THE EFFECT OF PROPOSED AMENDMENTS TO U.S. INSOLVENCY AND BANKING LAWS ON TRANSACTIONS INVOLVING SECURITIES, COMMODITIES AND OTHER FINANCIAL CONTRACTS[*/]

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Presented by:

Soo J. Yim
Partner
Wilmer, Cutler & Pickering
Washington, D.C.

William J. Perlstein
Partner
Wilmer, Cutler & Pickering
Washington, D.C.

Prepared with the assistance of:

Joel W. L. Millar
Associate
Wilmer, Cutler & Pickering
Washington, D.C.

Gwendolyn K. Ponder
Associate
Wilmer, Cutler & Pickering
Washington, D.C.

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I. INTRODUCTION

Proposed legislation, entitled the Financial Contract Netting Improvement Act of 2001[1/] (the "Proposed Amendments"), has been introduced in the House of Representatives to clarify the treatment of certain financial contracts upon the insolvency of a counterparty to such contracts. The primary purpose of such legislation is to reduce systemic risk to the financial and banking systems.[2/] The Proposed Amendments are virtually identical to the amendments that passed the House last legislative session and they are expected to enjoy bipartisan support.[3/]

The proposed legislation is based on recommendations made by the President's Working Group on Financial Markets[4/] ("President's Working Group") and would amend provisions of the federal Bankruptcy Code ("Bankruptcy Code"), the Federal Deposit Insurance Act ("FDIA"), the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") and the Securities Investor Protection Act of 1971 ("SIPA").[5/] The

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1/ Financial Contract Netting Improvement Act of 2001, H.R. 11, 107th Cong. (2001).

2/ Similar legislation has been introduced in the House and the Senate as part of a broader proposal for the reform of the Bankruptcy Code. These bills are substantially identical to legislation that was pocket vetoed by President Clinton last legislative session, the Bankruptcy Reform Act of 2000, S. 3186, 106th Cong. (2000). The Bankruptcy Reform Act of 2001 was introduced in the Senate on January 30, 2001. Bankruptcy Reform Act of 2001, S. 220, 107th Cong. (2001). The Bankruptcy Abuse Prevention and Consumer Protection Act of 2001 was introduced in the House the next day. Bankruptcy Abuse Prevention and Consumer Protection Act of 2001, H.R. 333, 107th Cong. (2001). Title IX of both S. 220 and H.R. 333 contains legislation almost identical to that found in H.R. 11.

3/ Financial Contract Netting Improvement Act of 2000, H.R. 1161, 106th Cong. (2000).

4/ The President's Working Group transmitted proposed legislation, upon which H.R. 11 is based, to Congress on March 16, 1998. According to the letter from Robert E. Rubin accompanying the legislation, "the proposed legislation would help reduce the risk that a failure of a single firm would cause significant disruption and danger to our financial markets. In particular, this proposal will help to reduce systemic risk arising out of activities in the derivatives market."

5/ Most individuals, corporations, partnership and limited liability companies that have a residence, domicile, place of business or property in the United States are eligible for relief under the Bankruptcy Code. The receivership and conservatorship provisions of the FDIA (as well as the National Bank Act and, for state-chartered institutions, state law) govern insolvency proceedings of insured banks and thrifts. The SIPA, in

Proposed Amendments are needed for a number of reasons. They would clarify the existing law; harmonize, as appropriate, the provisions of the Bankruptcy Code, the FDIA and FDICIA; bring the current legislation up to date with advances in the financial markets;[6/] and increase market liquidity.[7/] They thus would build on prior amendments to the Bankruptcy Code, the FDIA and FDICIA that are designed to exempt certain financial transactions from the ordinary operation of such statutes. These transactions encompass a variety of financial contracts, such as swaps, options, repurchase agreements, futures and forward contracts,[8/] that are often referred to in general terms as derivatives.

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conjunction with the Bankruptcy Code, governs insolvency proceeding of stockbrokers who are members of the Securities Investor Protection Corporation. FDICIA governs the treatment of netting contracts between financial institutions.

[6/] Testimony of Roger L. Anderson, Treasury Deputy Assistant Secretary for Federal Finance, before the Senate Judiciary Subcommittee on Administrative Oversight and the Courts (May 19, 1998).

[7/] Remarks of Representative McCollum during floor debate on Oct. 9, 1998 of the Conference Report to accompany H.R. 3150, 105th Cong., 2d Sess. (1998).

[8/] The term derivative generally refers to securities, contracts or other financial products whose market or trading value is "derived" from the value of one or more underlying assets, securities or variables. Some of the types of derivative instruments that have been the focus of legislative efforts under the Bankruptcy Code, the FDIA and FDICIA are described in general terms below.

A forward contract is a contact to buy, sell or transfer an asset at a specified price on a pre-determined future date. Generally, one party to the contract takes a long position and agrees to buy the asset at the price set forth in the contract. The other party to the contract assumes a short position and agrees to sell the asset at the specified price. The purpose of a forward contract is to hedge against market price fluctuations. The party taking the long position is predicting that the price of the asset will rise prior to delivery and the party taking the short position is anticipating that the price will fall prior to the settlement date. Forward contracts are customized, private agreements and are not traded on an exchange.

"Securities contract," as defined in the Bankruptcy Code, includes any contract for the purchase, sale or loan of securities; these securities include stocks and bonds, an options to purchase or sell stocks or bonds, a group or an index of securities or a certificate of deposit, or an option relating to foreign currencies or certain guarantees by or to clearing agencies. An option is a contract that gives the holder the right to buy or sell an asset at a predetermined price on a certain future date.

The overriding policy concern supporting different treatment of these financial contracts from other commercial transactions is the need to minimize systemic risk potentially resulting from the insolvency of a counterparty to such contracts. Systemic risk has been described 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."[9/]

It has been widely accepted among federal policymakers that systemic risk could be unacceptably high if market participants are unable to exercise contractual self-help remedies immediately upon the insolvency or other default of a counterparty to certain financial contracts. Such self-help remedies for those purposes include the right to terminate, or close-out, all outstanding financial contracts with the insolvent counterparty, net all payment obligations thereunder and foreclose on any collateral. Netting arrangements allow a party to offset mutual payment obligations to arrive at a single net amount reflecting the excess of one party's aggregate obligations over the other's, thereby limiting overall credit exposure to an insolvent counterparty. Immediate termination of outstanding contracts and liquidation of collateral facilitates the

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The Bankruptcy Code definition of "swap agreement" encompasses many types of agreements, including rate swap, basis swap, forward rate agreement, commodity swap, interest rate option, foreign exchange agreement, spot foreign exchange, rate cap, rate floor, rate collar, currency swap, cross-currency rate swap, currency option agreements and master agreements for any of the foregoing. One of the most common swap agreements is an interest rate swap agreement. Parties to an interest swap agreement agree to exchange payments based on fixed and variable interest rates. The purpose of these agreements is to hedge against fluctuations in interest rates.

A commodity contract can be either (x) a futures contract where the underlying asset is a commodity or (y) an option where the underlying asset is a commodity and a commodity options dealer is a party. Commodity contracts, like forward contracts, are generally agreements to buy and sell an asset (in this case a commodity) for a set price on a date in the future. These contracts, unlike forward contracts, are generally traded on public exchanges.

A repurchase agreement is a contract to sell an asset in conjunction with an agreement by the seller to repurchase the asset at a later date. This type of agreement is essentially a combination of a sales agreement and a forward contract. In a typical agreement, the seller will buy back the asset at the initial selling price plus an amount of imputed interest. A repurchase agreement is sometimes viewed as essentially a loan secured by the underlying assets.

[9/] Report of the Committee on Banking and Financial Services of the House of Representatives to accompany H.R. 1161 (Rept. 106-834, pt. 1, at 19, Sept. 7, 2000) ("H.R. 1161 House Report").

acquisition of replacement contracts, reduces uncertainty and uncontrollable risk, improves liquidity and reduces the risk of rapid devaluation of collateral in volatile markets.

The Bankruptcy Code, the FDIA and FDICIA generally bar creditors from implementing self-help remedies unless the bankruptcy court or receiver approves such action. In addition, the debtor or its trustee, receiver or conservator is generally authorized to unwind certain transfers and obligations of the debtor that are effected prior to bankruptcy. These provisions are intended to promote the orderly arrangement of the debtor's affairs and the equitable treatment of creditors.

A consensus has formed at the federal level that the broad application of these principles (as well as other powers granted to a debtor or its trustee, conservator or receiver in an insolvency proceeding) to derivative transactions has the potential to create wide-spread systemic effects on the overall functioning of the financial markets and banking systems. The inability of a counterparty to a significant insolvent market participant to exercise its contractual rights to close-out financial contracts, net payment obligations thereunder and liquidate collateral securing those obligations could cause a "possible domino effect that could turn the failure of one market participant as a result of a freeze on collateral in connection with a financial contract into a failure of the market."[10]

To minimize the systemic risk to financial markets, Congress has previously amended the Bankruptcy Code and the FDIA to exempt the exercise of self-help remedies under certain financial contracts from certain provisions of such statutes. In general, contractual termination, netting and liquidation rights under such financial contracts have been exempted from provisions of the Bankruptcy Code and the FDIA that impose an automatic stay on creditor collection actions, that void contractual termination clauses based on the debtor's insolvency, and that authorize the avoidance of transfers or setoffs effected shortly before the bankruptcy that are deemed preferential or constructively fraudulent. Provisions of FDICIA further protect agreements to net payment obligations under financial contracts under certain circumstances.

The manner in which the provisions have been adopted has left some uncertainty regarding the scope of the protections for financial contracts, and the interrelationship between provisions of FDICIA and provisions of the Bankruptcy Code and the FDIA. For example, it is not clear that hedge funds, which have become important market participants, would be eligible to take advantage of certain of the protections under the Bankruptcy Code that permit counterparties to certain contracts to liquidate and net termination amounts under such contracts with an insolvent counterparty subject to the

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[10] Letter dated September 30, 1998 to Hon. George W. Gekas, Chairman, Subcommittee on Commercial and Administrative Law, Committee on the Judiciary, from Robert E. Rubin, Secretary of the Treasury.

Bankruptcy Code. A hedge fund may qualify for the netting protections of FDICIA; however, there is some ambiguity under present law as to whether FDICIA protects close-out rights in addition to netting rights.

To address these and other concerns, the Proposed Amendments would seek to clarify and expand the scope of the protections for financial contracts. In addition, the Proposed Amendments would amend the Bankruptcy Code to provide that certain transfers in connection with asset-backed securitizations will be treated as valid transfers and not included in a debtor's bankruptcy estate.

The more significant changes that the Proposed Amendments would make to existing legislation are summarized immediately below. The following sections II, III and IV discuss the existing statutory framework and the Proposed Amendments in greater detail.

A. The Proposed Legislation.

1. Financial Contracts. The Bankruptcy Code and the FDIA currently extend protection to agreements falling under one of five statutory definitions: "securities contracts," "forward contracts," "commodity contracts," "repurchase agreements" and "swap agreements" (collectively referred to herein as "Protected Financial Contracts" or "Qualified Financial Contracts"[11/]). To address concerns that the existing definitions may not cover significant derivatives activities, the Proposed Amendments would expand and clarify the definitions in a number of important ways.

a. Swap Agreement. The Proposed Amendments would amend the definition of "swap agreement" to enumerate a broader array of specific instruments, such as an equity index or equity swap, debt index or debt swap and credit spread or credit swap. The Proposed Amendments would also promote flexible application of the definition to anticipate future evolution of the swap markets by adding provisions that would include any "similar" agreement that "is presently, or in the future becomes, regularly entered into in the swap market" and that is a forward, swap, future or option on rates, currencies, commodities, equity or debt

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[11/] The FDIA and FDICIA use the term "qualified financial contracts." The term Protected Financial Contract is not used by the Bankruptcy Code, FDIA, or FDICIA. However, for ease of reference, these types of contracts will be referred to in this outline, as a group, as Protected Financial Contracts, unless reference is being made to such contracts solely under the FDIA or FDICIA. In these cases, they will be referred to as "Qualified Financial Contracts" or "QFCs."

securities or instruments, economic indices or measures of economic risk or value.

b. Securities Contract. The definition of "securities contract" would be amended to cover a broader range of enumerated contracts, including margin loans and (to conform the Bankruptcy Code definition to the FDIA definition) contracts to purchase, lend or sell mortgage loans or interests therein. The definition would also be amended to extend protection to any "similar" agreement or transaction. The Proposed Amendments also grant the Federal Deposit Insurance Corporation ("the FDIC") the ability to determine that a purchase, sale or repurchase obligation in a commercial mortgage loan is a securities contract. These obligations would otherwise be excluded from the definition under the Proposed Amendments to the Bankruptcy Code and the FDIA.

c. Repurchase Agreement. The definition of "repurchase agreement" would be amended to extend protections to repurchase agreements in which the underlying assets are mortgage-related securities, mortgage loans or "qualified foreign government securities." The Proposed Amendments would define "qualified foreign government security" as any security that is a direct obligation of, or fully guaranteed by, the central government of members of the Organization for Economic Cooperation and Development.

d. Forward and Commodity Contracts. As with swap agreements and securities contracts, the Proposed Amendments would facilitate flexible application of the definitions of "forward contract" and "commodity contract" by amending such definitions to include agreements and transactions that are "similar" to enumerated agreements and transactions.

e. Related Security Agreements. There is some uncertainty under current law as to whether the protections for Protected Financial Contracts extend to the exercise of rights under related security agreements and other credit arrangements securing an insolvent counterparty's obligations. To address this concern, the Proposed Amendments would amend the definitions of all Protected Financial Contracts and Qualified Financial Contracts to include "any security agreement or arrangement" or "other credit enhancement" that is "related" to such financial contracts. By treating such security agreements as Protected Financial Contracts, the Proposed Amendments are designed to ensure that

counterparties may foreclose on collateral and exercise other rights under such agreements in the event of insolvency. The Proposed Amendments to the Bankruptcy Code would limit the above agreements to the "actual value of such contract on the date of the filing of the petition." The counterpart definitions in the FDIA would not contain such limitations.

2. Financial Market Participants. In addition to restrictions on the types of financial contracts that are protected, the Bankruptcy Code and FDICIA contain differing restrictions on the type of counterparties who may exercise netting and termination rights under such contracts free of the automatic stay and the trustee's or receiver's avoidance powers. To address concerns that existing counterparty definitions may exclude significant market participants, the Proposed Amendments would expand the scope of protected counterparties under the Bankruptcy Code and FDICIA.

a. Bankruptcy Code.

(i) New Definition of "Financial Participant". The Proposed Amendments would add a new counterparty definition for "financial participant." This definition would extend current protections to any counterparty with outstanding Protected Financial Contracts having an aggregate value in excess of one of two statutory thresholds. Specifically, a "financial participant" would include any party to one or more Protected Financial Contracts with the debtor or any other entity (other than an affiliate) if, on at least one day within a specified look-back period, such party's aggregate Protected Financial Contracts have (x) a total gross value of at least $1 billion in notional or actual principal amount or (y) gross mark-to-market positions of at least $100 million (aggregated across counterparties). The specified look-back period would be defined as the 15-month period preceding the filing of the petition or, if applicable, at the time when such party entered into a securities, commodity or forward contract with the debtor. This new definition is designed to capture significant market participants, such as hedge funds, that may not otherwise fall within existing counterparty definitions.

(ii) Repo Participant. Under the Bankruptcy Code, netting and termination rights under repurchase agreements are only protected if the counterparty is a "repo participant," which is currently defined as an entity who has a

repurchase agreement with the debtor outstanding during the 90 days prior to the filing of the petition. The Proposed Amendments would eliminate this 90-day limitation.

(iii) Other Market Participants. The Proposed Amendments to the Bankruptcy Code would add Federal Reserve Banks to the definitions of "financial institution" and "forward contract merchant." The Proposed Amendments would also add receivers or conservators of insolvent depository institutions to the definition of "financial institution" and would add securities clearing agencies exempted by order of the Securities and Exchange Commission ("SEC") to the definition of "securities clearing agency." The separate amendments proposed in the Bankruptcy Reform Act of 2000 would also have included as a "financial institution" investment companies registered under the Investment Company Act of 1940. The Proposed Amendments would not include such registered investment companies.

b. FDICIA. Unlike the netting provisions of the Bankruptcy Code, FDICIA's protections do not depend on the types of transactions that can be netted. Instead, FDICIA's protections depend only on the entities involved, protecting only netting contracts between financial institutions and between clearing organizations.

(i) New Definition of a Type of "Financial Institution." FDICIA defines "financial institution" as including brokers, dealers, depository institutions, futures commission merchants, and any other institution that the Federal Reserve Board determines should be included in the definition. The Proposed Amendments amend the definition of "depository institution" to also include (x) certain uninsured national or state banks and (y) certain foreign banks and their branches.

3. Netting Arrangements. Although netting arrangements are generally protected under the existing statutory framework, there is some uncertainty regarding the scope of those rights. The Proposed Amendments would clarify and strengthen contractual netting rights under Protected Financial Contracts.

a. Cross-Product Netting. To eliminate uncertainty in existing legislation, the Proposed Amendments to the Bankruptcy Code

and to the FDIA would add new provisions expressly protecting the right to net payment obligations across different categories of Protected Financial Contracts, such as securities contracts, repurchase agreements and swap agreements. The Proposed Amendments would also amend the definitions of all Protected Financial Contracts to include a "master agreement" providing for such contracts (together with any supplements). To provide further protection and certainty, the Proposed Amendments would add a new definition to the Bankruptcy Code for a "master netting agreement," which would be defined as an agreement "providing for the exercise of rights, including rights of netting, setoff, liquidation, termination, acceleration, or closeout" under one or more Protected Financial Contracts (including related security agreements). Netting and related rights under such master agreements and master netting agreements would be accorded protection to the extent they relate to Protected Financial Contracts.

b. Setoff and Foreclosure Rights. The Proposed Amendments to the Bankruptcy Code would modify existing statutory language to clarify protections for the right to setoff and foreclose on collateral that is not technically "held by" the counterparty, such as receivables, book-entry securities and collateral that the counterparty has repledged.

c. Netting Contracts Governed by Foreign Law. The Proposed Amendments to FDICIA eliminate the requirement that protected netting contracts be governed by the laws of the United States. However, the contracts must not be invalid under or precluded by United States federal law.

d. Walkaway Clauses. The Proposed Amendments would make "walkaway clauses" unenforceable under the FDIA. Walkaway clauses are provisions that extinguish a payment obligation based on the calculation of a party's position or the amount due from a party pursuant to a netting agreement. The Bankruptcy Code does not contain a similar provision.

e. Cherry Picking. The Proposed Amendments to the FDIA would limit the conservator's or trustee's ability to "cherry pick" among the debtor depository institution's Qualified Financial Contracts, thereby honoring informal netting arrangements. This section would limit the authority of the FDIC to disaffirm or repudiate Qualified Financial Contracts, conforming to its authority to transfer Qualified Financial Contracts under the

FDIA section 11(e)(9). The FDIC would have to disaffirm or repudiate all or none of the Qualified Financial Contracts between a person (and their affiliates) and the debtor depository institution.

4. Liquidation, Acceleration and Termination Rights. The Proposed Amendments to the Bankruptcy Code would clarify and strengthen contractual liquidation, acceleration and termination rights under Protected Financial Contracts.

a. Recognition of Normal Business Practice. The Proposed Amendments would amend protections relating to "securities contracts" (and the new master netting agreements) to protect the exercise of any termination, liquidation and acceleration rights that a counterparty may have under bylaws or resolutions of clearing organizations and contract markets, as well as any such rights existing under common law, the law merchant or by reason of normal business practice, even if unwritten. The H.R. 1161 House Report makes clear that liquidation, acceleration and termination is intended to be the "normal business practice" when a counterparty to financial contracts defaults.[12/]

b. Clarification of Liquidation and Termination Rights. The Proposed Amendments would clarify that existing statutory protections to liquidate securities, forward and commodity contracts and repurchase agreements also include rights to accelerate or terminate such contracts. Similarly, the Proposed Amendments would clarify that existing statutory protections to terminate swap agreements also include rights to accelerate or liquidate such agreements.

5. Clarification of Temporary Stay on Exercise of Ipso Facto Clauses. The Proposed Amendments to the FDIA clarify that a counterparty cannot exercise any rights it has under a Qualified Financial Contract ipso facto clause until after 5:00 p.m. on the business day following (x) the date of the appointment of the receiver, in the case of a receivership or (y) the date of the transfer of the Qualified Financial Contract by the conservator, in the case of a conservatorship. An ipso facto clause allows the counterparty to terminate, liquidate or net a contract upon specified insolvency events, which can include the appointment of a receiver or conservator.

6. Ancillary Proceedings and Municipal Bankruptcies. There is some uncertainty under existing law as to whether the provisions in the Bankruptcy Code relating to Protected Financial Contracts apply in ancillary proceedings brought in the

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12/ H.R. 1161 House Report at 34.

United States in support of foreign insolvency proceedings (under section 304 of the Bankruptcy Code) or municipal bankruptcies (under chapter 9 of the Bankruptcy Code). These uncertainties were highlighted in recent years by the bankruptcy of Orange County in California and the near failure of Long-Term Capital Management L.P., whose main insolvency proceeding might have been filed in the Cayman Islands rather than the United States. To eliminate these uncertainties, the Proposed Amendments would expressly extend the Bankruptcy Code's Protected Financial Contract provisions to ancillary proceedings and municipal bankruptcies.

7. Limitation of SIPA, Judicial and Administrative Stays. The Proposed Amendments would extend the protections for Protected Financial Contracts to any stay order issued pursuant to SIPA, except to the extent such stay applied to foreclosure on securities (whether held as collateral, sold by the debtor under a repurchase agreement or lent under a securities lending agreement). The Proposed Amendments clarify that the netting provisions of FDICIA are subject to any stay order issued pursuant to SIPA. Furthermore, the Proposed Amendments would make clear that contractual rights to setoff and foreclose on collateral under Protected Financial Contracts, which are already exempt from the Bankruptcy Code's automatic stay, may not be stayed by judicial or regulatory order in any proceeding under the Bankruptcy Code.

8. Clarification of Damages Measure Under Bankruptcy Code. There is some uncertainty under the Bankruptcy Code as to the time at which damages are measured arising from either the termination, acceleration or liquidation of a Protected Financial Contract by a counterparty or the rejection of such contract by the trustee. The Proposed Amendments would clarify that damages are calculated as of the earlier of either (x) the date of rejection by the trustee or (y) the date of such liquidation, termination or acceleration.

9. Asset-Backed Securitization Safe Harbor. The Proposed Amendments would reduce the bankruptcy risk associated with asset-backed securitizations by adding a new safe harbor providing that certain assets transferred in connection with an asset-backed securitization are not property of the debtor's estate in any subsequent bankruptcy proceeding. In general, to qualify for protection under the new safe harbor: (w) the transferred assets must be cash, securities or "financial assets" that "by their terms, convert into cash within a finite time period" (plus certain residual property interests or related servicing rights); (x) the assets must be transferred to an entity "engaged exclusively in the business of acquiring and holding" such assets, issuing securities backed by such assets and taking ancillary actions thereto (or transferred indirectly to such entity through certain vehicles); (y) the debtor must represent pursuant to a written agreement that the assets were transferred with the intention of removing them from the debtor's estate; and (z) the assets must be transferred in connection with a transaction in which the assets are used as the source of payment on securities, at least one tranche of which is rated investment grade by a nationally recognized securities rating organization. The Proposed Amendments would preserve the trustee's right to avoid such transfer, however, if it is a fraudulent transfer under section 548(a)(1) of the Bankruptcy Code.

10. FDIC's Power to Transfer Qualified Financial Contracts.

a. Parties Eligible to be Transferees. Currently, the FDIC can only transfer Qualified Financial Contracts to depository institutions. The Proposed Amendments expand the transfer authority of the FDIC, thereby permitting the FDIC to transfer Qualified Financial Contracts to "financial institutions" (as defined in FDICIA or in regulations). This provision will allow the FDIC to transfer Qualified Financial Contracts to non-depository financial institutions. Under the FDICIA definition, "financial institution" would include brokers, dealers, depository institutions and futures commission merchants. It would also include:

(i) Foreign Financial Institutions. The Proposed Amendments would permit transfers to non-U.S. financial institutions and their branches if the rights of the parties are still enforceable; and

(ii) Bridge Banks. The Proposed Amendments would permit the FDIC to transfer Qualified Financial Contracts to a bridge bank or a depository institution organized by the FDIC.

b. Clearing Organizations. If a Qualified Financial Contract is subject to rules of a clearing organization, the FDIC can still transfer it, but the clearing organization does not need to accept the transferee as a member.

B. Issues Not Addressed by Proposed Amendments.

Although the Proposed Amendments would clarify and improve the existing statutory framework in important ways, some concerns are not addressed by the current legislative proposals, including those described below.

1. Hedge Funds.

One such concern was highlighted by the near failure of a large hedge fund, Long Term Capital Management L.P. ("LTCM"), in September 1998.[13/] Hedge funds are not

[13/] The President's Working Group on Financial Markets analyzed the near failure of LTCM. It laid out its policy proposals in its April 1999 report, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management." This report is available at http://www.ustreas.gov/press/releases/docs/hedgfund.pdf.

defined by statute. "Hedge fund" is a term generally used to describe a pooled investment vehicle that is privately organized and managed by professional investment managers. Unlike mutual funds, hedge funds are generally structured to qualify for certain exemptions under the federal securities laws and, if the applicable requirements for such exemptions are satisfied, are not subject to certain SEC reporting obligations or substantive regulatory requirements.

Many hedge funds can be distinguished from other segments of the financial markets by their relatively greater reliance on active trading strategies, leveraged positions and the use of derivatives. Managers of hedge funds are typically paid advisory fees based on performance, which often encourages the adoption of short-term investment strategies. These strategies include taking long or short positions in equity or fixed income securities and hedging portfolios through the use of exchange-traded futures contracts or over-the-counter derivatives.

Hedge fund insolvencies raise complex issues under the Bankruptcy Code that will require further review. For example, hedge funds typically are structured as limited partnerships or limited liability corporations. There is general agreement that the Bankruptcy Code provisions relating to partnerships are in need of substantial revision.[14/]

The legislative efforts discussed in this outline generally have been premised on the need to avert market failures resulting from the inability of financial counterparties to close-out and liquidate financial product transactions in accordance with the standard terms negotiated by market participants. The LTCM near insolvency in 1998 demonstrates that, in some instances, systemic risk may result from the ability of counterparties to engage in self-help remedies in connection with the pending insolvency of a large, highly leveraged hedge fund. In the absence of the rescue plan facilitated by the Federal Reserve Bank of New York ("NYFRB"), LTCM may have been forced to file for bankruptcy, which could have resulted in the simultaneous unwinding of transactions and dumping of huge amounts of securities on the markets by creditors of LTCM exercising their termination and liquidation rights or liquidating collateral securing off-balance sheet exposures to LTCM. The simultaneous dumping of these enormous positions likely would have resulted in a significant decrease in the value of the securities, at least in the short term, causing further losses not only to LTCM and to its creditors, but also to many other market participants that otherwise had no exposure to LTCM, due to the devaluation of collateral and the need of participants to rebalance their portfolios in a volatile, illiquid market.[15/] The risk of this occurring apparently played a

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[14/] See Report of the National Bankruptcy Review Commission, v.1, 378 (Oct. 20, 1997) ("the Bankruptcy Code does not adequately address the complex issues that can arise when a bankruptcy petition is filed by or against a partnership").

[15/] See Basle Committee on Banking Supervision, Sound Practices for Banks' Interactions with Highly Leveraged Institutions (Jan. 1999) (available at, http://www.bis.org/press/index.htm). The Basle Committee on Banking Supervision

role in prompting the NYFRB to facilitate efforts by major market participants to structure a "rehabilitation plan" for LTCM without resorting to a formal Chapter 11 proceeding.

Regulators, lawmakers and market participants are examining preventative measures, such as implementation by counterparties of better standards and procedures for the evaluation and monitoring of credit exposures to hedge funds.[16/] In conjunction with these efforts, policymakers will probably revisit the financial contract provisions of the Bankruptcy Code to create incentives and other mechanisms to avoid the rush by creditors to liquidate (and thereby potentially devalue) collateral securing financial contracts with a large insolvent hedge fund.

One option that has been proposed would apply the Bankruptcy Code automatic stay to the liquidation and netting of financial contracts for a very brief time after the petition is filed and would give the bankruptcy trustee the power, similar to that of a receiver under the FDIA, to transfer financial contracts to new counterparties during that period. According to Michael Krimminger, a senior policy analyst with the FDIC, the more explicit transfer and repudiation rights provided to the FDIC reduce systemic risks by providing a mechanism to maintain ongoing hedge transactions or other derivatives that continue to benefit the solvent counterparties.[17/]

Supporters of this proposal contend that, although a counterparty's collateral could devalue during the period of any such automatic stay in a highly volatile market, such risks will have to be weighed against the argued benefits of creating a mechanism to maintain these transactions in place (if a buyer can be found) rather than allowing a

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recently released recommendations with respect to interactions with hedge funds and other "highly leveraged institutions." The Committee emphasized the need for banks to develop more effective measures for evaluating risks and to include provisions in their contract documentation providing the banks with an early warning system and the right to terminate or take other action in the event of a material deterioration of credit quality.

[16/] For a survey of initiatives for the supervision and regulation of derivatives activities of banks and other financial institutions, see Ernest T. Patrikis & Diane L. Virzera, Derivatives Activities of Banking Organizations: Initiatives for Supervision, Enhanced Disclosure, and Legislation, 892 PLI/Corp 411 (1995).

[17/] Michael Krimminger, Insolvency in the Financial Markets: Banks, Hedge Funds and Other Complications, Banking Pol'y Rep., Jan. 18, 1999, at 1. Krimminger noted that, "[i]n the case of LTCM, the absence of any mechanism under the Bankruptcy Code to 'slow' the liquidation of assets and collateral, [a power granted to the FDIC under the FDIA] and the resulting 'dump' upon the markets, was a key motivation for the pre-insolvency facilitation provided by the Federal Reserve Bank of New York."

simultaneous liquidation by numerous counterparties. It is unclear whether this proposal will gain support among market participants.

2. Insolvency Proceedings in Foreign Jurisdictions.

Another concern that the Proposed Amendments largely do not address is the uncertain enforceability of contractual netting and termination rights in foreign insolvency proceedings that affect counterparties and financial markets in the United States. Although the Proposed Amendments would improve existing legislation by ensuring that the trustee of a foreign debtor could not enjoin or unwind the exercise of self-help remedies by resorting to an ancillary proceeding in the United States, the Proposed Amendments do not address the enforcement of such rights against debtors and collateral located in foreign jurisdictions. Counterparties will often seek opinions by counsel in foreign jurisdictions as to the enforceability of these provisions under local law. The continuing globalization of financial markets ensures that trans-border insolvency issues will gain increasing significance in coming years.

3. Certain Market Participants and Financial Contracts May Not Be Protected Under the Proposed Amendments.

Another concern that may not be wholly alleviated by the Proposed Amendments is the statutory restrictions on counterparties entitled to the protections relating to Protected Financial Contracts. Although the Proposed Amendments would eliminate many of the counterparty restrictions that currently exist under the Bankruptcy Code and the FDIA, the remaining restrictions may still exclude significant market participants. For example, in many circumstances with respect to securities contracts, forward contracts and commodity contracts, the Proposed Amendments would not protect many active market participants, such as corporations, insurance companies, pension funds, mutual funds or state retirement funds, unless (x) such entities satisfy the numerical thresholds for "financial participants" or (y) in certain circumstances, the debtor was a commodity broker, forward contract merchant, stockbroker, financial institution or securities clearing agency. Although the systemic risk potentially arising from the inability of any single such entity to exercise netting, termination and liquidation rights could be relatively small, the inability of such entities in the aggregate to exercise these rights may nonetheless still pose a risk of widespread disruption.

In addition, the restrictions in the definition of "repurchase agreement" relating to the type of underlying asset and to the time periods established for repurchase would leave non-qualifying repurchase agreements subject to less certain protection, as it is unclear whether they would qualify for protection as "securities contracts" or "forward contracts." Even if these non-qualifying repurchase agreements were deemed to be securities contracts or forward contracts, the counterparty restrictions applicable to such contracts would remain significantly more restrictive than those applicable to qualifying repurchase agreements.

4. Power of the Trustee, Receiver or Conservator.

Other issues the Proposed Amendments do not address include a counterparty's potential exposure to the trustee's power to avoid obligations (as opposed to transfers) incurred by the debtor in the year prior to filing as "constructive" fraudulent transfers. Subject to certain exceptions, the trustee can generally avoid transfers and obligations as constructive fraudulent transfers if the debtor did not receive a reasonably equivalent value in exchange. Although transfers made pursuant to Protected Financial Contracts are protected under the Bankruptcy Code from avoidance, obligations incurred by the debtor do not enjoy similar protection and thus the Protected Financial Contracts themselves may remain subject to avoidance.

The Proposed Amendments also do not address the ability of a receiver or conservator under the FDIA to assume and enforce any contract, notwithstanding ipso facto clauses. The comparable provisions under the Bankruptcy Code are much more detailed. For example, there is no FDIA provision stating that the receiver or the transferee of a contract or lease must cure any defaults existing as of the time of the transfer before transferring such contracts.

Although these and other issues may continue to pose challenges to the development of satisfactory legislative solutions, the Proposed Amendments represent an important body of legislation that will strengthen and clarify the existing protections for financial market activities, thereby reducing the potential for systemic risk to the financial and banking systems.

II. BANKRUPTCY CODE FINANCIAL CONTRACT PROVISIONS

A. General.

1. The Debtors. Generally speaking, Bankruptcy Code proceedings are available to certain municipalities and persons (generally defined to include individuals, partnerships and corporations) that reside or have a domicile, a place of business, or property in the United States. 11 U.S.C. § 109(a).

    a. Bankruptcy Code proceedings are not available to insurance companies[18/] and banking institutions.[19/] 11 U.S.C. § 109(b).

    b. Stockbrokers and commodity brokers (each of which may liquidate under Chapter 7 of the Bankruptcy Code) may not be reorganized under Chapter 11. 11 U.S.C. § 109(d). Railroads may only be reorganized under Chapter 11 and cannot be liquidated under Chapter 7. 11 U.S.C. § 109(b), (d).

    c. Ancillary proceedings to a foreign proceeding may be commenced under section 304 of the Bankruptcy Code to administer assets located in the United States, and will likely be governed by foreign substantive law and U.S. procedural law. 11 U.S.C. § 304.

2. Powers of Trustee or Debtor-in-Possession. The Bankruptcy Code provides the trustee or debtor-in-possession certain powers designed to promote equitable and orderly treatment of creditors. As will be discussed in more detail below, the Bankruptcy Code provides the trustee or debtor-in-possession the general power to:

[18/] The exception encompasses both domestic insurance companies and foreign insurance companies engaged in business in the United States.

[19/] Excluded banking institutions include (x) any domestic bank, savings bank, cooperative bank, savings and loan association, building and loan association, homestead association, small business investment company licensed by the Small Business Administration under subsection (c) or (d) of section 301 of the Small Business Investment Act of 1958, credit union, or industrial bank or similar institution that is an insured bank as defined in section 3(h) of the FDIA and (y) any foreign bank, savings bank, cooperative bank, savings and loan association, building and loan association, homestead association, or credit union, engaged in such business in the United States.

a. avoid pre-petition transactions under contracts that could be considered preferential transfers, or fraudulent transfers or obligations; and

b. stay the exercise of contractual and state law rights, including contractual termination and set-off rights.

3. Protected Financial Contracts. The Bankruptcy Code provides certain exceptions to the general rules for "securities contracts," "forward contracts," "commodity contracts," "repurchase agreements," and "swap agreements" (collectively, "Protected Financial Contracts").

a. The provisions with respect to Protected Financial Contracts apply in proceedings under Chapters 7 and 11 of the Bankruptcy Code.

(i) The Bankruptcy Code's termination and liquidation provisions with respect to Protected Financial Contracts arguably may not apply in municipal bankruptcies under Chapter 9, as those provisions are not specifically incorporated by reference in section 901 (title "applicability of other sections of this title"). The Bankruptcy Code's provisions providing exemptions to the trustee's avoidance powers and exceptions to the automatic stay, however, are specifically incorporated by section 901. The applicability of these provisions to a case under Chapter 9 was brought to the fore in the Orange County case filed in December 1994.[20/]

(a) Proposed Amendments. The Proposed Amendments would make clear that the Bankruptcy Code protections with respect to termination and liquidation of Protected Financial Contracts apply in municipal bankruptcies subject to Chapter 9 of the Bankruptcy Code. Proposed Amendments § 8(l).

[20/] See Ira J. Schacter, Legal Aspects of "Netting" In Respect of Insolvent Derivative Product Counterparties, SC 41 ALI-ABA 315, 321 (1998).

(ii) The extent to which the Bankruptcy Code's provisions concerning Protected Financial Contracts apply in ancillary proceedings is not clear.[21/]

(a) Proposed Amendments. The Proposed Amendments would make clear that the Bankruptcy Code's protections regarding termination, liquidation and avoidance of Protected Financial Contracts apply in ancillary proceedings under section 304 of the Bankruptcy Code. Proposed Amendments § 8(m).

B. Protected Financial Contracts - Definitions.

1. Securities Contract.

a. "Securities Contract" is defined in the Bankruptcy Code, 11 U.S.C. § 741(7), as a:

> contract for the purchase, sale or loan of a security, including an option for the purchase or sale of a security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any option entered into on a national securities exchange relating to foreign currencies, or the guarantee of any settlement of cash or securities by or to a securities clearing agency.

b. Comparison with the FDIA: For a comparison with the FDIA definition of "securities contract," see section III.B.2 of this outline. The principal difference is that the FDIA definition includes, as a "security," mortgage loans, any mortgage-related security and any interest in any mortgage loan or mortgage-related security.

c. A recent 9th Circuit case held that a margin loan (i.e., a loan by a stockbroker to a customer secured by stock held in the customer's margin account) falls within the definition of a "securities contract." See Wolkowitz v. Shearson Lehman

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[21/] For an analysis of the application of the Bankruptcy Code provisions when the debtor is a non-U.S. entity, see Martin J. Bienenstock, Understanding the Business, Bankruptcy and Securities Aspects of Derivatives, 721 PLI/Comm 11, 68-75 (1995).

Brothers, Inc. (In re Weisberg), 136 F.3d 655, 659 (9th Cir. 1998).

d. Not all counterparties to securities contracts are protected under the Bankruptcy Code. See section II.D.1.e.(i).(b).

e. Proposed Amendments to Definition. Proposed Amendments to the definition would amend the phrase "securities contract" in the following substantive ways:

(i) The Proposed Amendments would extend the definition of "securities contract" to include the following:

(a) a contract for the purchase, sale or loan of mortgage loans and interests in mortgage loans, but would exclude any purchase, sale or repurchase obligation under a participation in a commercial mortgage loan;

(b) unlisted options on a group or index of securities, mortgage loans, interests in mortgage loans;

(c) the guarantee by or to any securities clearing agency of a settlement of mortgage loans or interests therein, group or index of securities or mortgage loans or interests therein, or options on any of the foregoing, including an option to purchase or sell such option.

(d) margin loans;

i) according to the H.R. 1161 House Report, only loans commonly known in the securities industry as "margin loans" are included within the definition, not other loans utilizing securities as collateral. H.R. 1161 House Report at 32.

(e) any other agreement or transaction that is similar to a specifically enumerated agreement or transaction within the definition. Proposed Amendments § 8(a)(2).

(ii) The Proposed Amendments would revise the definition of "securities contract" in a manner that, when read with other Proposed Amendments described below, is intended to facilitate cross-contract and cross-product netting of Protected Financial Contracts. Parallel amendments have been made to the definitions of "commodities contracts," "forward contracts," "swap agreements" and "repurchase agreements." The revised definition would include as a "securities contract":

(a) any combination of, or option to enter into any of, the agreements and transactions defined as "securities contracts";

(b) a "master agreement" that provides for an agreement or transaction defined in "securities contracts," together with all supplements, even if such agreement covers agreements or transactions that are not "securities contracts," to the extent that the master agreement is composed of individual agreements or transactions falling within the definition of a "securities contract"; and

(c) any security agreement or arrangement, or other credit enhancement, in connection with a "securities contract," but not to exceed the actual value of such agreement on the date of filing of the petition.

i) An example of a security arrangement is a setoff right and an example of "other credit enhancements" would be "letters of credit, guarantees, reimbursement obligations and other similar agreements." H.R. 1161 House Report at 31.

ii) The inclusion of security agreements within the definition of a securities contract will enable eligible counterparties to terminate, net claims under and foreclose on collateral for such contracts. Under current law, it is not clear that security agreements or

arrangements are entitled to the protections of the Bankruptcy Code unless such agreements are contained within the definition of a Protected Financial Contract.[22/] The House Report states that the references to "setoff" in sections 362(b)(6), (7), (17) and (19) (as added by the Proposed Amendments) of the Bankruptcy Code (described below) are "intended to refer also to rights to foreclose on, and to set off against, obligations to return collateral securing [Protected Financial Contracts]," which would eliminate any doubt as to whether collateral may be liquidated in order to achieve the termination and setoff protections of the Bankruptcy Code. H.R. 1161 House Report at 33.

iii) The Proposed Amendments also would amend the definition of "securities contract" under the FDIA to conform to the proposed definition under the Bankruptcy Code, including the addition of any security agreement or arrangement, or other credit enhancement, in connection with a "securities contract." The FDIA amended definition, however, does not limit the amount of such security agreement, arrangement or enhancement to "the actual value of such agreement on the date of filing of the petition." This difference is noteworthy because the proposed Bankruptcy Code definition could be read to limit the

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[22/] For a discussion of the issues concerning collateralization of derivatives contracts, see, Christian J. Johnson, Derivatives and Rehypothecation Failure: It's 3:00 p.m., Do You Know Where Your Collateral Is?, 39 Ariz. L. Rev. 949, 963-65 (1997); Martin J. Bienenstock, Understanding the Business, Bankruptcy and Securities Aspects of Derivatives, 721 PLI/Comm 11 (1995); Seth Grosshandler, Lech Kalembka & Daniel Feit, Securities, Forward and Commodity Contracts and Repurchase and Swap Agreements Under U.S. Insolvency Laws, 721 PLI/Comm 401, 417-421 (1995).

recovery on collateral to its value on the petition date, thus depriving the creditor of any post-petition increase in value. This could be meaningful if market turmoil preceding a bankruptcy filing has materially (and temporarily) affected the value of the collateral.

2. <u>Forward Contract</u>.

a. "Forward contract" is defined in the Bankruptcy Code, 11 U.S.C. § 101(25), as:

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

b. Comparison with the FDIA: For a comparison with the FDIA definition of "forward contract," see section III.B.4 of this outline.

c. <u>Proposed Amendments to Definition</u>. The Proposed Amendments would modify the definition of "forward contract" in the following substantive ways:

(i) The Proposed Amendments would expand the definition of "forward contract" to include the following:

(a) any agreement similar to the contracts specifically enumerated in the section. Proposed Amendments § 8(a)(1)(A)(ii).

i) The existing definition currently includes "but is not limited to" enumerated contracts, so this may be a conforming amendment.

(ii) The Proposed Amendments also would make revisions to the definition of "forward contract" that are parallel to those made for securities contracts, described in section II.B.1.e.(ii) of this outline. Proposed Amendments § 8(a)(1)(A)(iii).

3. Commodity Contract.

a. "Commodity contract" is defined in the Bankruptcy Code as:

(i) "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";

(ii) "with respect to a foreign futures commission merchant, foreign future";

(iii) "with respect to a leverage transaction merchant, leverage transaction";

(iv) "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"; or

(v) "with respect to a commodity options dealer, commodity option."[23/] 11 U.S.C. § 761(4).

[23/] As used in the definition of "commodities contract," the following terms have the following meanings:

foreign futures commission merchant: 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." 11 U.S.C. § 761(12).

foreign future: 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." 11 U.S.C. § 761(11).

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leverage transaction merchants: "persons in the business of engaging in leverage transactions." 11 U.S.C. § 761(14).

leverage transaction: an "agreement that is subject to regulation under section 19 of the Commodity Exchange Act, and that is commonly known to the commodities trade as a margin account, margin contract, leverage account, or leverage contract." 11 U.S.C. § 761(13).

clearing organization: an "organization that clears commodity contracts made on, or subject to the rules of, a contract market or board of trade." 11 U.S.C. § 761(2).

commodity options dealer: 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." 11 U.S.C. § 761(6).

commodity option: an "agreement or transaction subject to regulation under section 4c(b) of the [Commodity Exchange] Act." 11 U.S.C. § 761(5).

contract market: a "board of trade designated as a contract market by the [Commodity Futures Trading] Commission under the [Commodity Exchange] Act." 11 U.S.C. § 761(7).

contract of sale: "includes sales, agreements of sale, and agreements to sell." 7 U.S.C. § 1a(6) (incorporated by reference in 11 U.S.C. § 761(8)).

commodity: "wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions [as provided in the Commodity Exchange Act], and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in." 7 U.S.C. § 1a(3) (incorporated by reference in 11 U.S.C. § 761(8)).

future delivery: "does not include any sale of any cash commodity for deferred shipment or delivery." 7 U.S.C. § 1a(11) (incorporated by reference in 11 U.S.C. § 761(8)).

board of trade: "any exchange or association, whether incorporated or unincorporated, of persons who are engaged in the business of buying and selling any commodity or receiving the same for sale on consignment." 7 U.S.C. § 1a(1) (incorporated by reference in 11 U.S.C. § 761(8)).

b. Comparison with the FDIA: For a comparison with the FDIA definition of "commodities contract," see section III.B.3 of this outline.

c. Proposed Amendments to Definition. The Proposed Amendments would amend the definition of "commodities contract" in the following substantive ways:

(i) The Proposed Amendments would expand the existing definition to cover the following:

(a) any other agreement or transaction that is similar to an agreement or transaction specifically included in the definition of "commodities contract"; and

(b) any combination of, or option to enter into, agreements or transactions defined in "commodity contract." Proposed Amendments § 8(a)(3).

(ii) The Proposed Amendments would include the same modifications to the definition of "commodities contract" as are included in the definition of "securities contract" to facilitate cross-contract and cross-product netting (described in section II.B.1.e.(ii) of this outline). Proposed Amendments § 8(a)(3).

4. Repurchase Agreement.

a. "Repurchase agreement" (which includes a reverse repurchase agreement) is defined in the Bankruptcy Code, 11 U.S.C. § 101(47), as follows:

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futures commission merchant: "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; and (B) in or in 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." 7 U.S.C. § 1a(12) (incorporated by reference in 11 U.S.C. § 761(8)).

"an agreement, including related terms, which provides for the transfer of certificates of deposit, eligible bankers' acceptances, or securities that are direct obligations of, or that are fully guaranteed as to principal and interest 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, or securities with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, eligible bankers' acceptances, or securities as described above, at a date certain not later than one year after such transfers or on demand, against the transfer of funds."

b. Comparison with the FDIA: For a comparison with the FDIA definition of "repurchase agreement," see section III.B.5 of this outline.

c. Repurchase agreements that do not fall within the definition set forth in section 101(47) of the Bankruptcy Code may fall within the section 741(7) definition of "securities contracts." See Wyle v. Howard, Weil, Labouisse, Freidrichs, Inc. (In re Hamilton Taft & Co.), 114 F.3d 991 (9th Cir. 1997); Jonas v. Farmers Bros. Co. (In re Comark), 124 B.R. 806 (Bankr. C.D. Cal. 1991), aff'd, 145 B.R. 47 (B.A.P. 9th Cir. 1992); In re Residential Resources Mortgage Investments Corp., 98 B.R. 2 (Bankr. D. Ariz. 1989). The issue of whether a repurchase agreement involving a commercial mortgage-backed security is a "securities contract" was raised in litigation in connection with the Chapter 11 proceeding of CRIIMI MAE in Maryland.[24/]

d. Only "repo participants" are protected under the Bankruptcy Code. See section II.D.1.e.(iii).(b).

[24/] In re CRIIMI MAE, Inc., No. 98-23115 (Bankr. D. Md. filed Oct. 5, 1998); In re CRIIMI MAE Management, Inc., No. 98-23116 (Bankr. D. Md. filed Oct. 5, 1998); In re CRIIMI MAE Holdings II, L.P., No. 98-23117 (Bankr. D. Md. filed Oct. 5, 1998); see also In re CRIIMI MAE, Inc., 251 B.R. 796, 802-05 (Bankr. D. Md. 2000) (concluding that material issues of fact existed regarding whether a non-section 101(47) repurchase agreement constituted a true sale or a secured lending under New York law and noting that contract provisions providing that repurchase transactions were "securities contracts" were immaterial to decision because the definition, even if applicable in chapter 11, would encompass both a sale and a secured loan).

e. Proposed Amendments to Definition. Section 8(a)(1)(C) of the Proposed Amendments would amend the definition of "repurchase agreement" in the following substantive ways:

(i) The Proposed Amendments would extend the definition to include transactions involving the following:

(a) a mortgage-related security (as defined in the Securities Exchange Act of 1934), mortgage loan, interest in a mortgage-related security or mortgage loan, and a qualified foreign government security;

i) the Proposed Amendments exclude from the definition of "repurchase agreement" a "repurchase obligation" embedded in a participation in a commercial mortgage loan (such as a recourse obligation). The House Report explains, however, that "a repurchase agreement involving the transfer of participations in commercial mortgage loans with a simultaneous agreement to repurchase the participation on demand or at a date certain one year or less after such transfer would constitute a 'repurchase agreement.'" H.R. 1161 House Report at 31.

ii) the term "qualified foreign government security" is 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 for Economic Cooperation and Development." The inclusion of repurchase agreements in qualified foreign government securities is intended to reflect the increasing use in the markets of such securities as the underlying asset in repurchase agreements. H.R. 1161 House Report at 30-31. The House Report states that "[a]ny risk presented by this modification is addressed by limiting it

to those obligating or guaranteed by OECD member states." Id. at 31.

(b) a combination of, or an option to enter into, a repurchase agreement, including any combination of such agreements and options, or options thereon.

(ii) The Proposed Amendments would include the same modifications to the definition of "repurchase agreement" as were included in the definition of "securities contract" to facilitate cross-contract and cross-product netting (described in section II.B.1.e of this outline).

5. Swap Agreement.

a. "Swap agreement" is defined in the Bankruptcy Code, 11 U.S.C. § 101(53B), as:

(A) an agreement (including terms and conditions incorporated by reference therein) which is 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 rate swap agreement, currency option, any other similar agreement (including any option to enter into any of the foregoing); (B) any combination of the foregoing; or (C) a master agreement for any of the foregoing together with all supplements.

b. Comparison with the FDIA. For a comparison of this definition with the definition under the FDIA, see section III.B.6 of this outline.

c. Proposed Amendments to Definition. The Proposed Amendments to the definition of "swap agreement" are described below. Proposed Amendments § 8(a)(1)(E).

(i) The proposed definition expands the specifically enumerated contracts that qualify as "swap agreements" to include an interest rate future; a same day-tomorrow or tomorrow-next or other foreign exchange agreement; a "spot, same day-tomorrow, tomorrow-next, forward or other precious metals agreement"; a currency future or

forward agreement; an "equity index or an equity swap, option, future, or forward agreement"; a "debt index or a debt swap, option, future, or forward agreement"; a "credit spread or a credit swap, option, future, or forward agreement"; a "commodity index or a commodity . . . option, future or forward agreement"; a "weather swap, weather derivative, or weather option"; and an option on any specifically enumerated "swap agreement."

(ii) The current definition includes the phrase "any other similar agreement" to those enumerated while the proposed amended definition would include an agreement or transaction similar to the specifically enumerated agreements that:

(a) "is presently, or in the future becomes, regularly entered into in the swap market (including terms and conditions incorporated by reference therein)"; and

(b) "is a forward, swap, future, or option on 1 or more rates, currencies, commodities, equity securities, or other equity instruments, debt securities or other debt instruments, or economic indices or measures of economic risk or value."

(iii) According to the Report of the Committee on Banking and Financial Services of the House of Representatives to accompany H.R. 4393 (H.R. Rep. No. 105-688, pt. 1 (1998)),[25/] the Proposed Amendments exclude "traditional commercial and lending arrangements, or other non-financial market transactions, such as commercial, residential or consumer loans" even if the parties to such transactions purport to document or label the transactions as "swap agreements." Id. at 14.

(iv) The Proposed Amendments include the same modifications to the definition of "swap agreement" as were included in the definition of "securities contract" to

[25/] Financial Contract Netting Improvement Act of 1998, H.R. 4393, 105th Cong. (1998). H.R. 4393 was a predecessor of H.R. 11. The portion of H.R. 11 that redefines swap agreements is almost identical to the corresponding section of H.R. 4393.

facilitate cross-contract and cross-product netting (described in section II.B.1.e.(ii) of this outline).

(v) The Proposed Amendments state that the new definition of "swap agreement" is applicable exclusively for purposes of the Bankruptcy Code and not, by analogy, to any other law, including the federal securities laws.

C. Avoidance Powers and Exceptions for Protected Financial Contracts.

1. General Avoidance Powers of Trustee or Debtor-in-Possession. The trustee or debtor in possession generally has the ability to avoid pre-petition preferential transfers, fraudulent transfers and obligations and pre-petition setoffs.

a. Preferences.

(i) Section 547 of the Bankruptcy Code generally grants the trustee or debtor-in-possession the power to avoid any pre-petition transfer of an interest of the debtor in property:

(a) to or for the benefit of a creditor;

(b) on account of an antecedent debt;

(c) made while the debtor was insolvent;

(d) made either (x) on or within 90 days prior to the date of the filing of the petition or (y) between 90 days and one year before the date of the filing of the petition if the creditor is an insider; and

(e) that enables the creditor to receive more than what such creditor would have received in the absence of such transfer if the debtor were liquidated under Chapter 7 of the Bankruptcy Code.

(ii) Section 547 provides exceptions for certain transfers, including contemporaneous exchanges for new value or in payment of a debt incurred and paid by the debtor in the ordinary course of business.

(iii) In the absence of a statutory exception for Protected Financial Contracts, the power to avoid preferential

transfers would enable the trustee to "avoid" or nullify any pre-petition transfer pursuant to the terms of a contract between the debtor and a counterparty (including termination payments, margin payments and settlement payments), if the transfers were made under the conditions described above unless they qualified for one of the statutory exceptions.

(a) A creditor with a perfected security interest in a Chapter 7 bankruptcy case would generally recoup the amount of the obligations secured by the security interest, so any transfer of, or payment not exceeding the value of, the secured obligation would not be avoidable as a preference. For example, if a stockbroker holding margin liquidates such margin in full payment of debts owed to it, generally the stockbroker would not be viewed as having received a preferential transfer, since the transfer received by the stockbroker would be the amount that would have been received by the stockbroker in a Chapter 7 proceeding. There are, however, numerous valuation, perfection and other issues arising in such cases.

b. Fraudulent Transfer.

(i) Section 548 of the Bankruptcy Code grants the trustee or debtor-in-possession the power to avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily

(a) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud a creditor; or

(b) received less than a reasonably equivalent value in exchange for the transfer or obligation when the debtor was insolvent or became insolvent as a result of such transfer or obligation; or was engaging in business with unreasonably small capital; or intended to incur, or believed it would incur, debts beyond its ability to repay as they

matured. Transfers that fall within this subparagraph (b) are considered "constructively" fraudulent.

c. Pre-petition Setoffs.

(i) The Bankruptcy Code provides that the Bankruptcy Court may avoid a pre-petition setoff if the debt owed to the debtor by the creditor was (x) transferred to such creditor after 90 days before the date of the filing of the petition, while the debtor was insolvent or (y) incurred by such creditor after 90 days before the filing, while the debtor was insolvent and for the purpose of obtaining a right of setoff against the debtor. 11 U.S.C. § 553(a)(2)-(3).

(ii) The trustee may recover from a creditor the amount of any setoff made on or 90 days before the date of the filing of the petition to the extent that any "insufficiency" on the date of such setoff is less than the insufficiency on the later of (x) 90 days before the date of the filing of the petition and (y) the first date during the 90 days immediately preceding the date of the filing of the petition on which there is an insufficiency. The term "insufficiency" means the amount, if any, by which a claim against the debtor exceeds the claim against the counterparty.

2. Exceptions for Protected Financial Contracts. Section 546 of the Bankruptcy Code provides several exceptions to the avoidance powers discussed above, including exceptions for Protected Financial Contracts discussed below.

a. Definitions. Certain definitions used in connection with the exceptions to the trustee's avoidance powers are discussed below:

(i) "Transfer" is defined as "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption." 11 U.S.C. § 101(54).

(ii) "Margin Payment"

(a) The term "margin payment" is defined in the Bankruptcy Code:

for securities contracts, as any "payment or deposit of cash, a security or other property, that is commonly known to the securities trade as original margin, initial margin, maintenance margin, or variation margin, or as a mark-to-market payment, or that secures an obligation of a participant in a securities clearing agency." 11 U.S.C. § 741(5).

(b) for commodities contracts, as any "payment or deposit of cash, a security, or other property, that is commonly known to the commodities trade as original margin, initial margin, maintenance margin, or variation margin, including mark-to-market payments, settlement payments, variation payments, daily settlement payments, and final settlement payments made as adjustments to settlement prices." 11 U.S.C. § 761(15).

(c) for forward contracts, as any "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." 11 U.S.C. § 101(38).

(d) See Seitter v. Farmer's Commodities Corp. (In re Yeagley), 220 B.R. 402, 404-05 (Bankr. D. Kan. 1998) (stating that "the term 'margin payment' includes any payment by the debtor to reduce a deficiency in that debtor's margin account," regardless of whether the payment is made in response to a margin call).

(iii) "Settlement payment"

(a) The term "settlement payment" is defined in the Bankruptcy Code as:

"preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade." 11 U.S.C. § 741(8).

(b) for forward contracts, as any "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." 11 U.S.C. § 101(51A).

(c) The term "settlement payment" has been broadly construed by the courts. See Wyle v. Howard, Weil, Labouisse, Freidrichs Inc. (In re Hamilton Taft & Co.), 114 F.3d 991, 993 (9th Cir. 1997) (concluding that the transfer by stock broker of cash proceeds to a third party pursuant to debtor's instructions and a reverse repurchase agreement is a "settlement payment"); Jonas v. Resolution Trust Corp. (In re Comark), 971 F.2d 322, 325-26 (9th Cir. 1992) (noting that debtor's return of securities when debtor withdrew from reverse repurchase agreement and no longer required such securities as "excess margin" constituted a settlement payment); Kaiser Steel Corp. v. Pearl Brewing Co. (In re Kaiser Steel Corp.), 952 F.2d 1230, 1237-40 (10th Cir. 1991) (declaring that the exchange of stock for consideration in connection with a leveraged buyout ("LBO") constitutes a settlement payment); Bevill, Bresler & Shulman Asset Mgmt. Corp. v. Spencer Savings & Loan Ass'n, 878 F.2d 742, 752-53 (3d Cir. 1989) (recognizing that the delivery of securities pursuant to the conversion of a hold-in-custody repo to a deliver-out repo constitutes a settlement payment); Biggs v. Smith Barney, Inc. (In re David), 193 B.R. 935, 940 (Bankr.

C.D. Cal. 1996) (stating that transfers may constitute settlement payments even though they do not match with a transaction or a series of transactions).

(d) Courts have found a variety of transactions not to be settlement payments. See Interbulk, Ltd. v. Louis Dreyfus Corp. (In re Interbulk, Ltd.), 240 B.R. 195, 201 n.8 (Bankr. S.D.N.Y. 1999) (holding that attachment by a counterparty of a debt due from a third party to the debtor to satisfy the debtor's payment obligation under forward rate agreement was not a settlement payment); Zahn v. Yucaipa Capital Fund, 218 B.R. 656, 675-78 (Bankr. D.R.I. 1998) (holding that transfers in connection with an LBO were not settlement payments due to the complete absence of any involvement with the clearance and settlement process); Weinman v. Fidelity Capital Appreciation Fund (In re Integra Realty Resources, Inc.), 198 B.R. 352, 359-60 (Bankr. D. Colo. 1996) (delivery of stock to shareholders without payment of consideration or vote by shareholders in connection with a spin-off not a settlement payment); Brandt v. Hicks, Muse & Co., Inc. (In re Healthco Int'l, Inc.), 195 B.R. 971, 983 (Bankr. D. Mass. 1996) (holding that transfer in connection with an LBO was not a settlement payment because a one-time distribution in complete liquidation of stock interest, particularly in the absence of a securities clearing agency's guaranty, was not in the ordinary course of business transfers related to the purchase or sale of securities).

(iv) "Financial Institution"

(a) The term "financial institution" is defined to include "a commercial or savings bank, industrial savings bank, savings and loan association, or trust company and, when any such person is acting as agent or custodian for a customer in connection with a securities contract . . . , such customer." 11 U.S.C. § 101(22).

(b) Proposed Amendments. The Proposed Amendments would extend the reach of this definition to include Federal Reserve Banks and receivers or conservators for "financial institutions." Proposed Amendments § 8(b)(1).

i) The Proposed Amendments clarify that "financial institution" includes any of the enumerated entities "which operates, or operates as, a multilateral clearing organization" under section 409 of FDICIA. This clarification was omitted from Title IX of the Bankruptcy Reform Act of 2000.

ii) Unlike the Proposed Amendments, Title IX of the Bankruptcy Reform Act of 2000 also included investment companies registered under the Investment Company Act of 1940 in connection with securities contracts. Bankruptcy Reform Act of 2000 § 907(b)(1).

(v) "Securities Clearing Agency"

(a) The Bankruptcy Code defines the term "securities clearing agency" to include a "person that is registered as a clearing agency under section 17A of the Securities Exchange Act of 1934 or whose business is confined to the performance of functions of a clearing agency with respect to exempted securities, as defined in section 3(a)(12) of such Act for the purposes of such section 17A." 11 U.S.C. § 101(48).

(b) Proposed Amendments. The Proposed Amendments would amend this definition to include those securities clearing agencies that are exempt from registration pursuant to an order of the SEC. Proposed Amendments § 8(a)(1)(D).

(vi) "Commodity Broker"

(a) The Bankruptcy Code defines "commodity broker" to mean "futures commission merchant, foreign futures commission merchant, clearing organization, leverage transaction merchant, or commodity options dealer . . . with respect to which there is a customer." 11 U.S.C. § 101(6).

(vii) "Stockbroker"

(a) The Bankruptcy Code defines "stockbroker" to mean a "person (A) with respect to which there is a customer . . . and (B) that is engaged in the business of effecting transactions in securities (i) for the account of others; or (ii) with members of the general public, from or for such person's own account." 11 U.S.C. § 101(53A).

(viii) "Forward Contract Merchant"

(a) The Bankruptcy Code defines "forward contract merchant" to mean a "person whose business consists in whole or in part of entering into forward contracts as or with merchants in a commodity . . . or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade." 11 U.S.C. § 101(26).

(b) Proposed Amendments. The Proposed Amendments would amend this definition to include Federal Reserve Banks. Proposed Amendments § 8(b)(3).

b. Certain Margin and Settlement Payments. The Bankruptcy Code exempts from the trustee's avoidance powers certain pre-petition margin and settlement payments between certain financial institutions. Section 546(e) provides as follows:

"[T]he trustee may not avoid a transfer that is a margin payment . . . or settlement payment . . . made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, or securities clearing agency, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title." 11 U.S.C. § 546(e).

(i) Section 546(e) does not specify the nature of the underlying transaction in connection with which the settlement payment or margin payment is made, but rather focuses on the nature of the counterparties and the type of payment that may not be avoided. Hedge funds generally will not fall within one of the groups eligible to use this exception to a trustee's avoidance powers.[26/] Thus, a hedge fund will not be able to take advantage of the exception unless its counterparty is an entity that falls within one of the enumerated categories of entities. Hedge funds may fall within the broader definitions of "repo participant" and "swap participant" and may be protected thereunder for qualifying repurchase agreements and swap agreements.

(ii) As noted above, the exceptions to the trustee's avoidance powers for Protected Financial Contracts protect "constructively" fraudulent transfers covered by section 548, but do not protect from avoidance transfers made with actual fraudulent intent.

(iii) Compare this provision with section 546(g), which provides an exception (other than for actual fraud) for any payment under a swap agreement, not just margin and settlement payments.

(iv) As noted above, a pre-petition transfer of margin by or to an eligible counterparty should not be avoidable by the trustee. Note, however, that this section by its terms protects "transfers" of property of the debtor. The trustee also has the ability to seek to avoid "obligations" incurred by the debtor under section 548(a). Therefore, the trustee or debtor-in-possession may be able to avoid a new Protected Financial Contract (i.e., an obligation) that was entered into by the debtor under the conditions set forth in section 548(a) as a constructively fraudulent obligation, whereas the trustee would not be able to avoid a transfer under a preexisting Protected Financial Contract.

[26/] Traditionally, hedge funds have not been required to register with the SEC as broker-dealers.

(v) Proposed Amendments. The Proposed Amendments would extend the reach of section 546(e) to counterparties falling within the new, expanded definitions of "financial institution," "forward contract merchant" and "securities clearing agency" provided by the Proposed Amendments (discussed in section II.C.2.a. of this outline), and to "financial participant." Proposed Amendments § 8(q)(2).

(a) "Financial participant" is defined as:

"an entity that, at the time it enters into a securities contract, commodity contract or forward contract, or at the time of the filing of the petition, has 1 or more [Protected Financial Contracts] with the debtor or any other entity (other than an affiliate) of a total gross dollar value of at least $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 at least $100,000,000 (aggregated across counterparties) in 1 or more such agreement or transaction with the debtor or any other entity (other than an affiliate) on any day during the previous 15-month period." Proposed Amendments § 8(b)(2).

i) The proposed definition of "financial participant" is similar, but not identical, to the definition of "financial institution" under Reg. EE. See section IV.B.1 of this outline.

ii) According to the H.R. 1161 House Report, the purpose of expanding the application of the exceptions for Protected Financial Contracts to a broader range of market participants is to limit the impact of the insolvency of a market participant on other major market participants. H.R. 1161 House Report at 32. This broader transactional definition would make the exemption available to large hedge funds that might

otherwise be impeded from fully exercising netting rights because of existing counterparty limitations.

c. Margin and Settlement Payments - Repurchase Agreements. The Bankruptcy Code provides an exemption from the trustee's avoidance powers for pre-petition margin and settlement payments in connection with repurchase agreements. Section 546(f) provides as follows:

"[T]he trustee may not avoid a transfer that is a margin payment . . . or settlement payment . . . made by or to a repo participant, in connection with a repurchase agreement and that is made before the commencement of the case, except under section 548(a)(1)(A) of this title."

(i) Only counterparties to the debtor that are repo participants may use this exception. The term "repo participant" includes any "entity that, on any day during the period beginning 90 days before the date of the filing of the petition, has an outstanding repurchase agreement with the debtor." 11 U.S.C. § 101(46). Thus the class of counterparties is not as narrowly drawn as in the exception provided by section 546(e) discussed above; on the other hand, a repo participant not having an open position in the 90 days prior to the petition would not be protected against a fraudulent transfer claim brought by the trustee. Given the transactional nature of the definition of "repo participants," hedge funds engaging in qualifying repurchase transactions should qualify for the exemption.

(a) Proposed Amendments. The Proposed Amendments would expand the definition of "repo participant" to include an entity that had an outstanding repurchase agreement with the debtor "at any time" before the filing of the petition, not only those that were outstanding in the 90 days before the filing. Proposed Amendments § 8(a)(1)(B).

(ii) Only margin payments and settlement payments under "repurchase agreements," as defined in the Bankruptcy Code, are eligible for this exception. The class of permissible underlying securities for repurchase

agreements under the Bankruptcy Code is relatively restricted (see section II.B.4. of this outline) and the date for return of the securities must not exceed one year after the transfer of the securities (unless returnable on demand).

(iii) As noted above, the exceptions to the trustee's avoidance powers for Protected Financial Contracts do not protect from avoidance transfers made with actual fraudulent intent under 548(a)(1) (as opposed to "constructively" fraudulent transfers).

(iv) Compare this provision with section 546(g), which provides an exception for any payment in connection with a swap agreement, not just margin and settlement payments.

d. Transfers In Connection with a Swap Agreement. The Bankruptcy Code provides an exemption from the trustee's avoidance powers for pre-petition transfers in connection with swap agreements. Section 546(g) provides as follows:

"[T]he trustee may not avoid a transfer under a swap agreement, made by or to a swap participant, in connection with a swap agreement and that is made before the commencement of the case, except under section 548(a)(1)(A) of this title."

(i) Unlike the exceptions contained in sections 546(e) and (f), the transfers permitted under this provision are not limited to margin payments and settlement payments, but may be any transfer in connection with a swap agreement.

(a) The limitation to payments "under a swap agreement" raises the issue whether transfers under security agreements that are not an integral part of a swap agreement may be avoidable. Under the Proposed Amendments to the definition of "swap agreement" described above, however, transfers under security agreements "related" to swap agreements should be protected. See section II.B.5. of this outline.

(b) Unlike what may apply under other Protected Financial Contracts, liquidation of margin to pay

termination damages appears to be protected under this section, as liquidation may be a "transfer under a swap agreement" even if not a "settlement payment." See the definition of "transfer" in section II.C.2.a. of this outline.

(ii) Only counterparties to the debtor that are swap participants may take advantage of this exception. The term "swap participant" includes any "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 the type of counterparties is not as limited as in the exceptions provided by section 546(e) discussed above, and does not have the 90 day time limitation applicable to repo participants (which would be eliminated under the Proposed Amendments). Hedge funds engaged in swap transactions should qualify for this exemption.

(iii) Proposed Amendments. The Proposed Amendments would amend section 546(g) to provide that a transfer could not be avoided if made "under or in connection with any swap agreement." Proposed Amendments § 8(e)(1) (emphasis added). It has been held under existing law that a transfer may be avoided unless it was made "under" and "in connection with" a swap agreement. See Interbulk, Ltd. v. Louis Dreyfus Corp. (In re Interbulk, Lt.), 240 B.R. 195, 202-03 (Bankr. S.D.N.Y. 1999) (holding that an attachment by a counterparty of a debt owed by a third party to the debtor to satisfy the debtor's obligation under a forward rate agreement did not qualify for protection under section 546(g) because it was not a transfer "under a swap agreement," even if it might be deemed to be "in connection with a swap agreement").

e. Proposed Exception for Master Netting Agreements. The Proposed Amendments would add a new provision to protect "master netting agreements" from the trustee's avoidance powers. The provision, which would be designated new section 546(j), would prohibit the trustee from avoiding:

"a transfer made by or to a master netting agreement participant under or in connection with any master netting agreement or any individual contract covered thereby that is made before the commencement of the case, except under section 548(a)(1)(A)

and except to the extent the trustee could otherwise avoid such a transfer made under an individual contract covered by such master netting agreement." Proposed Amendments § 8(e)(2).

(i) Proposed Amendments § 8(e)(2).

(a) The Proposed Amendments would add two new definitions as new sections 101(38A) and 101(38B) as follows:

(b) Master netting agreement - "an agreement providing for the exercise of rights, including rights of netting, setoff, liquidation, termination, acceleration, or closeout, under or in connection with 1 or more [Protected Financial Contracts], or any security agreement or arrangement or other credit enhancement related to 1 or more of the foregoing. If a master netting agreement contains provisions relating to agreements or transactions that are not [Protected Financial Contracts], the master netting agreement shall be deemed to be a master netting agreement only with respect to [Protected Financial Contracts]." Proposed Amendments § 8(c).

(c) Master netting agreement participant - "an entity that, at any time before the filing of the petition, is a party to an outstanding master netting agreement with the debtor." Proposed Amendments § 8(c).

i) Note that if a master netting agreement covers transactions in Protected Financial Contracts as well as transactions that do not qualify as Protected Financial Contracts, transfers in connection with the non-qualifying transactions are not protected from avoidance.

ii) The House Report states that the master netting agreement amendment "is designed to protect the termination and close-out netting provisions of cross-

product master agreements between parties." H.R. 1161 House Report at 32.

f. Additional Exceptions for Constructive Fraudulent Transfers. As noted in section II.C.1.b of this outline, a trustee may avoid as a constructively fraudulent transfer certain pre-petition transfers made by the debtor while the debtor was insolvent, if the debtor did not receive "reasonably equivalent value." The Bankruptcy Code provides that a commodity broker, forward contract merchant, stockbroker, financial institution, securities clearing agency or repo participant (in connection with a repurchase agreement) that receives a margin payment or settlement payment takes for value to the extent of such payment, and a swap participant that receives a transfer in connection with a swap agreement takes for value to the extent of such transfer. 11 U.S.C. §§ 548(d)(2)(B)-(D).

(i) Proposed Amendments.

(a) The Proposed Amendments would expand the reach of section 548(d)(2)(B) to counterparties falling within the new definitions of "financial institution," "forward contract merchant" and "securities clearing agency" provided by the amendments discussed in section II.C.2.a., and to "financial participants" discussed in section II.C.2.b. Proposed Amendments § 8(q)(3).

(b) The Proposed Amendments also would add a new provision relating to "master netting agreements" concerning the measure of "reasonably equivalent value" for such agreements as follows:

(E) a master netting agreement participant that receives a transfer in connection with a master netting agreement or any individual contract covered thereby takes for value to the extent of such transfer, except, with respect to a transfer under any individual contract covered thereby, to the extent such master netting agreement participant otherwise did not take (or is otherwise not deemed to have taken) such transfer for value. Proposed Amendments § 8(f)(3).

(c) The meaning of the exception contained within this provision is not clear. It may be meant to exclude from the presumption those transfers under a master netting agreement that relate to individual agreements that are not themselves Protected Financial Contracts, while maintaining the presumption for the remaining transfers under the master netting agreement. This appears to have been the intent of a similar (and perhaps clearer) provision in section 8(f) of H.R. 4393 (a predecessor bill)[27/] that read as follows:

(E) a master netting agreement participant that receives a transfer in connection with a master netting agreement takes for value to the extent of such transfer, but only to the extent that such participant would take for value under paragraph (B), (C), or (D) for each individual contract covered by the master netting agreement in issue.

g. Setoff Protections. Section 553(b)(1) excludes Protected Financial Contracts from the trustee's power to avoid and recover amounts setoff as described in section II.C.1.c of this outline, to the extent that the setoff is accomplished in accordance with sections 362(b)(6) and 362(b)(7) of the Bankruptcy Code (described below). The requirements for setoff are discussed in section II.D.2.b.(iv) of this outline.

(i) Proposed Amendments.

(a) Section 553(a)(3)(C) would be amended to provide an exception to the effect that the Bankruptcy Court would not be able to avoid a setoff in connection with Protected Financial Contracts (of a kind described in sections 362(b)(6), 362(b)(7), 362(b)(17), 362(b)(32), 555, 556, 559, 560 or 561 of the Bankruptcy Code) solely on the basis that the debt owed to the debtor by the creditor was incurred by such creditor, (x) after 90 days before the date of the

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27/ Financial Contract Netting Improvement Act of 1998, H.R. 4393, 105th Cong. (1998).

filing of the petition, (y) while the debtor was insolvent and (z) for the purpose of obtaining a right of setoff against the debtor. Proposed Amendments § 8(p)(1).

(b) The Proposed Amendments appear inadvertently to refer to section 362(b)(32) (which does not exist), rather than new section 362(b)(19) (relating to master netting agreements). The counterpart amendment in Title IX of the Bankruptcy Reform Act of 2000 refers, in place of section 362(b)(32), to section 326(b)(28), which is the counterpart amendment in Title IX to section 362(b)(19) in the Proposed Amendments. Bankruptcy Reform Act of 2000 § 907(n)(1).

(c) In addition, section 553(b)(1) (granting the trustee the authority to recover as preferences certain amounts setoff within 90 days before the date of the bankruptcy filing) would be amended to clarify that setoffs in connection with Protected Financial Contracts (pursuant to sections 362(b)(17), 362(b)(32), 555, 556, 559, 560 and 561) are excluded from these avoidance provisions. Proposed Amendments § 8(p)(2).

i) Again, the Proposed Amendments appear inadvertently to refer to section 362(b)(32), rather than new section 362(b)(19). Likewise, the counterpart amendment in Title IX of the Bankruptcy Reform Act of 2000 refers to section 326(b)(28) in place of 362(b)(32). Bankruptcy Reform Act of 2000 § 907(n)(2).

D. <u>Stay Powers and Exceptions for Protected Financial Contracts</u>.

1. <u>Termination Rights</u>.

a. <u>Automatic Stay</u>. Generally, when a petition is filed under the Bankruptcy Code, there is an automatic stay imposed on creditors of the debtor preventing the creditors from taking any action against the debtor or its property to collect claims, enforce

liens, or terminate contracts without the approval of the Bankruptcy Court. The automatic stay is intended to halt collection efforts and creditor harassment of the debtor and to promote an orderly and equitable distribution of the debtor's assets among claimants.

b. Stay Powers. In addition to the automatic stay imposed by the Bankruptcy Code, the trustee, with certain exceptions, has the power to request the bankruptcy court to stay actions by creditors that are not subject to the automatic stay.

c. Cherry Picking; Assumption and Rejection of Existing Contracts.

(i) Upon the filing of the petition, the Bankruptcy Code gives the trustee or debtor-in-possession the power, with certain limitations and exceptions, to assume or reject individual executory contracts of the debtor. 11 U.S.C. § 365(a). This right provides the trustee or debtor in possession the ability to "cherry pick" among the debtor's executory contracts and to assume contracts that benefit the debtor and reject those that are unfavorable to the debtor. See Liona Corp., N.V. v. PCH Assocs. (In re PCH Assocs.), 804 F.2d 193, 200 (2d Cir. 1986). The right to cherry pick provides the trustee the ability to undermine setoff rights of a creditor to several contracts with the debtor: the trustee can assume those favorable to the debtor, on which the creditor will have to perform, and reject those unfavorable to the debtor, leaving the creditor with an unsecured damages claim.

(ii) Under the legislative history of the Code, an executory contract is generally defined as a contract "on which performance remains due to some extent on both sides." H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 347 (1977); S. Rep. No. 95-989, 95th Cong. 2d Sess. 58 (1978). Thus, Protected Financial Contracts may be executory contracts, depending upon the state of performance under the contract upon the filing of the petition.

d. Rejection of Contracts. The non-debtor party to a rejected contract will have a claim for damages for breach of the contract. The Bankruptcy Code provisions do not clearly prescribe the date as of which the contract will be deemed to have been breached, and as of which damages should be calculated, in the

event the trustee rejects an executory contract. Although the Bankruptcy Code makes clear that claims for rejected contracts will be considered pre-petition debts, it is not clear whether damages will be measured as of the petition date or the date of rejection of the contract.

(i) Proposed Amendments. The Proposed Amendments would provide more clarity regarding the calculation of damages upon termination by the counterparty or rejection by the trustee of Protected Financial Contracts (including "master netting agreements"). A new provision (new 11 U.S.C. § 562) would provide that upon such occurrence, damages will be measured as of the earlier of (1) the date of such rejection; or (2) the date of such liquidation, termination, or acceleration. Proposed Amendments § 11(a). The Proposed Amendments would also add a new section 502(g)(2) for claims arising from rejection by the trustee to the effect that a claim for damages calculated as noted above shall be allowed or disallowed as if such claim had arisen before the date of the filing of the petition. Proposed Amendments § 11(b).

(ii) Assumption and Ipso Facto Clauses. The trustee generally may assume an executory contract even if the non-debtor party has the right to terminate or modify the contract upon the insolvency or poor financial condition of the debtor or commencement of any type of insolvency proceeding.[28/] Contractual clauses providing

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[28/] Section 365(e)(1) of the Bankruptcy Code provides as follows:

Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on?

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title; or

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement. 11 U.S.C. § 365.

contracting parties the right to terminate an agreement under such circumstances are known as "ipso facto clauses" and generally are unenforceable against the trustee or debtor-in-possession. In addition, with certain limitations and exceptions, the trustee generally may assume and assign an executory contract to a third party even if such contract prohibits assignment of the contract. 11 U.S.C. § 365(f).

e. Exceptions for Protected Financial Contracts. The Bankruptcy Code provides that "contractual rights" to terminate Protected Financial Contracts cannot be stayed, except in certain cases, by an order authorized under the SIPA or statutes administered by the SEC. Therefore, a contractual right of the non-debtor party to terminate a Protected Financial Contract will continue in effect after the petition is filed unless modified by mutual agreement of the parties. If the non-debtor counterparty liquidates a Protected Financial Contract, the trustee does not have the right to assume or assign the contract. Nevertheless, if such counterparty fails to liquidate such contract, the trustee's assumption and assignment powers remain intact.

(i) Securities Contracts. The unilateral exercise by a counterparty of a right to liquidate a "securities contract" is protected by section 555 of the Bankruptcy Code, which provides:

"The exercise of a contractual right of a stockbroker, financial institution, or securities clearing agency to cause the liquidation of a securities contract . . . , 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 such order is authorized under the provisions of the Securities Investor Protection Act of 1970 or any statute administered by the [SEC]. As used in this section, the term 'contractual right' includes a right set forth in a rule or bylaw of a national securities exchange, a national securities association, or a securities clearing agency." 11 U.S.C. § 555.

(a) This section provides that ipso facto clauses in executory securities contracts shall be

enforceable, as well as contractual rights to liquidate contracts that are established by a rule or bylaw of a national securities exchange, a national securities association or a securities clearing agency. Unlike other Protected Financial Contracts, this provision does not provide that a contractual right to liquidate a securities contract may be established for the purposes of this exception on the basis of normal business practice.

(b) Only counterparties to the debtor that are stockbrokers,[29] financial institutions[30] or securities clearing agencies[31] may liquidate securities contracts on the basis of ipso facto clauses (or applicable exchange, association or agency rules). Parties who enter into securities contracts through affiliates should carefully note whether the affiliate qualifies for the protections of this section. As discussed above, hedge funds may not qualify for this exemption (see section II.C.2.b.).

(c) SIPA. The exercise of these contractual rights will not be subject to the stay or avoidance powers of the trustee or a bankruptcy court. A stockbroker or securities clearing agency, however, that is a member of the Securities Investor Protection Corporation ("SIPC") may be subject to the provisions of SIPA or any statute administered by the SEC, which may seek a stay of the termination, liquidation or setoff of a securities contract. Stockbrokers that are members of SIPC typically are liquidated in proceedings under SIPA, rather than under the

[29] For a definition of "stockbroker," see discussion above in section II.C.2.a.

[30] For a definition of "financial institution," see discussion above in section II.C.2.a.

[31] For a definition of "securities clearing agency," see discussion above in section II.C.2.a.

Code. The provisions of the Code apply in a liquidation proceeding under SIPA.[32/]

(d) Proposed Amendments. The Proposed Amendments would amend section 555 as follows:

i) The Proposed Amendments would make clear that section 555 protects not only liquidation rights, but also termination and acceleration rights under securities contracts. Proposed Amendments § 8(g).

ii) The Proposed Amendments would expand the reach of section 555 to counterparties falling within the new broader definitions of "financial institution" and "securities clearing agency" provided by the amendments (discussed in section II.C.2.a.), and to "financial participants" (discussed in section II.C.2.b.). This would still omit many affiliates of stockbrokers, for example, but would make the exemption available to hedge funds falling within the definition of "financial participant." Proposed Amendments § 8(q)(4)(A).

iii) The Proposed Amendments would expand the meaning of "contractual right" for "securities contracts" to include "a right set forth in a bylaw of a clearing organization or contract market or in a resolution of the governing board thereof, and a right, whether or not in writing, arising under common law, under law merchant, or by reason of

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[32/] For a discussion of SIPA procedures in these cases, see, Seth Grosshandler, Lech Kalembka & Daniel Feit, Securities, Forward and Commodity Contracts and Repurchase and Swap Agreements Under U.S. Insolvency Laws, 721 PLI/Comm 401, 416-18 (1995); Harold S. Novikoff, Special Bankruptcy Code Protections for Derivative and Other Capital Market Transactions, 721 PLI/Comm 95, 109-111 (1995).

normal business practice." Proposed Amendments § 8(q)(4)(B).

iv) The House Report states that for the purposes of the Proposed Amendments to sections 555, 556, 559, 560 and 561 of the Bankruptcy Code, "it is intended that the normal business practice in the event of a default of a party based on bankruptcy or insolvency is to terminate, liquidate or accelerate" Protected Financial Contracts. H.R. 1161 House Report at 34.

v) The Proposed Amendments would amend SIPA to provide that notwithstanding section 362 of the Bankruptcy Code, the filing of an application under section 5(a)(3) of SIPA or an order or decree obtained by SIPC will not stay any right of liquidation, termination, acceleration, offset or netting under one or more securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements or master netting agreements (as defined in the Bankruptcy Code and including rights of foreclosure on cash collateral). A SIPA application, order or decree, however, may stay a right to foreclose on securities collateral pledged by the debtor under any Protected Financial Contract (including master netting agreements) or sold by the debtor under a repurchase agreement or securities lent under a securities lending agreement. Proposed Amendments § 12.

(ii) Commodities and Forward Contracts. The exercise by a counterparty of a right unilaterally to liquidate a "commodities contract" or a "forward contract" is protected by section 556 of the Bankruptcy Code. Section 556 of the Bankruptcy Code provides:

"The contractual right of a commodity broker or forward contract merchant to cause the liquidation of a commodity contract . . . or forward contract because of a condition of the kind specified in section 365(e)(1) of this title, and the right to a variation or maintenance margin payment received from a trustee with respect to open commodity contracts or forward contracts, shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by the order of a court in any proceeding under this title." 11 U.S.C. § 556.

(a) This section provides that ipso facto clauses in executory contracts shall be enforceable, as well as contractual rights to liquidate contracts that are established by a rule or bylaw of a clearing organization or contract market or in a resolution of the governing board thereof, and also may arise under law merchant or by reason of normal business practice.

(b) Unlike the definition of "securities contract," this provision also provides that the right to a variation or maintenance margin payment received from a trustee with respect to open commodity contracts or forward contracts may not be stayed or avoided.

(c) Only commodity brokers[33/] and forward contract merchants[34/] may liquidate commodities contracts or forward contracts pursuant to this exception. Accordingly, hedge funds would not be eligible to use this exemption

(d) Proposed Amendments. The Proposed Amendments would amend section 556 as follows:

33/ For a definition of "commodity broker," see discussion above in section II.C.2.a of this outline.

34/ For a definition of "forward contract merchant," see discussion above in section II.C.2.a. of this outline.

i) The Proposed Amendments would make clear that section 556 protects not only liquidation rights, but also termination and acceleration rights under "commodity contracts" and "forward contracts." Proposed Amendments § 8(h).

ii) The Proposed Amendments would expand the reach of section 556 to counterparties falling within the new, expanded definition of "forward contract merchant" provided by the Proposed Amendments discussed in section II.C.2.a., and to "financial participant" discussed in section II.C.2.b. This amendment would open this exemption to use by hedge funds qualifying as "financial participants." Proposed Amendments § 8(q)(5).

(iii) Repurchase Agreements. The right of a counterparty unilaterally to liquidate a "repurchase agreement" is protected by section 559 of the Bankruptcy Code. Section 559 of the Bankruptcy Code provides:

"The exercise of a contractual right of a repo participant to cause the liquidation 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 [SIPA] or any statute administered by the [SEC]. In the event that a repo participant liquidates one or more repurchase agreements with a debtor and under the terms of one or more such agreements has agreed to deliver assets subject to repurchase agreements to the debtor, any excess of the market prices received on liquidation of such assets (or if any such assets are not disposed of on the date of liquidation of such repurchase agreements, at the prices available at the time of liquidation of such repurchase agreements from a generally recognized

source or the most recent closing bid quotation from such a source) over the sum of the stated repurchase prices and all expenses in connection with the liquidation of such repurchase agreements shall be deemed property of the estate, subject to the available rights of setoff." 11 U.S.C. § 559.

(a) This section provides that ipso facto clauses in executory repurchase agreements shall be enforceable, as well as contractual rights to liquidate contracts that are established by a "rule or bylaw, applicable to each party to the repurchase agreement, of a national securities exchange, a national securities association, or a securities clearing agency," or it may arise under common law, law merchant or by reason of normal business practice, whether or not evidenced in writing.

(b) Only counterparties of the debtor that are repo participants[35/] may take advantage of this exception. As noted above in section II.C.2.c. of this outline, this definition could leave a party that closed out all repo transactions more than 90 days pre-petition exposed to liability. Subject to that limitation, hedge funds that fulfill the transactional test should qualify as "repo participants."

(c) The provision provides that, if a repo participant has agreed to deliver assets subject to repurchase agreements to the debtor upon liquidation of a contract, any excess of the market prices of the liquidated assets on the liquidation date over the sum of the stated repurchase prices and all expenses in connection with the liquidation of such repurchase agreements shall be deemed property of the estate, subject to the available rights of setoff. This mandates two-way netting, even if the agreement would allow the counterparty to retain the excess proceeds following the debtor's default. Section 559 is

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[35/] For the definition of "repo participant," see section II.C.2.c of this outline.

the only provision regarding liquidation of Protected Financial Contracts to authorize explicitly that the non-debtor counterparty may retain expenses in connection with the termination of the contract.

(d) SIPA. As with securities contracts, if the debtor counterparty to a repurchase agreement is a stockbroker or securities clearing agency, liquidation of a repurchase agreement may be stayed or avoided if ordered under the provisions of SIPA or any statute administered by the SEC.

(e) Proposed Amendments.

i) The Proposed Amendments would make clear that section 559 protects not only liquidation rights, but also termination and acceleration rights under "repurchase agreements." Proposed Amendments § 8(i).

ii) As noted above, the Proposed Amendments would amend SIPA to limit SIPC's stay power regarding Protected Financial Contracts. See section II.D.1.e.(i).(c) of this outline.

iii) As noted above in section II.C.2.c of this outline, the Proposed Amendments would expand the definition of "repo participant" to include any counterparty who had a repurchase agreement outstanding with the debtor "at any time" before the filing, rather than only during the 90 days prior to the filing. Proposed Amendments § 8(a)(1)(B).

(iv) Swap Agreements. The exercise by a counterparty of a right unilaterally to terminate a "swap agreement" is protected by section 560 of the Bankruptcy Code. Section 560 of the Bankruptcy Code provides:

"The exercise of any contractual right of any swap participant to cause the termination of a

swap agreement 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 any swap agreement 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." 11 U.S.C. § 560.

(a) This section provides that ipso facto clauses in executory swap agreements shall be enforceable, as well as contractual rights to liquidate contracts that are established by a "right, whether or not evidenced in writing, arising under common law, under law merchant, or by reason of normal business practice."

(b) The term swap participant[36/] applies generally to any person, including hedge funds, having an outstanding swap agreement with the debtor at any time pre-petition.

(c) Section 560 is the only provision regarding termination of Protected Financial Contracts that expressly makes enforceable contractual rights "to offset or net out any termination values or payment amounts arising under or in connection with" a Protected Financial Contract. For Protected Financial Contracts other than swap agreements, such rights are protected under the section 362 netting exceptions (described below).

(d) Proposed Amendments. The Proposed Amendments would make clear that section 560 protects not only termination rights, but also liquidation and acceleration rights under "swap agreements." Proposed Amendments § 8(j)(2).

(v) Proposed Amendments - Master Netting Agreements. The Proposed Amendments would add a new section

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36/ For the definition of "swap participant," see section II.C.2.d. of this outline.

561 to the Code to permit the exercise of termination, liquidation, acceleration or offset rights under a "master netting agreement" and across Protected Financial Contracts even in the absence of a master netting agreement where another "contractual" right to offset obligations thereunder exists. Proposed Amendments § 8(k).

(a) The new provision would protect from stay or avoidance a contractual right to terminate, liquidate or accelerate across Protected Financial Contracts and "master netting agreements," as well as contractual rights to offset or net termination value payment amounts or other transfer obligations arising under Protected Financial Contracts and "master netting agreements."[37]

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[37] The relevant part of the new provision is below:

561. Contractual right to terminate, liquidate, accelerate, or offset under a master netting agreement and across contracts

(a) In General.--Subject to subsection (b), the exercise of any contractual right, because of a condition of the kind specified in section 365(e)(1), to cause the termination, liquidation, or acceleration of or to offset or net termination values, payment amounts or other transfer obligations arising under or in connection with 1 or more (or the termination, liquidation, or acceleration of 1 or more) --

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

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

(3) forward contracts;

(4) repurchase agreements;

(5) swap agreements; or

(6) 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.

(b) The Proposed Amendments would provide two exceptions to the general rule:

i) a party may exercise a contractual right to terminate, liquidate, or accelerate "only to the extent that such party could exercise such a right under section 555, 556, 559, or 560 for each individual contract covered by the master netting agreement. . . ." Proposed Amendments § (k) (adding a new section 561(b)(1)).

ii) If a debtor is a commodity broker subject to subchapter IV of chapter 7 of the Bankruptcy Code,

a) "a party may not net or offset an obligation to the debtor arising under, or in connection with, a commodity contract against any claim arising under, or in connection with, other [Protected Financial Contracts (including master netting agreements)] except to the extent the party has positive net equity in the commodity accounts at the debtor" (as calculated under subchapter IV) Proposed Amendments § 8(k) (adding a new section 561(b)(2)(A));

b) "another commodity broker may not net or offset an obligation to the debtor arising under, or in connection with, a commodity contract entered into or held on behalf of a customer of the debtor against any claim arising under, or in connection with, other [Protected Financial Contracts (including master netting agreements)]." Proposed Amendments § 8(k)

(adding a new section 561(b)(2)(B)).

iii) The exceptions with respect to commodity brokers are intended to "limit the depletion of assets available for distribution to customers of commodity brokers" to be consistent with the general principle of giving priority to customer claims in the bankruptcy of a commodity broker. H.R. 1161 House Report at 34.

iv) The Proposed Amendments provide that the exceptions with respect to commodity brokers do not bar the offset of claims and obligations under certain cross margining agreements, or netting agreements involving clearing organizations, that have been approved by the Commodity Futures Trading Commission. Proposed Amendments § 8(k) (adding a new section 561(c)).

(c) This section provides that ipso facto clauses in executory contracts shall be enforceable, as well as contractual rights to terminate, liquidate, accelerate and offset contracts that are established by a right "set forth in a rule or bylaw of a national securities exchange, a national securities association, or a securities clearing agency, a right set forth in a bylaw of a clearing organization or contract market 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." Proposed Amendments § 8(k) (adding a new section 561(d)).

(d) The protection of contractual netting and offset rights under section 561 is intended to be in addition to rights under 362(b)(6), (b)(7), (b)(17) and new section 362(b)(19). Cross-product netting rights "will be protected from the

automatic stay under section 561 even in the absence of a master netting agreement." H.R. 1161 House Report at 34.

(vi) Proposed Amendments. The Proposed Amendments would add new provisions making clear that in stockbroker or commodity broker liquidations, the exercise of rights of counterparties to Protected Financial Contracts under the Bankruptcy Code will not affect the priority of any unsecured claim the counterparty may have after the exercise of such rights. Proposed Amendments § 8(n)-(o) (adding new sections 767 and 753). The House Report states that these provisions are designed to "ensure that noncustomers will not defeat the priority scheme" set forth under the stockbroker and commodity broker liquidation subchapters of the Bankruptcy Code. H.R. 1161 House Report at 35.

2. Exercise of Setoff and Netting Rights.

a. Automatic Stay. As noted above, generally when a petition is filed under the Bankruptcy Code, there is an automatic stay imposed on creditors of the debtor preventing the creditors from taking any action against the debtor or its property, including exercising setoff and liquidation rights that arose before the commencement of the insolvency case, without the authorization of the Bankruptcy Court. 11 U.S.C. §§ 362(a)(3), (7). The automatic stay does not destroy setoff rights (as would the trustee's avoidance powers) but rather requires the Bankruptcy Court's approval for their exercise.

b. Exceptions for Protected Contracts.

(i) Securities Contracts, Commodity Contracts and Forward Contracts.

(a) Section 362(b)(6) of the Bankruptcy Code provides that neither the filing of a petition under the Bankruptcy Code nor an application under section 5(a)(3) of SIPA operates as a stay of the "setoff by a commodity broker, forward contract merchant, stockbroker, financial institutions, or securities clearing agency of any mutual debt and claim under or in connection with commodity contracts . . . , forward

contracts, or securities contracts . . . that constitutes the setoff of a claim against the debtor for a margin payment . . . , or settlement payment . . . , arising out of commodity contracts, forward contracts, or securities contracts against cash, securities, or other property held by or due from such commodity broker, forward contract merchant, stockbroker, financial institutions, or securities clearing agency to margin, guarantee, secure, or settle commodity contracts, forward contracts, or securities contracts." 11 U.S.C. § 362(b)(6).

(b) There are four requirements to fall within section 362(b)(6):

i) the party that effects the setoff must be a commodity broker, forward contract merchant, stockbroker, financial institution, or securities clearing agency. Hedge funds generally will not be eligible for this exemption.

ii) the debt and claim to be setoff must be a mutual debt and claim under or in connection with commodity contracts, forward contracts, or securities contracts. For a discussion of mutuality, see section II.D.2.b.(iv) of this outline.

iii) the claim against the debtor to be setoff must be a "margin payment" or a "settlement payment" arising out of commodity contracts, forward contracts, or securities contracts. For definitions of "settlement payment" and "margin payment," see section II.C.2.a. of this outline.

iv) the property of the debtor against which the debt of the debtor may be setoff must be cash, securities, or other property held by or due from the counterparty to margin, guarantee, secure, or settle commodity contracts,

forward contracts, or securities contracts.

(c) One decision held that the sale by a broker-dealer of securities held in a customer's margin account in order to meet margin calls is exempt from the automatic stay. Wolkowitz v. Shearson Lehman Brothers, Inc. (In re Weisberg), 136 F.3d 655, 657-59 (9th Cir. 1998).

(d) Proposed Amendments.

i) The Proposed Amendments would expand section 362(b)(6) to protect transactions between counterparties falling within the new definitions of "financial institution," "forward contract merchant" and "securities clearing agency" provided by the amendments discussed in section II.C.2.a., and "financial participant" discussed in section II.C.2.b. Proposed Amendments § 8(q)(1).

ii) The Proposed Amendments would expand sections 362(b)(6) to exempt from the automatic stay a setoff by an eligible counterparty using property "pledged to, and under the control of" the counterparty, in addition to property "held by or due from" such counterparty. Proposed Amendments § 8(d)(1)(A). The H.R. 1161 House Report states that such collateral may include receivables, book-entry securities, and collateral that has been repledged by the creditor. H.R. 1161 House Report at 33.

(ii) Repurchase Agreements.

(a) Section 362(b)(7) of the Bankruptcy Code provides that neither the filing of a petition under the Bankruptcy Code nor the filing of an application under section 5(a)(3) of SIPA

operates as a stay of "the setoff by a repo participant, of any mutual debt and claim under or in connection with repurchase agreements that constitutes the setoff of a claim against the debtor for a margin payment . . . or settlement payment . . . arising out of repurchase agreements against cash, securities, or other property held by or due from such repo participant to margin, guarantee, secure or settle repurchase agreements." 11 U.S.C. § 362(b)(7).

(b) There are four requirements to fall within section 362(b)(7):

i) the party that effects the setoff must be a repo participant. For a definition of "repo participant," see section II.C.2.c of this outline.

ii) the debt and claim to be setoff must be a "mutual debt and claim under or in connection with repurchase agreements." For a description of "mutuality," see section II.D.2.b.(iv) of this outline.

iii) the claim against the debtor to be setoff must be a "margin payment" or a "settlement payment" arising out of repurchase agreements. For definitions of "settlement payment" and "margin payment," see section II.C.2.a of this outline.

iv) the property of the debtor against which the debt of the debtor may be setoff must be cash, securities, or other property held by or due from such repo participant to margin, guarantee, secure or settle repurchase agreements.

(c) Proposed Amendments.

i) The Proposed Amendments would expand section 362(b)(7) to protect

transactions between counterparties falling within the new definition of "repo participant," which eliminates the 90-day pre-petition period restriction on outstanding repurchase agreements. <u>See</u> section II.C.2.c. of this outline.

ii) The Proposed Amendments would expand section 362(b)(7) to exempt from the automatic stay a setoff by an eligible counterparty using property "pledged to, and under the control of" the counterparty, in addition to property "held by or due from" such counterparty. Proposed Amendments § 8(d)(1)(B).

(iii) Swap Agreements.

(a) Section 362(b)(17) provides that neither the filing of a petition under the Bankruptcy Code nor of an application under section 5(a)(3) of SIPA operates as a stay of the "setoff by a swap participant, of any mutual debt and claim under or in connection with any swap agreement that constitutes the setoff of a claim against the debtor for any payment due from the debtor under or in connection with any swap agreement against any payment due to the debtor from the swap participant under or in connection with any swap agreement or against cash, securities, or other property of the debtor held by or due from such swap participant to guarantee, secure or settle any swap agreement." 11 U.S.C. § 362(b)(17).

(b) There are four requirements to fall within section 362(b)(17):

i) the party that effects the setoff must be a swap participant. For a definition of "swap participant," see section II.C.2.d.(ii) of this outline. Hedge funds fulfilling the transactional test should qualify for the exception.

ii) the debt and claim to be setoff must be a "mutual debt and claim under or in connection with any swap agreement." For a description of "mutuality" see section II.D.2.b.(iv) of this outline.

iii) the claim against the debtor may be a claim for "any payment due from the debtor under or in connection with any swap agreement." Thus unlike section 362(b)(6) and (7), the claim is not limited only to a "margin payment" or a "settlement payment."

iv) the debt of the debtor to the swap participant may be setoff against any payment due to the debtor from the swap participant under or in connection with any swap agreement or cash, securities, or other property of the debtor held by or due from such swap participant to guarantee, secure or settle any swap agreement.

(c) Compare with sections 362(b)(6) and (7), which do not permit setoff against <u>any</u> "payment due to the debtor" under the applicable protected agreement by the counterparty, but only against "cash, securities, or other property of the debtor held by or due from" such counterparty to guarantee, secure or settle the protected contract.

(d) <u>Proposed Amendments</u>. Section 362(b)(17) would be amended to include property "pledged to, and under the control of" the counterparty. This section also would be amended to include setoffs against a "transfer due" from the debtor in addition to a "payment due" from the debtor. Proposed Amendments § 8(d)(1)(C).

(iv) Limitations on Setoff Rights.

(a) The provisions set forth above exempt certain setoffs related to Protected Financial Contracts from the automatic stay. These provisions do

not exempt such setoffs from a court-ordered stay.

i) Proposed Amendments. The Proposed Amendments would not only exempt the setoffs permitted under sections 362(6), (7), or (17) from the "automatic stay" but would protect such contracts from the imposition of a stay by any court or administrative agency in a proceeding under the Bankruptcy Code. Proposed Amendments § 8(d)(2).

a) This provision refers, apparently inadvertently, to section 362(b)(32) (which does not exist in the current or proposed legislation) rather than new section 362(b)(19) (relating to master netting agreements). The counterpart provision in Title IX of the Bankruptcy Reform Act of 2000 refers to section 362(b)(28), the counterpart in that legislation to new section 362(b)(19) in the Proposed Amendments. Bankruptcy Reform Act of 2000 § 907(d)(2).

(b) The right of setoff is not prescribed in the Bankruptcy Code, but rather must be independently established under applicable non-bankruptcy law.[38/] See In re Ingersoll, 90 B.R. 168, 171 (Bankr. W.D.N.C. 1987); see also Darr v. Muratore, 8 F.3d 854, 860 (1st Cir. 1993). Although the Bankruptcy Code purports not to affect any right of setoff, the Bankruptcy Code

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[38/] For a discussion of setoff and recoupment rights in bankruptcy, see Donald S. Bernstein & Pamela Arnsten, Current Developments: Setoff and Recoupment, 767 PLI/Comm 371 (1998); Samuel R. Maizel, Setoff and Recoupment in Bankruptcy, 804 PLI/Comm 949 (2000); Martin J. Bienenstock, Understanding the Business, Bankruptcy and Securities Aspects of Derivatives, 721 PLI/Comm 11 (1995).

does appear to limit such rights (see subsections (c), (d), and (e) below). 11 U.S.C. § 553(a).

(c) The debts to be offset must be mutual.

i) In order for debts to be "mutual," the debts need to be in the same right between the same parties, standing in the same capacity. See Boatmen's Nat'l Bank v. Sears, Roebuck & Co., 106 F.3d 227, 230 (8th Cir. 1997); Davidovich v. Welton (In re Davidovich), 901 F.2d 1533, 1537 (10th Cir. 1990). For example, there is no mutuality where one counterparty is a debtor in its own right, while the other counterparty is obligated only in its capacity as a fiduciary, such as a trust. See Darr v. Muratore, 8 F.3d 854, 860 (1st Cir. 1993); Official Comm. Unsecured Creditors v. Mfrs. & Traders Trust Co. (In re Bennett Funding Group, Inc.), 212 B.R. 206, 213 (B.A.P. 2d Cir. 1997), aff'd, 146 F.3d 136 (2d Cir. 1998); In re Knedlik, 192 B.R. 559, 561 (Bankr. D. Kan. 1995).

ii) The mutuality requirement could raise a significant issue for companies that engage in Protected Financial Contracts through a variety of affiliated entities. For example, regulatory requirements generally mandate that securities transactions with customers be effected through a registered broker-dealer, whereas swap transactions often are effected through swap affiliates of registered broker-dealers that are not themselves registered broker-dealers. The mutuality requirement that debts be between "the same parties" would appear to prohibit affiliated creditors from setting off debts owed by one affiliate to the debtor against debts owed by the debtor to another affiliate. See In

re Elcona Homes Corp., 863 F.2d 483, 486 (7th Cir. 1988); Jones v. United States (In re Jones), 107 B.R. 888, 897 (Bankr. N.D. Miss. 1989). It has been held that a contract whereby two creditors and the debtor explicitly agree to setoff debts owed between them is enforceable under the Bankruptcy Code. See Walter E. Heller & Co. v. Food Mktg. Assocs. (In re Fasano/Harriss Pie Co.), 43 B.R. 864, 870-71 (Bankr. W.D. Mich. 1984), aff'd on other grounds, 70 B.R. 285 (W.D. Mich. 1987); Bloor v. Shapiro, 32 B.R. 993, 1001-02 (S.D.N.Y. 1983). Accordingly, where separate affiliates are used for Protected Financial Contracts, it is advisable to include provisions within the Protected Financial Contracts specifically providing for such "triangular setoffs."

iii) Many derivative transactions involve government counterparties. A growing number of courts have held that different agencies of the federal government should be treated as the same entity for setoff purposes. See United States v. Maxwell, 157 F.3d 1099, 1100, 1102 (7th Cir. 1998); Hal, Inc. v. United States (In re Hal, Inc.), 122 F.3d 851, 853-54 (9th Cir. 1997); Turner v. Small Business Administration (In re Turner), 84 F.3d 1294, 1299 (10th Cir. 1996) (en banc). There appears to be a greater difference of opinion at the state level. Compare In re Lakeside Community Hosp., Inc., 139 B.R. 886, 889 (Bankr. N.D. Ill. 1992) (claim by debtor against state agency for unpaid Medicaid not mutual with claim of different Illinois state agencies for unpaid taxes), aff'd, 151 B.R. 887 (N.D. Ill. 1993) with In re Bennett Co., 118 B.R. 564, 566 (Bankr. M.D. Tenn. 1990) (contractual claim of debtor against

Tennessee Department of Mental Health and Mental Retardation and claim of Tennessee Department of Employment Security against debtor for unpaid taxes are mutual claims). If two governmental entities are deemed the same party, then mutuality should be found even when two transactions are done with different agencies of that entity.

(d) Section 553(a) permits a party to setoff a mutual debt owing by a creditor to the debtor "that arose before the commencement of the case" against a claim of such creditor against the debtor "that arose before the commencement of the case."

i) Although the Bankruptcy Code does not discuss the setoff of postpetition debts against postpetition claims, courts have permitted such setoffs. In re Seal, 192 B.R. 442, 457 (Bankr. W.D. Mich. 1996); Jones v. United States (In re Jones), 107 B.R. 888, 897 (Bankr. N.D. Miss. 1989); Mohawk Indus., Inc. v. United States (In re Mohawk Indus., Inc.), 82 B.R. 174, 178-79 (Bankr. D. Mass. 1987). But see In re Kleather, 208 B.R. 406, 413-14 (Bankr. S.D. Ohio 1997) (rejecting right of setoff for post-filing claims).

ii) Section 553(a) does not recognize a right to setoff post-petition debts against pre-petition debts. See Boston & Maine Corp. v. Chicago Pacific Corp., 785 F.2d 562, 565 (7th Cir. 1986) ("Bankruptcy draws a line between the existing claims to a firm's assets and newly-arising claims."); In re Kleather, 208 B.R. 406, 413-14 (Bankr. S.D. Ohio 1997); Mohawk Indus., Inc. v. United States (In re Mohawk Indus., Inc.), 82 B.R. 174, 177 (Bankr. D. Mass. 1987).

iii) Recoupment. An alternative to a setoff claim is a recoupment claim. Like setoff, recoupment is a right of a creditor to net a debt it owes to the debtor against a claim it has against the debtor. Unlike setoff rights, however, the debt and claim each have to arise out of a single integrated transaction. See Kosadnar v. Metropolitan Life Ins. Co. (In re Kosadnar), 157 F.3d 1011, 1013 (5th Cir. 1998); New York State Elec. & Gas Corp. v. McMahon (In re McMahon), 129 F.3d 93, 96 (2d Cir. 1997); Davidovich v. Welton (In re Davidovich), 901 F.2d 1533, 1537 (10th Cir. 1990). The Bankruptcy Code is silent as to recoupment, but courts have recognized the exercise of recoupment rights in bankruptcy proceedings. See In re McMahon, 129 F.3d at 95-96. Recoupment is allowed even where claims and debts arose pre-petition and post-petition.

(e) Debts that are disallowed under section 502 may not be offset.

(v) Cross-Product Netting. Nothing in sections 362(b)(6),(7) or (17) limits the ability of a counterparty to net obligations under separate agreements of the same category (i.e., two separate security agreements) against each other.

(a) Section 362(b)(6) authorizes netting of claims in connection with commodity contracts, forward contracts, or securities contracts against property held to margin, guarantee, secure, or settle commodity contracts, forward contracts, or securities contracts. The wording of this section would support cross-product netting between or among commodity contracts, forward contracts and securities contracts. Because of the counterparty limitations in section 362(b)(6), however, hedge funds may not qualify under the exemption. See section II.D.2.b.(i).(b) above.

(b) Section 362(b)(7) authorizes netting of claims in connection with repurchase agreements against property held to margin, guarantee, secure or settle repurchase agreements. 11 U.S.C. § 362(b)(17).

(c) Section 362(b)(17) authorizes netting of claims in connection with "any swap agreement" against a payment due the debtor in connection with "any swap agreement."

(d) The exemption of cross-product netting from the automatic stay is uncertain given that the statutory language of each section limits the collateral that can be netted to collateral given to margin, guaranty, secure or settle the type of Protected Financial Contract covered by the particular subsection of section 362(b).

i) Given the language of these provisions, parties to Protected Financial Contracts seeking to maximize the enforceability of cross-product netting arrangements should consider (x) providing contractual arrangements to cross-collateralize (i.e., provide that all collateral held by each counterparty secures all obligations of the other counterparty) and (y) providing setoff rights across all contracts between the two counterparties (defining counterparties to encompass all affiliates and related parties).

ii) The definition of "swap agreement," "forward contract" and "repurchase agreement" may overlap sufficiently with each other to enable cross-product netting under certain circumstances.

(e) FDICIA explicitly authorizes cross-product netting between financial institutions. FDICIA preempts the Bankruptcy Code where FDICIA applies. For a discussion of FDICIA netting provisions, see section IV of this outline.

(vi) Proposed Amendments - Cross-product Netting. The Proposed Amendments would explicitly provide that cross-product netting of Protected Financial Contracts would be exempt from the automatic stay. The proposed new section 362(b)(19) would provide that the automatic stay will not stay:

"the setoff by a master netting agreement participant of a mutual debt and claim under or in connection with 1 or more master netting agreements or any contract or agreement subject to such agreements that constitutes the setoff of a claim against the debtor for any payment or other transfer of property due from the debtor under or in connection with such agreements or any contract or agreement subject to such agreements against any payment due to the debtor from such master netting agreement participant under or in connection with such agreements or any contract or agreement subject to such agreements or against cash, securities, or other property held by, pledged to and under the control of, or due from such master netting agreement participant to margin, guarantee, secure, or settle such agreements or any contract or agreement subject to such agreements, to the extent such participant is eligible to exercise such offset rights under paragraph (6), (7), or (17) for each individual contract covered by the master netting agreement in issue." Proposed Amendments § 8(d)(1)(E).

(a) The addition of this provision would eliminate doubts as to whether cross-product netting is exempted from the automatic stay.

(b) The purpose of the Proposed Amendments is "to protect the termination and close-out netting provisions of cross-product master agreements between parties. Such an agreement may be used (i) to document a wide variety of securities contracts, commodity contracts, forward contracts, repurchase agreements and swap agreements or (ii) as an umbrella agreement for separate master agreements between the same parties, each of which is used to document a discrete type of transaction." H.R. 1161 House Report at 32.

E. <u>Asset-Backed Securitization</u>. The Proposed Amendments also would add a new provision to the Bankruptcy Code with respect to asset-backed securitizations. The Proposed Amendments would expressly exclude from property of the estate under section 541:

> any eligible asset (or proceeds thereof), to the extent that such eligible asset was transferred by the debtor, before the date of commencement of the case, to an eligible entity in connection with an asset-backed securitization, except to the extent such asset (or proceeds or value thereof) may be recovered by the trustee under section 550 by virtue of avoidance under section 548(a)(1). Proposed Amendments § 13(1)(C) (new section 541(b)(5)).

1. As used in the new provision, the following terms have the following meanings: (Proposed Amendments § 13(2) (new section 541(e))).

   "Asset-backed securitization" is defined as "a transaction in which eligible assets transferred to an eligible entity are used as the source of payment on securities, including all securities issued by governmental units, at least 1 class or tranche of which is rated investment grade by 1 or more nationally recognized securities rating organizations, when the securities are initially issued by an issuer."

   "Eligible asset" is defined as (x) "financial assets (including interests therein and proceeds thereof), either fixed or revolving, whether or not such assets are in existence as of the date of the transfer, including residential and commercial mortgage loans, consumer receivables, trade receivables, assets of governmental units (including payment obligations relating to taxes, receipts, fines, tickets, and other sources of revenue), and lease receivables, that, by their terms, convert into cash within a finite time period, plus any residual interest in property subject to receivables included in such financial assets plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders"; (y) cash; and (z) securities, including those issued by governmental units.

   "Eligible entity" is defined as (x) an issuer; or (y) "a trust, corporation, partnership, governmental unit, limited liability company (including a single member limited liability company), or other entity engaged exclusively in the business of acquiring and transferring eligible assets directly or indirectly to an issuer and taking actions ancillary thereto."

   "Issuer" is defined as "a trust, corporation, partnership, governmental unit, limited liability company (including a single member limited liability company), or other entity engaged exclusively in the business of

acquiring and holding eligible assets, issuing securities backed by eligible assets, and taking actions ancillary thereto."

a. The counterpart amendment in Title IX of the Bankruptcy Reform Act of 2000 appears to omit inadvertently from the definition of "issuer" any governmental unit or limited liability company (including single member limited liability companies). Bankruptcy Reform Act of 2000 § 912(2).

"Transferred" is defined to mean that "the debtor, pursuant to a written agreement, represented and warranted that eligible assets were sold, contributed, or otherwise conveyed with the intention of removing them from the estate of the debtor pursuant to subsection (b)(5) (whether or not reference is made to this title or any section of this title), irrespective, without limitation of--

(A) whether the debtor directly or indirectly obtained or held an interest in the issuer or in any securities issued by the issuer;

(B) whether the debtor had an obligation to repurchase or to service or supervise the servicing of all or any portion of such eligible assets; or

(C) the characterization of such sale, contribution, or other conveyance for tax, accounting, regulatory reporting, or other purposes."

2. The Proposed Amendments would recognize that "a valid transfer of such assets to an 'eligible entity' generally eliminates the debtor's legal or equitable interests in those assets." H.R. 1161 House Report at 36.

3. Assets transferred in a securitization may still be avoided if the transfer was fraudulent under section 548(a)(1), including if the transfer was "constructively" fraudulent because the debtor did not receive a reasonably equivalent value in exchange.

III. THE FDIA FINANCIAL CONTRACT PROVISIONS

A. The Debtors. The conservatorship and receivership provisions of the FDIA generally apply to federally and state chartered banks and thrifts.[39/] Non-federally insured banks, thrifts, and branches and agencies of foreign banks are not subject to the FDIA's conservatorship and receivership provisions.

1. Proposed Amendments. The Proposed Amendments add a new section 407 to FDICIA. The new section would extend the applicability of the Qualified Financial Contract ("QFC") provisions in paragraphs (8), (9), (10), and (11) of section 11(e) of the FDIA (discussed below) to uninsured national banks and uninsured Federal branches or Federal agencies, with certain modifications reflecting the different regulatory authorities. The Comptroller of the Currency, in consultation with the Federal Deposit Insurance Corporation, may promulgate regulations to implement the new provisions; the regulations must be consistent with the regulations and policies of the Federal Deposit Insurance Corporation under the FDIA. Proposed Amendments § 7(d). The H.R. 1161 House Report states that "[t]his provision will ensure that parties to QFCs with uninsured national banks or uninsured Federal branches or agencies will have the same rights and obligations as parties entering into the same agreements with insured depository institutions. The new section also specifically limits the powers of a receiver or conservator for an uninsured national bank or uninsured Federal branch or agency to those contained in 12 U.S.C. §§ 1821(e)(8), (9), and (11), which address QFCs." H.R. 1161 House Report at 30.

B. Protected Contracts.

1. Qualified Financial Contract. Like the Bankruptcy Code, the FDIA provides special treatment for QFCs, which are defined to include any securities contract, forward contract, commodity contract, repurchase agreement, and swap agreement (each as defined under the FDIA). The FDIC can determine, by regulation, that "any similar agreement" is a QFC. 12 U.S.C. § 1821(e)(8)(D)(i).

39/ A receiver is usually appointed to liquidate the assets of an insolvent institution and wind up its affairs. A conservator, in contrast, is appointed to restore the institution's financial health. A conservator is usually appointed to operate the bank when it is expected that the bank has value as a going concern. An insolvency proceeding can be instituted against a bank even when the bank is not insolvent; proceedings can be instituted when the bank violates certain laws or is operating in an "unsafe or unsound" manner.

a. Proposed Amendments. The Proposed Amendments would permit the FDIC to determine agreements to be QFCs by "resolution or order," as well as by regulation. Proposed Amendments § 2(a).

2. Securities Contract, as defined under the FDIA, includes the same type of agreements as section 741 of the Bankruptcy Code;[40/] it also includes mortgage loans, any mortgage related security and any interest in any mortgage loan or mortgage-related security. It does not include participation in a commercial mortgage loan, unless the FDIC determines otherwise. 12 U.S.C. § 1821(e)(8)(D)(ii).[41/]

a. Proposed Amendments. The Proposed Amendments would amend the definition of "securities contract" to match the proposed new definition of "securities contract" under the Proposed Amendments to the Bankruptcy Code, except that:

(i) the proposed definitions under the Bankruptcy Code and the FDIA both exclude purchase, sale or repurchase obligations under a participation in a commercial mortgage loan. However, unlike the Bankruptcy Code, the FDIA would permit the FDIC to determine that such obligations are "securities contracts" by regulation, resolution, or order.

(ii) the proposed definitions under the FDIA and the Bankruptcy Code include security agreements or arrangements, or other credit enhancements. However, the FDIA would differ from the Bankruptcy Code in that, under the proposed Bankruptcy Code definition, such security agreements or arrangements or other credit enhancements would be limited to the actual value of such contract on the date of filing the petition for purposes of the Bankruptcy Code; there is no such

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40/ See section II.B.1. of this outline for a discussion of the Bankruptcy Code definition of "securities contract."

41/ See Nashville Lodging Co. v. FDIC, 934 F. Supp. 449 (D.D.C. 1996) (mortgage refinancing agreement not QFC); FDIC v. Parent Funding Corp., 82 F.3d 417 (6th Cir. 1996) (mortgage servicing agreement not QFC); Heiko v. FDIC, No. 93 Civ. 8635 (LAP) 1995 WL 117604 (S.D.N.Y. 1995) (mortgage refinancing agreement not QFC); Conroy v. FDIC, No. Cir. A. No. 95-11658-GAO 1995 WL 598961 (D. Mass. 1995) (mortgage agreement not a QFC).

limitation under the proposed the FDIA Amendments. Proposed Amendments §§ 2(b), 8(a)(2).

3. Commodity Contract is currently defined as it is defined in the Bankruptcy Code.[42] 12 U.S.C. 1821(e)(8)(D)(iii).

a. Proposed Amendments. The Proposed Amendments would amend the definition of "commodity contract" to match the proposed definition of "commodity contract" under the Bankruptcy Code. Proposed Amendments §§ 2(c), 8(a)(3). The proposed definitions under the FDIA and the Bankruptcy Code include security agreements or arrangements, or other credit enhancements related to commodity contracts in the definition of commodity contract. As with the definitions of "securities contracts," the two definitions of "commodity contract" differ in that, under the Bankruptcy Code, such security agreements or arrangements or other credit enhancements would be limited to the actual value of such contract on the date of filing the petition for purposes of the Bankruptcy Code.

4. Forward Contract is defined as it is defined in Bankruptcy Code. 12 U.S.C. 1821(e)(8)(D)(iv).[43]

a. Under the FDIA, "forward contract" is defined to include only those contracts "with a maturity date more than two days after the date the contract is entered into." 11 U.S.C. § 101(25). By its terms, this would not encompass spot forward contracts. In its comments accompanying Reg. EE, the FDIC contended that "arguably, the . . . definition of swap agreement already includes spot forward contracts." Nonetheless, Reg. EE specifically includes spot forward contracts within the definition of QFC.[44]

b. Proposed Amendments. The Proposed Amendments would amend the definition of "forward contract" to match the proposed definition of "forward contract" under the Bankruptcy

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[42] See section II.B.3. of this outline for a discussion of the Bankruptcy Code definition of "commodity contract."

[43] See section II.B.2. of this outline for a discussion of the Bankruptcy Code definition of "forward contract."

[44] Netting Eligibility for Financial Institutions, 59 Fed. Reg. 4,780-01 (Feb. 2, 1994).

Code, with the same exception regarding limitations on the value of any security agreements described in the section on "securities contract" above. Proposed Amendments §§ 2(d), 8(a)(1)(A).

5. Repurchase Agreement is defined as it is defined in the Bankruptcy Code,[45/] with essentially the same additions as in the "securities contract" definition under the FDIA. 12 U.S.C. § 1821(e)(8)(D)(v).

    a. Certain repurchase agreements involving qualified foreign government securities constitute "repurchase agreements."

    b. Proposed Amendments. The Proposed Amendments would amend the definition to match the proposed definition under the Bankruptcy Code, with the same exception regarding limitations on the value of any security agreements described in the section on "securities contract" above. Proposed Amendments §§ 2(e), 8(a)(1)(C).

6. Swap Agreement.

    a. "Swap agreement" is defined essentially as it is defined in the Bankruptcy Code,[46/] except that it also (x) includes interest rate futures and currency futures in the definition and (y) provides that any master agreement for swaps, plus supplements, should be treated as one agreement. The FDIA defines "swap agreement" to include:

        (i) "any agreement, including the terms and conditions incorporated by reference in any such agreement, which is a rate swap agreement, basis swap, commodity swap, forward rate agreement, interest rate future, interest rate option purchased, forward foreign exchange agreement, rate cap agreement, rate floor agreement, rate collar agreement, currency swap agreement, cross-currency rate swap agreement, currency future, or currency option purchased or any other similar agreement, and"

[45/] See section II.B.4. outline for a discussion of the Bankruptcy Code definition of "repurchase agreement."

[46/] See section II.B.5. of this outline for a discussion of the Bankruptcy Code definition of "swap agreement."

(ii) "any combination of such agreements and any option to enter into any such agreement." 12 U.S.C. § 1821(e)(8)(D)(vi)(I)-(II).

b. The FDIC regulations provide that spot and other short-term foreign exchange agreements and repurchase agreements on certain foreign government securities constitute "swap agreements." 12 C.F.R. § 360.5 (2000).

c. Proposed Amendments. The Proposed Amendments would amend the definition of "swap agreement" to match the proposed definition of "swap agreement" under the Bankruptcy Code. Proposed Amendments §§ 2(f), 8(a)(1)(E).

7. Master Agreements. The FDIA states that any master swap agreement, together with all supplements to such a master agreement, shall be treated as one swap agreement. 12 U.S.C. § 1821(e)(8)(D)(vii).

a. Proposed Amendments. Section 6 of the Proposed Amendments would clarify that a master agreement covering any combination of QFCs would be treated as one QFC under the FDIA. The purpose of the amendment is to clarify that cross-product netting under a master agreement will be enforceable under the FDIA. H.R. 1161 House Report at 28-29. If, however, a master agreement contains provisions related to contracts that are not QFCs (e.g., ordinary loan contracts), those non-QFC provisions would not be included; the master agreement would be considered a QFC only as to the provisions that are themselves related to QFCs.[47/] Section 8(a)(1) to (a)(3) of the Proposed Amendments makes similar changes to the Bankruptcy Code.

[47/] The new provision would read as follows:

(vii) TREATMENT OF MASTER AGREEMENT AS 1 AGREEMENT.--Any master agreement for any contract or agreement described in any preceding clause of this subparagraph (or any master agreement for such master agreement or agreements), together with all supplements to such master agreement, shall be treated as a single agreement and a single qualified financial contract. If a master agreement contains provisions relating to agreements or transactions that are not themselves qualified financial contracts, the master agreement shall be deemed to be a qualified financial contract only with respect to those transactions that are themselves qualified financial contracts. Proposed Amendments § 6.

C. Avoidance Powers and Exceptions for Qualified Financial Contracts.

1. Avoidance of Fraudulent Conveyances.

a. The FDIC, in its capacity as receiver or conservator, "may avoid a transfer of any interest of an institution-affiliated party, or any person who the [FDIC] or conservator determines is a debtor of the institution, in property, or any obligation incurred by such party or person, that was made within 5 years of the date on which the [FDIC] was appointed conservator or receiver if such person voluntarily or involuntarily made such transfer or incurred such liability with the intent to hinder, delay, or defraud the insured depository institution, the [FDIC], or any other appropriate Federal banking agency." 12 U.S.C. § 1821(d)(17)(A).

(i) "Institution-affiliated party" includes, among others: directors, officers, employees, controlling stockholders, and any "independent contractor" who "knowingly or recklessly participates" in any violation of law or regulation, any breach of fiduciary duty, or any unsafe or unsound practice. 12 U.S.C. § 1813(u). An attorney hired as an independent contractor can be an institution-affiliated party.[48/]

b. The FDIC can recover, for the benefit of the insured institution, the property transferred or, if the court orders, the value of the property transferred (measured as of the time of the transfer). The FDIC can seek such recovery from the institution-affiliated party for whose benefit the transfer was made, the initial transferee or any subsequent transferee. 12 U.S.C. § 1821(d)(17)(B). The FDIC cannot recover, however, from any transferee that takes for value and in good faith, or from any transferee subsequent to such entity that takes in good faith. 12 U.S.C. § 1821(d)(17)(C).

c. In addition, the FDIC can seek a preliminary injunction placing transferee assets under the control of the court and appointing a trustee to hold such assets. The FDIC would not have to demonstrate irreparable and immediate harm in order to prevail in its request for a preliminary injunction. The FDIC would,

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48/ See Cavallari v. Office of Comptroller of Currency, 57 F.3d 137 (2d Cir. 1995).

however, have to satisfy the requirements set forth in Fed. R. Civ. P. 65.[49/]

d. The rights of the FDIC to seek recovery under 12 U.S.C. § 1821(d)(17) are "superior to any rights of a trustee or any other party (other than any party which is a Federal agency)" under the Bankruptcy Code.[50/]

2. Avoidance of Preferences. Section 91[51/] of the National Bank Act, with certain exceptions, renders null and void any transfer made "with a view to the preference of one creditor to another." 12 U.S.C. § 91. The FDIC, when it is acting as a conservator or receiver, can use section 91 to avoid preferential transfers. 12 U.S.C. §§ 1821(c)(2)(B), (c)(3)(B) and (c)(9)(A).

49/ See FDIC v. Garner 125 F.3d 1272, 1277 (9th Cir. 1997); see also FDIC v. Cafritz, 762 F. Supp. 1503, 1505-06 (D.D.C. 1991) (the FDIC is entitled to a preliminary injunction in connection with a fraudulent conveyance action under section 1821(d)(17) if it can demonstrate that there is a substantial likelihood of success on the merits, that the relief is in the public interest, and that other interested parties will not suffer substantial harm if the Court grants the request).

50/ In FDIC v. Hirsh (In re Colonial Realty Co.), 980 F.2d 125 (2d Cir. 1992), the Second Circuit held that the automatic stay provisions of the Bankruptcy Code are applicable to the FDIC's fraudulent conveyance powers under this section. The Court contended that the FDIC's rights under this section should be considered "superior" because they are prior in right to those of the trustee, much like those of a secured creditor, even though subject to the automatic stay. See also McGowan v. Ciccone (In re Ciccone), 171 B.R. 4 (Bankr. D.R.I. 1994).

51/ Section 91 (titled "transfers by bank and other acts in contemplation of insolvency") reads as follows:

All transfers of the notes, bonds, bills of exchange, or other evidences of debt owing to any national banking association, or of deposits to its credit; all assignments of mortgages, sureties on real estate, or of judgments or decrees in its favor; all deposits of money, bullion, or other valuable thing for its use, or for the use of any of its shareholders or creditors; and all payments of money to either, made after the commission of an act of insolvency, or in contemplation thereof, made . . . with a view to the preference of one creditor to another, except in payment of its circulating notes, shall be utterly null and void; and no attachment, injunction, or execution, shall be issued against such association or its property before final judgment in any suit, action, or proceeding, in any State, county, or municipal court. 12 U.S.C. § 91.

3. Perfected Security Interests. The FDIC may not avoid legally enforceable or perfected security interests unless such interest was taken "in contemplation of the institution's insolvency or with intent to hinder, delay, or defraud." 12 U.S.C. § 1821(e)(11).[52]

   a. This provision protects both legally enforceable interests and perfected interests from the contract repudiation powers. The provision does not appear to grant new avoidance powers, but clarifies that other avoidance provisions do not give the conservator or receiver power to avoid such security interests, if taken in good faith.

4. Exceptions for QFCs.

   a. Unless the FDIC determines that a transfer (as defined in the Bankruptcy Code) was taken with actual intent to hinder, delay or defraud creditors, no transfer of money or other property in connection with a QFC with an insured depository institution may be avoided. 12 U.S.C. § 1821(e)(8)(C)(i).[53]

      (i) Proposed Amendments. The Proposed Amendments provide that the FDIC may not invoke section 91, or any other federal or state law, to avoid transfers made in connection with QFCs with an insured depository institution (in the absence of transferee's intent to hinder, delay or defraud). Proposed Amendments § 2(i).

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[52] Section 1821(e)(11) provides as follows:

No provision of this subsection [titled "provisions relating to contracts entered into before appointment of conservator or receiver"] shall be construed as permitting the avoidance of any legally enforceable or perfected security interest in any of the assets of any depository institution except where such an interest is taken in contemplation of the institution's insolvency or with the intent to hinder, delay, or defraud the institution or the creditors of such institution. 12 U.S.C. § 1821(e)(11).

[53] But see Resolution Trust Corp. v. Cheshire Mgmt. Co., 18 F.3d 330 (6th Cir. 1994) (anti-avoidance provision only applies to asset transfers by an institution prior to insolvency and does not apply to a judgment lien, recorded after the commencement of the receivership, connected to a QFC).

D. Stay Powers and Exceptions for Protected Financial Contracts.

1. Stay Powers. Unlike the Bankruptcy Code, the FDIA does not provide for an "automatic stay" of self-help remedies by creditors. The conservator or receiver, however, may request a stay of any judicial action or proceeding involving the insolvent institution. The stay is for 45 days in case of a conservator, 90 days in case of a receiver.[54/] 12 U.S.C. § 1821(d)(12)(A). The court must grant such a stay when so requested. 12 U.S.C. § 1821(d)(12)(B). Note that, unlike the Bankruptcy Code, the stay (x) is not automatic but must be requested; (y) extends for a fixed period of time; and (z) applies only to judicial actions or proceedings to which the institution is or becomes a party—not to creditor actions, or non-judicial actions, or actions in which the institution is not a party. Also, there is no explicit provision for relief from the stay or for extension of the stay.[55/]

2. No Attachment or Execution. Section 1821(d)(13)(C) states that "[n]o attachment or execution may [be issued] by any court upon assets in the possession of the receiver." This would not appear to bar execution or attachment on assets in the possession of third-party custodians or escrow agents (although, if a judicial action is required before attachment or execution, the action may be subject to a stay). Nor does the stay bar the liquidation of assets in the possession of the creditor. These factors should cause creditors to insist on maintaining possession and control over the collateral they receive from depository institutions so that the

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[54/] In addition, the FDIC, in its capacity as receiver for a bank, is entitled to an automatic 180-day stay after a claim against the bank is filed with the FDIC for administrative resolution, even if the FDIC has already been granted a 90-day stay upon its appointment as receiver. 12 U.S.C. § 1821(d)(5)(A)(i), (d)(12). See Proctor-Smith v. Red Bird Bank of Dallas, 806 F. Supp. 129 (N.D. Tex. 1992).

[55/] There is some dispute whether the FDIC is only entitled to a stay during the first 90-days of the receivership, or whether the FDIC can obtain a 90-day stay at any time during the receivership. Compare Praxis Properties, Inc. v. Colonial Sav. Bank, 947 F.2d 49 (3d Cir. 1991) (the receiver is entitled to a stay whose outer bound is 90 days after the receiver's appointment, no matter when the receiver requests the stay), and Nation v. Resolution Trust Corp., 791 F. Supp. 1152 (N.D. Tex. 1992) (same), with Boylan v. George E. Bumpus, Jr. Constr. Co. (In re George E. Bumpus, Jr. Constr. Co.), 144 B.R. 1 (Bankr. D. Mass. 1992) (the FDIC can obtain stay at any time). While the statute does not expressly so provide, courts generally have ruled that the stay applies equally to any cross or counter claims against a claimant. See In re FDIC, 762 F. Supp. 1002 (D. Mass. 1991); Bank of New England v. Callahan, 758 F. Supp. 61 (D.N.H. 1991).

creditor has the ability to liquidate that collateral in the event of the failure of the institution.

a. The FDIC has issued an Advisory Opinion stating that secured creditors could engage in self-help measures so long as:

(i) the creditor holds a perfected security interest in the collateral as a result of a bona fide, arms length transaction;

(ii) the underlying obligation is in default, other than due to an ipso facto clause based on the institution of the receivership proceeding; and

(iii) the self-help measures are commercially reasonable and do not require either judicial action or action by the receiver.[56/]

3. Repudiation of Contracts.

a. The Conservator or receiver may repudiate any contract or lease (x) to which the institution is a party, (y) that is determined to be burdensome and (z) if repudiation will promote orderly administration of the institution's affairs. 12 U.S.C. § 1821(e)(1). There is no time limit on the decision to repudiate; it need only be done within a "reasonable" time after appointment. 12 U.S.C. § 1821(e)(2). Note that a conservator as well as a receiver has this power.

b. The FDIC has taken the position that it has the right to repudiate non-executory as well as executory contracts.[57/]

[56/] The Advisory Opinion noted that a secured creditor that failed to file a timely proof of claim would have its claim denied and would thereby forfeit its rights to the collateral or the proceeds thereof. The FDIC Advisory Op. No. 89-49 (Dec. 15, 1989), reprinted in [1989-1990 Transfer Binder] Banking L. Rep. (CCH) ¶ 81,265. The Advisory Opinion also noted that the receiver, in some situations, may be able to seek a temporary restraining order or other injunctive relief.

[57/] The Second Circuit has agreed with this argument. See, e.g., IBJ Schroder Bank & Trust Co. v. Resolution Trust Corp., 26 F.3d 370 (2d Cir. 1994) (RTC has authority to repudiate indenture and zero coupon bonds issued thereunder); Employees' Retirement Sys. v. Resolution Trust Corp., 840 F. Supp. 972 (S.D.N.Y. 1993). Other courts have rejected the argument that the FDIC has the power to reject non-executory contracts.

c. Generally, if the FDIC repudiates or disaffirms the contract, the counterparty can only claim actual direct compensatory damages, determined as of the date of appointment of the receiver or conservator. Punitive, exemplary, lost profits and opportunity damages are statutorily excluded from the definition of actual direct compensatory damages.[58/] 12 U.S.C. § 1821(e)(3)(A)-(B).

4. Provisions With Respect to QFCs.

a. Damages are calculated differently if a QFC is repudiated or disaffirmed:

(i) damages are determined in reference to the date of disaffirmance or repudiation, rather than the date of appointment (12 U.S.C. § 1821(e)(3)(A)(ii)(II)); and

(ii) compensatory damages include "normal and reasonable costs of cover or other reasonable measures of damages utilized in the industries for such contract and agreement claims." 12 U.S.C. § 1821(e)(3)(C). This provision permits recovery for future damages to the extent that they are reflected in the cost of cover or other industry practice.[59/]

See, e.g., LaMagna v. FDIC, 828 F. Supp. 1 (D.D.C. 1993) (the FDIC cannot repudiate contracts where non-bankrupt party has performed). For a discussion of this disagreement between the courts, see Michael A. de Freitas, Annotation, Repudiation and Remedies For Repudiation Under § 212(E) of Financial Institutions Reform, Recovery, And Enforcement Act (FIRREA) (12 U.S.C.A. § 1821(E)), 132 A.L.R. Fed. 1 (1996). At least one court has observed, however, that where the end result is the same if the court finds that the FDIC cannot repudiate the contract or if the court finds that the FDIC can repudiate but must pay damages, it is not necessary to reach the issue of the FDIC's power to repudiate non-executory contracts. Fresca v. FDIC, 818 F. Supp. 664 (S.D.N.Y. 1993).

[58/] The FDIC takes the view that there is no claim under FIRREA for losses arising after the date of appointment; the courts appear to be in agreement. See e.g., In re Miraj & Sons, Inc., 192 B.R. 297, 312 (Bankr. D. Mass. 1996); FDIC v. Coleman, 611 So.2d 1300, 1302 (Fla. Dist. Ct. App. 1992).

[59/] See Employees' Retirement Sys. v. Resolution Trust Corp., 840 F. Supp. 972 (S.D.N.Y. 1993).

b. The repudiation powers granted by section 1821(e)(1) enable the conservator or receiver to "cherry pick" between the contracts of the debtor depository institution, effectively destroying certain of the creditor's netting rights.[60]

5. Proposed Amendments. The Proposed Amendments would add a new provision to the FDIA designed to eliminate the ability of the conservator or trustee to cherry pick among the debtor depository institution's QFCs. Section 5 of the Proposed Amendments would add a new provision as follows:

In exercising the rights of disaffirmance or repudiation of a conservator or receiver with respect to any qualified financial contract to which an insured depository institution is a party, the conservator or receiver for such institution shall either--

(A) disaffirm or repudiate all qualified financial contracts between--

(i) any person or any affiliate of such person; and

(ii) the depository institution in default; or

(B) disaffirm or repudiate none of the qualified financial contracts referred to in subparagraph (A) (with respect to such person or any affiliate of such person). Proposed Amendments § 5.

a. The purpose of this provision is to make the FDIC's repudiation authority consistent with its transfer authority under the FDIA section 11(e)(9) and to codify the FDIC's policy not to selectively enforce, repudiate or disaffirm QFCs.[61] According to the H.R. 1161 House Report, "[t]his unified treatment is fundamental to the reduction of systemic risk." H.R. 1161 House Report at 28.

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[60] However, the conservator or receiver cannot repudiate one agreement and assume another between the same parties if the two agreements are part of a single, integrated transaction or contract. See FDIC v. S.A.S. Assocs., 44 F. Supp 2d. 781 (E.D. Va. 1999); Hackel v. FDIC, 858 F. Supp 289 (D. Mass 1994).

[61] Risk-Based Capital Standards; Bilateral Netting Requirements, 59 Fed. Reg. 37726, 37730 n.15 (July 25, 1994).

6. Assumption of Contracts.

a. The receiver or conservator generally may assume and enforce any contract, notwithstanding the existence of any default clauses allowing termination upon insolvency or the appointment of a receiver or conservator. 12 U.S.C. § 1821(e)(12). This provision may render ipso facto clauses unenforceable.

b. The comparable provisions of section 365 of the Bankruptcy Code are much more detailed. For example, there is no FDIA provision stating that the receiver or the transferee of a contract or lease must cure any defaults existing as the time of the transfer. There is also no FDIA provision requiring that the transferee show that it is able to perform under the contract. On the other hand, if there is a default in the contract, it is not clear that the receiver or the transferee could prevent the other party from terminating for default after the transfer. The stay of litigation against the receiver or conservator would appear to bar the counterparty from bringing suit to terminate the lease or contract for 45 or 90 days. It is not clear whether the counterparty will be able to terminate if the default is cured by the time the stay has ended.

7. Exception for QFCs.

a. Protection of QFCs Upon Appointment of Receiver.

(i) Unless the receiver transfers QFCs and gives appropriate notice in accordance with 12 U.S.C. § 1821(e)(10) (discussed in section III.D.7 of this outline), and so long as the written agreement provisions are met, no provision of the FDIA or other federal or state law will stay a person from exercising:[62/]

[62/] The section reads:

(a) Subject to paragraph (10) of this subsection and notwithstanding any other provision of this chapter (other than subsection (d)(9) of this section and section 1823(e) of this title), any other Federal law, or the law of any State, no person shall be stayed or prohibited from exercising -

(a) any right to cause termination or liquidation of a QFC with an insured depository institution upon appointment of a receiver;

(b) any right under any security arrangement related to a QFC; or

(c) any right to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with one or more QFCs, including any master agreement for such contracts. 12 U.S.C. § 1821(e)(8)(A).

(ii) The statute does not grant rights to counterparties to QFCs. These rights have to be derived from some other source. Counterparties should make sure that the written agreements in QFCs expressly grant the counterparty the right to terminate the agreement upon the appointment of a receiver and the right to net out termination values and other payments.

(iii) Unlike the protections under the Bankruptcy Code, any counterparty to a QFC is protected, not just certain categories of counterparties. Therefore, no issue arises as to whether a hedge fund qualifies for this exception.

(iv) The provision does not expressly limit its protections to "single product line" master agreements. In addition, the provision protects contractual offset and netting rights "under or in connection with one or more QFCs" and does not exclude the exercise of offset and netting rights

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(i) any right to cause the termination or liquidation of any qualified financial contract with an insured depository institution that arises upon the appointment of the Corporation as receiver for such institution at any time after such appointment;

(ii) any right under any security arrangement relating to any contract or agreement described in clause (i); or

(iii) any right to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more contracts and agreements described in clause (i), including any master agreement for such contracts or agreements. 12 U.S.C. § 1821(e)(8)(A).

between different types of QFCs. Therefore, there is a strong argument that the FDIA protects cross-product netting rights among QFCs and under master agreements.

(v) The general 45 or 90-day stay provision applies to any judicial action or proceeding brought against the institution or the receiver by the counterparty to the QFC. Thus, although the counterparty can close-out open positions, net termination values, and proceed under a security arrangement, it will be stayed from pursuing judicial action. This puts a premium on obtaining collateral that does not require a judicial proceeding in order to realize upon it.

(vi) Thus, liquidation, termination and netting rights are protected from the receiver's right to enforce and assign contracts, unless the receiver transfers all QFCs between a counterparty, its affiliates and the failed institution to another depository institution and provides notice of the transfer to the counterparty in the required time period, as described in section III.D.7 of this outline.

b. Protections of QFC upon Appointment of Conservator.

(i) Appointment of a conservator allows exercise of certain rights by counterparties to a QFC. 12 U.S.C. § 1821(e)(8)(E). Although these rights are substantially the same as those available upon the appointment of a receiver, they are not identical.

(a) First, ipso facto clauses allowing termination upon appointment of a conservator are not enforceable. Thus, unlike in the case of the appointment of a receiver, the act of the appointment of a conservator does not itself allow the termination of QFCs. Compare 12 U.S.C. § 1821(e)(8)(E)(i), with 12 U.S.C. § 1821(e)(8)(A)(i).

(b) Second, although it is arguable that the general provisions concerning recognition of master agreements for QFCs are also applicable in conservatorships, the specific conservatorship provisions refer to the right to offset or net out

obligations arising under QFCs, but do not refer to any right to offset or net master agreements. Compare 12 U.S.C. § 1821(e)(8)(E)(iii), with 12 U.S.C. § 1821(e)(8)(A)(iii).

(ii) In the event of a default "enforceable under applicable non-insolvency law" by a conservator, the FDIA protects liquidation, termination and netting rights for any counterparty.[63/] 12 U.S.C. § 1821(e)(8)(E)(i).

c. Proposed Amendments.

(i) The Proposed Amendments would make clear that the protections with respect to QFCs upon the appointment of a receiver apply equally to the "acceleration" of QFCs as to the termination or liquidation of QFCs. Proposed Amendments § 2(h)(2).

(ii) The Proposed Amendments would amend the protections available for QFCs in both receiverships and conservatorships as they relate to security agreements to make the protections of those provisions available to "any right under any security agreement or arrangement or other credit enhancement related to 1 or more qualified financial contracts." The Proposed

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[63/] The section reads:

Notwithstanding any other provision of this chapter (other than paragraph (12) of this subsection, subsection (d)(9) of this section and section 1823(e) of this title), any other Federal law, or the law of any State, no person shall be stayed or prohibited from exercising -

(i) any right such person has to cause the termination, liquidation, or acceleration of any qualified financial contract with a depository institution in a conservatorship based upon a default under such financial contract that is enforceable under applicable noninsolvency law;

(ii) any right under any security arrangement relating to such qualified financial contracts;

(iii) any right to offset or net out any termination values, payment amounts, or other transfer obligations arising under or in connection with such qualified financial contracts. 12 U.S.C. § 1821(e)(8)(E).

Amendments would conform the language under the FDIA to the language, as amended, used in the Bankruptcy Code. Proposed Amendments §§ 2(h)(3)-(4), 8(a)(1)(A).

8. Power to Transfer Contracts.

a. It is unclear whether the FDIC may selectively transfer assets and liabilities of an insolvent institution, regardless of non-assignment or other contractual restrictions on transfer.[64/]

b. Exception for QFCs.

(i) The conservator or receiver can transfer QFCs only if it transfers to one depository institution all of the following:

(a) all QFCs between a counterparty (and any affiliates) and the institution in default;

(b) all claims by the counterparty or affiliate against the institution in default under any QFC (except subordinated claims);

(c) all claims by the institution in default against the counterparty or affiliate under any QFC; and

(d) all property securing any claim under any QFC. 12 U.S.C. § 1821(e)(9).

(ii) Otherwise the receiver or conservator may not transfer any QFCs of a counterparty or any affiliate.

[64/] See Resolution Trust Corp. v. Charles House Condominium Ass'n, 853 F. Supp. 226 (E.D. La. 1994) (right of first refusal ineffective); NVMercure Ltd. Partnership v. Resolution Trust Corp., 871 F. Supp. 488, 491-92 (D.D.C. 1994) (same). Some courts, however, have required the RTC to pay damages if it transferred assets or liabilities despite a contractual restriction on transfer. See Waterview Management Co. v. FDIC, 105 F.3d 696, 699-701 (D.C. Cir. 1997) (stating that "the RTC can avoid the obligations imposed by such agreements only by repudiating them in accord with FIRREA . . . and paying damages in accord with FIRREA") (explaining that the conservator or receiver may not "increase the value of the asset in its hands by simply 'preempting' out of existence prereceivership contractual obligations").

(iii) The ability of a receiver or conservator to selectively transfer or "cherry pick" contracts of an insolvent depository institution could destroy the counterparty's cross-collateralization and netting rights. Section 1821(e)(9) is intended to preserve such rights by requiring the receiver or conservator to transfer all or none of its QFCs with a given counterparty.

c. Proposed Amendments Relating to Transfers of QFCs.

(i) Section 1821(e)(9) currently requires the conservator or receiver to transfer QFCs to a "depository institution." The Proposed Amendments would permit QFCs to be transferred to a "financial institution," which is defined as "a broker or dealer, a depository institution, a futures commission merchant, or any other institution as determined by the [the FDIC] by regulation to be a financial institution." Proposed Amendments § 4(a).

(ii) Section 1821(e)(9) prohibits a conservator or receiver for a depository institution from transferring any QFCs to a depository institution that is "in default." The Proposed Amendments would clarify this provision by providing that such transfers may not be made to an institution "for which a conservator, receiver, trustee in bankruptcy, or other legal custodian has been appointed or which is otherwise the subject of a bankruptcy or insolvency proceeding." Proposed Amendments § 4(a).

(iii) The Proposed Amendments would add a new provision, section 1821(e)(9)(B), providing that the conservator or receiver may transfer QFCs to a foreign entity only if applicable law in the foreign jurisdiction would protect the contractual rights of the parties to such QFCs to the same extent as the FDIA.[65]

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[65] The language of the new provision would read as follows:

"TRANSFER TO FOREIGN BANK, FOREIGN FINANCIAL INSTITUTION, OR BRANCH OR AGENCY OF A FOREIGN BANK OR FINANCIAL INSTITUTION.--In transferring any qualified financial contracts and related claims and property pursuant to subparagraph (A)(i), the conservator or receiver for such depository institution shall not make such transfer to a foreign bank, financial institution organized under the laws of a foreign country, or a branch or agency of a foreign bank or financial institution unless, under the law

(iv) The Proposed Amendments would further provide, consistent with the existing policy statement on QFCs issued by the FDIC on December 12, 1989,[66/] that transfers to the following institutions will be permissible:

(a) a bridge bank; or

(b) a depository institution organized by the FDIC, for which a conservator is appointed either--

i) immediately upon the organization of the institution; or

ii) at the time of a purchase and assumption transaction between such institution and the FDIC as receiver for a depository institution in default. Proposed Amendments § 4(c)(2).

(v) The Proposed Amendments would provide that, in the event that a conservator or receiver transfers a QFC (and related claims, property and credit enhancements) and such contract is subject to the rules of a clearing organization, "the clearing organization shall not be required to accept the transferee as a member by virtue of the transfer." Proposed Amendments § 4(a).

(a) The H.R. 1161 House Report explains that "[t]his provision gives the FDIC flexibility in resolving QFCs subject to the rules of a clearing organization, while preserving the ability of such organizations to enforce appropriate risk

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applicable to such bank, financial institution, branch or agency, to the qualified financial contracts, and to any netting contract, any security agreement or arrangement or other credit enhancement related to 1 or more qualified financial contracts the contractual rights of the parties to such qualified financial contracts, netting contracts, security agreements or arrangements, or other credit enhancements are enforceable substantially to the same extent as permitted under this section. Proposed Amendments § 4(a).

[66/] "FDIC Statement of Policy on Qualified Financial Contracts" (Dec. 12, 1989), available at, http://www.fdic.gov/regulations/laws/rules/5000-1100.html (last visited Feb. 1, 2001).

reducing membership requirements." H.R. 1161 House Report at 27.

9. Notice. The conservator or receiver that transfers a QFC must use its "best efforts" to notify counterparty by 12:00 noon of the business day following such transfer. 12 U.S.C. § 1821(e)(10).

a. The December 12, 1989 Statement of Policy indicates that, although it is the FDIC's policy to use its "best efforts" to notify a counterparty to a QFC whether it has transferred the QFC prior to 12:00 noon on the business day following the appointment of the receiver, any rights of the counterparties to terminate a QFC upon the appointment of a receiver, pursuant to 12 U.S.C. § 1821(c)(10), will not be applicable if the counterparty has received notice of a transfer of a QFC prior to the close of business on that date.

(i) As a practical matter, this position appears intended to prevent counterparties from exercising their rights to liquidate under 12 U.S.C. § 1821(e)(8)(A) until after the close of the first business day following the appointment of the receiver.

b. The receiver shall be deemed to have given such notice if it has taken steps "reasonably calculated" to provide notice to such party.

c. Note that if the counterparty has exercised its right to terminate QFCs upon appointment of a receiver, or after the appointment of a conservator, the conservator or receiver will not have QFCs to transfer. This appears to put a premium on fast action by both the counterparty and by the receiver or conservator to act before the other acts. As noted above, the FDIC has taken the position that counterparties must give the FDIC at least until the next business day after the date of appointment to give the FDIC the opportunity to transfer QFCs before counterparties terminate the QFCs.

d. Proposed Amendments. The Proposed Amendments contain several provisions intended to clarify the time periods contained in the FDIA.

(i) The Proposed Amendments would amend 12 U.S.C. § 1821(e)(10)(a) to provide that the "conservator or receiver shall notify any person who is a party to any

such contract of such transfer by 5:00 p.m. (eastern time) on the business day following the date of the appointment of the receiver, in the case of a receivership, or the business day following such transfer, in the case of a conservatorship." Proposed Amendments § 4(b).

(ii) The Proposed Amendments would further provide that a counterparty may not exercise its right to terminate, liquidate or net a QFC upon the appointment of a receiver (x) until 5:00 p.m. (eastern time) on the business day following the date of the appointment of the receiver; or (y) after the counterparty has received notice that the contract has been transferred pursuant to paragraph (9)(a).[67/]

(a) The Proposed Amendments further provide that the FDIC shall be deemed to have notified a counterparty to a QFC if the FDIC has taken steps reasonably calculated to provide notice to such person by 5:00 p.m. (eastern time) on the business day following the date of the appointment of the receiver." Proposed Amendments § 4(c)(2). This amendment is consistent with the Statement of Policy on QFCs issued by the FDIC on December 12, 1989.

67/ The relevant provision of the Proposed Amendments is set forth below:

(B) Certain rights not enforceable.

(i) RECEIVERSHIP.--a person who is a party to a qualified financial contract with an insured depository institution may not exercise any right such person has to terminate, liquidate, or net such contract under paragraph (8)(A) or section 403 or 404 of the Federal Deposit Insurance Corporation Improvement Act of 1991 solely by reason of or incidental to the appointment of a receiver for the depository institution (or the insolvency or financial condition of the depository institution for which the receiver has been appointed)

(I) until 5:00 p.m. (eastern time) on the business day following the date of the appointment of the receiver; or

(II) after the person has received notice that the contract has been transferred pursuant to paragraph (9)(A). Proposed Amendments § 4(c)(2).

(iii) The Proposed Amendments would also clarify that no provision of law should be construed to limit or delay the FDIC's right to transfer, repudiate, or disaffirm QFCs. [68]

(iv) According to the H.R. 1161 House Report, the foregoing amendments are intended to clarify the relationship between the FDIA and FDICIA by making clear that FDICIA does not permit the termination, liquidation or netting of QFCs before the applicable time periods under the FDIA for the FDIC to transfer or repudiate QFCs of insolvent depository institutions have expired. The purpose of this amendment is to ensure that the FDIC has the time required to make determinations with respect to the dispositions of the contracts of the insolvent depository institution. H.R. 1161 House Report at 27-28.

10. The FDIA's Written Agreement and Related Requirements. 12 U.S.C. §§ 1821(d)(9), (n)(4)(I) and 1823(e)

a. Written Agreement Requirements.

(i) An agreement that fails to meet the written agreement provisions of 12 U.S.C. § 1823(e), cannot form the basis of, or substantially comprise, a claim against the receiver or the FDIC.[69] Section 1823(e)(1) provides that such an agreement is not valid unless it:

(a) is in writing;

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[68] The proposed paragraph would read as follows:

CLARIFICATION.--No provision of law shall be construed as limiting the right or power of the Corporation, or authorizing any court or agency to limit or delay, in any manner, the right or power of the Corporation to transfer any qualified financial contract in accordance with paragraphs (9) and (10) of this subsection or to disaffirm or repudiate any such contract in accordance with paragraph (1). Proposed Amendments § 3(a)(2).

[69] In addition to the "written agreement" requirement defenses, a receiver or conservator also has available the "federal holder in due course doctrine" to defeat counterclaims asserted against the institution or challenges to the enforceability of assets held by the institution. See, e.g., FDIC v. Wrapwell Corp., 922 F. Supp. 913 (S.D.N.Y. 1996).

(b) was executed by the institution and the claimant contemporaneously with the acquisition of the asset by the institution;

(c) was approved by the board of directors of the institution or its loan committee; and

(d) has been, continuously, from the time of its execution, an official record of the institution.

b. The only stated exception to the written agreement provision is for extensions of credit by Federal home loan banks or Federal Reserve banks, which are exempted from the contemporaneous execution provision. 12 U.S.C. § 1823(e)(2).

c. The provision as enacted could be read to deprive a claimant of its claim if the institution lied about having obtained board approval or failed to maintain the agreement as an official record, even if the claimant took all available steps to obtain such representations from the failed institution. Notwithstanding this formulation, parties dealing with financial institutions should obtain the institution's written acknowledgment of board or loan committee approval and its acknowledgment that the agreement is and will continue to be an official record of the institution. The counterparty should maintain these acknowledgments in its own files to show that it has made efforts to meet the written agreement requirements. Parties entering into QFCs and other significant transactions with financial institutions should consider insisting on receiving a certified board resolution showing approval of such a transaction and delegation of authority to a responsible officer to enter into the transaction.

d. The written agreement provisions are among the most litigated sections of 12 U.S.C. § 1821, and the case law is often contradictory. For example:

(i) There has been some uncertainty about the strictness with which the written agreement requirements will be applied to security interests, particularly the "contemporaneous" requirement.[70/]

[70/] Compare the FDIC Advisory Opinion No. 89-48 (Dec. 15, 1989), reprinted in [1989-1990 Transfer Binder] Banking L. Rep. (CCH) ¶ 81,264 (a court would hold that the FDIC could not "avoid a security interest in Collateral solely because the grant of

(a) In response, the FDIC issued a Statement of Policy stating that the FDIC will not seek to avoid an otherwise legally enforceable security interest solely because the security agreement granting the security interest does not meet the "contemporaneous" requirement. This policy applies both to collateral that was not acquired contemporaneously with the execution of the security agreement and to collateral that may change, increase, or be subject to substitution during the period that the security interest is enforceable.[71] The Statement of Policy assumes that the security agreement was entered into as part of a bona fide, arms length transaction not involving insiders or affiliates.

(ii) The problems arising from differing interpretations of 12 U.S.C. § 1823(e) are compounded by the uncertainty over whether 12 U.S.C. § 1823(e) codifies (and thereby replaces) the common law principles upon which it is based, as set forth in D'Oench, Duhme & Co. v. FDIC.[72] Many courts have concluded that 12 U.S.C. § 1823(e) was not intended to preempt the D'Oench doctrine.[73] The D'Oench doctrine, because it is "based on the concept of equitable estoppel," is, in some ways, narrower than 12 U.S.C. § 1823(e), which "makes the fault of the party asserting the unwritten agreement

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security interest . . . did not occur contemporaneously with the Institution's acquisition of the Collateral"), with North Arkansas Med. Cntr. v. Barrett, 962 F.2d 780 (8th Cir. 1992) (the FDIC could reject a secured claim in property acquired after the execution of the security agreement because, among other things, the "contemporaneous" requirement was not met).

[71] The FDIC Statement of Policy Regarding Treatment of Security Interests After Appointment of the FDIC as Conservator or Receiver, 58 Fed. Reg. 16,833-02 (Mar. 31, 1993).

[72] 315 U.S. 447 (1942). See Kessler v. National Enterprises, Inc., 165 F.3d 596 (8th Cir. 1999).

[73] See, e.g., Murphy v. FDIC, 208 F.3d 959 (11th Cir. 2000); Young v. FDIC, 103 F.3d 1180 (4th Cir. 1997); FSLIC v. Flithers, 683 F. Supp. 552 (E.D. La. 1987); FDIC v. McClanahan, 795 F.2d 512 (5th Cir. 1986).

irrelevant."[74] Courts, however, have split over whether the scope of the common law D'Oench doctrine is broader than § 1823(e), in that some courts argue that the D'Oench doctrine extends to non-loan transactions.[75]

(iii) There are certain "safe harbors" from the written agreement requirements for QFCs.

(a) In the December 12, 1989, Statement of Policy with respect to QFCs, the FDIC states, among other things, that QFCs would be deemed to satisfy the written agreement requirements if:

i) the QFC is evidenced by a writing (including a confirmation) sent by one counterparty to the QFC to the other "reasonably contemporaneously" with the agreement to enter into the transaction; however, the writing need not be signed, unless applicable non-insolvency law requires a signature;

ii) the depository institution was authorized by "corporate action" to enter into the transaction, which will be deemed to have occurred if the counterparty relied in good faith on a resolution (or extract thereof) provided by the institution's secretary or assistant secretary, or

iii) there is a written representation (including in a master agreement) by an officer at the level of vice-president or higher as to the institution's authority; and

iv) the writing evidencing the QFC and the evidence of authority is maintained by the depository institution in its official books and records (although the

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[74] Du Pont v. FDIC, 32 F.3d 592, 597 (D.C. Cir.1994).

[75] See John v. Resolution Trust Corp., 39 F.3d 773 (7th Cir. 1994).

counterparty may establish the existence of such documents by producing the copies it maintains).

(b) In applying these criteria, the FDIC will "look to the totality of the circumstances surrounding the [QFC transactions] including the counterparty's good faith attempt to comply with all reasonable trading practices and requirements, and any non-insolvency law requirements and the requirements stated herein." December 12, 1989 Statement of Policy.

(iv) Proposed Amendments. The Proposed Amendments would amend section 1823(e)(2) of the FDIA to provide that an agreement for the collateralization of one or more QFCs will not be deemed invalid on the basis that the agreement was not entered into contemporaneously with the acquisition of the collateral.[76/] The amendment codifies portions of Statements of Policy codifying the D'Oench doctrine. The H.R. 1161 House Report explains that:

> [w]ith respect to QFCs, this codification recognizes that QFCs often are subject to collateral and other security arrangements that may require posting and return of collateral on an ongoing basis based on the mark-to-market values of the collateralized transactions. The codification of only portions of the existing the FDIC policy statements on these and related issues should not give rise to any negative implication regarding the continued validity of these policy statements. H.R. 1161 House Report at 36.

76/ The relevant portion of the Proposed Amendments reads as follows:

EXEMPTIONS FROM CONTEMPORANEOUS EXECUTION REQUIREMENT. -- An agreement to provide for the lawful collateralization of … 1 or more qualified financial contracts, as defined in section 11(e)(8)(D), shall not be deemed invalid pursuant to paragraph (1)(B) solely because such agreement was not executed contemporaneously with the acquisition of the collateral or because of pledges, delivery, or substitution of the collateral made in accordance with such agreement. Proposed Amendments § 10.

IV. FDICIA NETTING PROVISIONS

A. General. In order to promote the efficient processing of transactions among financial institutions, and in recognition that netting contracts among financial institutions "reduce systemic risk within the banking system and financial markets," FDICIA supplemented the FDIA by adding Chapter 45, 12 U.S.C. §§ 4401-07, protecting certain netting contracts among financial institutions. Unlike the netting provisions of the Bankruptcy Code and the FDIA, FDICIA's protections do not depend on the types of transactions that can be netted, but rather focus exclusively upon the counterparties to the netting agreement. FDICIA generally protects netting agreements between financial institutions and netting agreements between clearing organizations. 12 U.S.C. §§ 4402-03.

B. Definitions.

1. Financial Institution means a broker or dealer, a depository institution, a futures commission merchant, or any other institution that the Federal Reserve Board determines should be included in the definition of financial institution. 12 U.S.C. § 4402(9)

   a. "broker or dealer" means (x) any company registered under Federal or state law to engage in brokering, underwriting, or dealing in securities in the United States, and (y) to the extent determined by the Federal Reserve Board, any affiliate of the above engaged in the business of entering into netting contracts. 12 U.S.C. § 4402(1).

   b. Reg. EE, promulgated by the Federal Reserve Board (FRB), includes additional entities in the definition of "financial institution." 12 C.F.R. pt. 231 (2000).

      (i) Any person[77/] can be a financial institution if it:

         (a) represents that it will engage in financial contracts as a counterparty on both sides of one or more financial markets; and either

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[77/] A person is defined as "any legal entity, foreign or domestic, including a corporation, unincorporated company, partnership, government unit or instrumentality, natural person, or any other entity or organization." 12 C.F.R. § 231.2(f) (2000).

i) had one or more financial contracts of a total gross dollar value of $1 billion in notional principal amount outstanding (with counterparties other than its affiliates) on any day during the previous 15-month period; or

ii) had total gross mark-to-market positions (aggregated across counterparties that are not its affiliates) in one or more financial contracts of $100 million on any day during the previous 15-month period. 12 C.F.R. § 231.3 (2000).

(ii) A hedge fund fulfilling the transactional test above should qualify for FDICIA's netting protection.

(iii) Reg. EE provides that, if a person qualifies as a financial institution under the regulation, it will be considered a financial institution for any contract entered into during the period it so qualifies, even if it later fails to qualify as a financial institution. 12 C.F.R. § 231.3(b) (2000). Furthermore, if a person qualified as a financial institution on March 7, 1994—the effective date of the regulation—it is considered a financial institution for the purposes of any outstanding contract entered into prior to March 7, 1994. 12 C.F.R. § 231.3(c) (2000).

(iv) Reg. EE defines "financial markets" to be any "market for a financial contract." 12 C.F.R. § 231.2(d) (2000). Financial contract is defined as a QFC, "except that a forward contract includes a contract with a maturity date two days or less after the date the contract is entered into (i.e. a 'spot' contract)." 12 C.F.R. § 231.2(c) (2000).

(v) The comments accompanying Reg. EE indicate that the FRB is primarily concerned with creating a broad rule that would capture any participant whose failure could create systemic risk in the financial markets. For this reason, the FRB rejected a test based on the regulatory status, affiliation, or charter of the entity.[78/]

[78/] Netting Eligibility for Financial Institutions, 59 Fed. Reg. 4,780-01 (Feb. 2, 1994).

c. Under 12 U.S.C. § 4402(6), "depository institution" is defined to include:

(i) depository institutions as defined in 12 U.S.C. § 461(b)(1)(A)(i)-(vi);

(ii) foreign bank branches or agencies (12 U.S.C. § 3101);

(iii) Edge Act corporations (12 U.S.C. § 611); and

(iv) Agreement corporations (12 U.S.C. § 601).

d. Proposed Amendments. The Proposed Amendments would amend the definition of "depository institution" to also include, and thereby provide statutory protection to, the following institutions:

(i) an uninsured national or state bank that is a member of the Federal Reserve System if the national bank or state member bank is not eligible to apply to become an insured bank under section 5 of the FDIA; and

(ii) a branch or agency of a foreign bank, a foreign bank and any branch or agency of the foreign bank, or the foreign bank that established the branch or agency, as those terms are defined in section 1(b) of the International Banking Act of 1978. Proposed Amendments § 7(a)(2)(B) & (C).

(a) Reg. EE already included certain foreign banks in the definition of "financial institution;" the purpose of the amendment is to "statutorily extend the protections of FDICIA to ensure that U.S. financial organizations participating in netting agreements with foreign banks are covered by [FDICIA], thereby enhancing the safety and soundness of these arrangements." H.R. 1161 House Report at 29.

2. Failed Financial Institution. 12 U.S.C. § 4402(7) defines "failed financial institution" to include any financial institution that:

a. fails to satisfy a covered contractual payment obligation when due;

b. is the subject of "insolvency, liquidation, reorganization, receivership, . . . conservatorship, or similar proceedings"; or

c. has ceased to meet its obligations when due.

3. Clearing Organization. 12 U.S.C. § 4402(2) defines "clearing organization" to include a clearinghouse, clearing association, clearing corporation, or similar organization, that:

a. provides clearing, netting or settlement services for its members and (x) in which all members are financial institutions or other clearing organizations or (y) which is registered as a clearing agency under the Securities Exchange Act of 1934; or

b. performs clearing functions for a contract market designated pursuant to the Commodity Exchange Act.

4. Member, under 12 U.S.C. § 4402(11), specifically refers to a member of or participant in a clearing organization, and includes the clearing organization.

a. Proposed Amendments. The Proposed Amendments would amend the definition of "member" to also include "any other clearing organization with which such clearing organization has a netting contract." Proposed Amendments § 7(a)(3).

(i) The H.R. 1161 House Report states that the purpose of the Proposed Amendments would be to assure "the enforceability of netting arrangements involving two or more clearing organizations and a member common to all such organizations, thus reducing systemic risk in the event of the failure of such a member. Under the current FDICIA provisions, the enforceability of such arrangements depends on a case-by-case determination that clearing organizations could be regarded as members of each other for purposes of FDICIA." H.R. 1161 House Report at 29.

5. Failed Member has a definition parallel to that of a failed financial institution. 12 U.S.C. § 4402(8).

6. Netting Contract is defined by 12 U.S.C. § 4402 (14) to mean a contract or agreement[79/] between two or more financial institutions that is governed by the laws of the United States or any political subdivision thereof, if the contract or agreement provides for netting present or future payment obligations or entitlements (including liquidation or close-out values relating to such obligations or entitlements) among the parties to the agreement.

   a. The definition does not include contracts that are "invalid under or precluded by Federal commodities law." Because this provision includes only commodities law, arguably netting contracts with financial institutions subject to the FDIA would be protected even if they do not meet the written agreement requirements.

   b. Proposed Amendments. The Proposed Amendments would amend the definition of "netting contract" to delete the requirement that a netting contract be governed by the laws of the United States, any state, or any political subdivision of any state. Netting contracts governed by foreign law must satisfy the requirement that such contracts not be invalid under, or precluded by, United States federal law. Proposed Amendments § 7(a)(4).

7. Payment.

   a. Proposed Amendments. The Proposed Amendments would add a new definition of "payment" that would include "payment of United States dollars, another currency, or a composite currency, and a noncash delivery, including a payment or delivery to liquidate an unmatured obligation." Proposed Amendments § 7(a)(5).

C. Bilateral Netting.

1. Calculation. Currently, pursuant to 12 U.S.C. § 4403(a)-(b), the payment obligations between financial institutions are netted according to the terms of the applicable netting contract. Each party's obligation to make (or entitlement to receive) payment is limited to the amount determined under the terms of the such contract.

[79/] "Contract" or "agreement" is interpreted as including the rule s of a clearing organization

a. The net amount, if any, due a failed financial institution "shall be paid to the failed financial institution" in accordance with the netting contract. There is no express requirement that the failed financial institution make payment of any net amount it may owe under a netting contract; however, failed financial institutions are not excused from their contractual obligations. 12 U.S.C. § 4403(d).

b. The bilateral netting provisions appear to protect both limited and full two-way netting payment provisions. See 12 U.S.C. § 4403(c).

2. Proposed Amendments.

a. Enforceability of Security Agreements. The Proposed Amendments would provide that the provisions of any security agreement or arrangement or other credit enhancement related to one or more netting contracts between any two financial institutions shall be enforceable in accordance with their terms and shall not be stayed, avoided, or otherwise limited by any state or federal law. Proposed Amendments § 7(b)(1)-(2)

b. Walkaway Clauses of Netting Contracts Unenforceable. The Proposed Amendments would make "walkaway clauses" unenforceable under the FDIA, notwithstanding FDICIA. The Proposed Amendments define a "walkaway clause" as a provision in a QFC "that, after calculation of a value of a party's position or an amount due to or from 1 of the parties in accordance with its terms upon termination, liquidation, or acceleration of the qualified financial contract, either does not create a payment obligation of a party or extinguishes a payment obligation of a party in whole or in part solely because of such party's status as a nondefaulting party." The Bankruptcy Code does not contain a similar provision. Proposed Amendments § 3(a)(2).

D. Clearinghouse Netting.

1. Calculation. The provisions with respect to multilateral netting under a clearing organization are similar to those for bilateral netting; the amount due to, or owed by, any member of the organization to the other members of the organization is limited to the net amount due or owed that member under the applicable netting contract. These amounts are calculated with respect to each applicable netting contract. 12 U.S.C. § 4404.

a. In addition, amounts due to a failed member are the net amounts calculated under the applicable netting contract, and "shall be paid" to the failed member. 12 U.S.C. § 4404(d). There is no express requirement that the failed member make payment of any net amount it may owe under a netting contract, although neither are failed members excused from their contractual obligations. 12 U.S.C. § 4404(e).

b. The clearing organization netting provisions appear to protect both limited and full two-way netting payment provisions. 12 U.S.C. § 4404(c). As noted above, the Proposed Amendments would make "walkaway clauses" unenforceable under the FDIA, notwithstanding FDICIA.

2. Proposed Amendments. The Proposed Amendments would provide that the provisions of any security agreement or arrangement or other credit enhancement related to one or more netting contracts between any two members of a clearing organization shall be enforceable in accordance with their terms and shall not be stayed, avoided, or otherwise limited by any state or federal law.

E. Relationship With Other Laws.

1. Exception to Stay. 12 U.S.C. § 4405 provides that "[n]o stay, injunction, avoidance, moratorium, or similar proceeding or order, whether issued or granted by a court, administrative agency, or otherwise, shall limit or delay application of otherwise enforceable netting contracts in accordance with [Chapter 45 of title 12]."

a. The language of this provision would appear to capture both the automatic stay of the Bankruptcy Code as well as the stay provisions of the FDIA. Because the definition of "netting contracts" is different from (and in some cases more inclusive than) the definition of QFCs in the FDIA or similar definitions in the Bankruptcy Code, this provision appears to be an additional exception to both the automatic stay under the Bankruptcy Code and the receivership/conservatorship stay powers.

2. Proposed Amendments.

a. FDICIA currently does not protect rights to terminate contracts by financial institutions? only the exercise of netting rights pursuant to such contracts. Arguably, therefore, FDICIA does not limit the FDIC's power to transfer or repudiate QFCs in accordance with the FDIA. The FDIC supports this view.[80/] The

[80/] See 59 Fed. Reg. 37,726-01, 37,730 (July 25, 1994).

Proposed Amendments would codify the FDIC's position, clarifying that FDICIA netting contracts may not be terminated based solely upon termination provisions that provide for termination on:

(i) the appointment of a conservator for an insolvent depository institution under the FDIA or

(ii) the appointment of a receiver for such institution under the FDIA, if such receiver transfers or repudiates QFCs in accordance with the FDIA and gives notice of a transfer by 5:00 p.m. on the business day following the appointment of a receiver. Proposed Amendments § (b)-(c). See also H.R. 1161 House Report at 30.

b. The Proposed Amendments would further clarify that the netting provisions of FDICIA are subject to any order authorized under section 5(b)(2) of the SIPA. Proposed Amendments § 7(b)(1). The H.R. 1161 House Report states that the Proposed Amendments provide that "FDICIA does not override a stay order under SIPA with respect to foreclosure on securities (but not cash) collateral of a debtor" H.R. 1161 House Report at 30.

c. Netting contracts will be subject to the provisions of a new Bankruptcy Code section 561, which will limit certain netting rights of commodities brokers. This section is discussed in more detail in section II.D.1.e.(v). Proposed Amendments §§ 7(b)(1), 8(k).