money on the petition date and terminating the trade would result in money being owed to the debtor, it may not be able to do so.

In this situation the debtor might seek to preserve its gains by filing a motion to reject the contract, which would have the effect of terminating the derivative and liquidating the trade on the date the contract is rejected.

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Thus, if the parties' pre-petition derivative agreement or applicable law does not permit the non-debtor to terminate, accelerate or liquidate the derivative upon the counterparty's bankruptcy filing, the non-debtor will not have that right regardless of whether the derivative otherwise may qualify for protection under the Bankruptcy Code's safe harbors.

Further, the safe harbors cannot cure a collateral deficiency or protect a party when the underlying transaction is fraudulent or void under applicable state law.

The Bankruptcy Code's safe harbors that protect the rights of a non-debtor counterparty with respect to derivatives entered into pre-petition do not apply to post-petition trading activity.

Likewise, the bankruptcy court may disallow any claims against a debtor arising from post-petition trades if it does not approve the trading activity. While Section 363 of the Bankruptcy Code permits a Chapter 11 debtor to engage in "ordinary course" business transactions without court approval, the debtor must seek court approval for transactions outside the ordinary course. Even if the debtor routinely traded derivatives pre-petition, court approval should be obtained as a protective measure.

Trading with a Debtor

As noted above, the Bankruptcy Code permits the non-debtor counterparty to exercise any rights it may have to accelerate, terminate or liquidate a derivative notwithstanding the code's automatic stay and anti-forfeiture provisions.

In most cases the non-debtor will exercise its rights as soon as possible upon learning that its counterparty filed a bankruptcy petition in order to cut any potential losses and set off any amounts due to it against the collateral it holds. It should be noted, however, that if the counterparty were "out of the money," any amounts due to the debtor would be measured and payable upon termination of the outstanding trade. *See* 11 U.S.C. §§ 562 and 542.

In contrast, payments due from a debtor over and above any collateral held by or for the counterparty's benefit would be measured as of the liquidation/termination date and would not be payable until after confirmation of the debtor's plan. Even then it would likely be payable at a fraction of the actual claim amount.

The filing of a Chapter 11 petition does not mean the debtor is going out of business or that pre-petition trading activity should or must stop. The Bankruptcy Code permits a Chapter 11 debtor to continue operating its business. In many cases a debtor will want to continue trading derivatives post-petition, particularly when the debtor is an airline or is engaged in another business for which the trading of derivatives is a key hedge against rising costs that might threaten its ability to reorganize. To that end, many debtors will seek the bankruptcy court's permission to continue to trade derivatives post-petition.

Post-petition costs a debtor incurs in connection with the operation of its business or the administration of the estate are given a higher priority than unsecured pre-petition claims and generally are paid in full. That being said, the Bankruptcy Code's safe harbors that protect the rights of a non-debtor counterparty with respect to derivatives entered into pre-petition do not apply to post-petition-trading activity. As such, the non-debtor counterparty should require the debtor to obtain an order protecting the counterparty's right to exercise contractual remedies post-petition before entering into any such activity.

The Bankruptcy Code's safe harbors also do not prevent litigation when there is a dispute concerning the terms of the trade. If the relevant OTC derivative has not been clearly documented or put in writing (even electronic writing) and the parties disagree on the terms, the non-debtor counterparty may be forced to litigate the dispute in the bankruptcy court.

The non-debtor party may be delayed or prohibited from terminating the derivative or liquidating collateral while the litigation is pending. It also may be liable for damages to the estate if the Bankruptcy Court finds that the safe harbors were inapplicable or the derivative did not permit early termination.

Although producing clear documentation is the best way to avoid litigation, if it is inevitable, the non-debtor should seek relief from the Bankruptcy Court to avoid running afoul of the automatic stay.

Conclusion

The bottom line is this: the Bankruptcy Code's safe harbors will protect a non-debtor counterparty's rights and remedies and prohibit the debtor from avoiding what might otherwise be preferential pre-petition transfers. However, the transaction at issue and the entities involved must qualify for such special treatment under the definitions set out in the Bankruptcy Code.

The safe harbors also will not create remedies or rights where none exist. Market participants should consult with bankruptcy counsel to ensure that their pre-petition trading documents and transfers meet the applicable Bankruptcy Code definitions and contain all rights and remedies and that any post-petition trading activity is covered by an adequate protective order.

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