Overview and Analysis of Select Provisions of the ABI Chapter 11 Reform Commission Final Report and Recommendations

Part Two of Three

By Orrick Restructuring Group
Last month, Orrick’s Restructuring team began a three-part look at the American Bankruptcy Institute’s Chapter 11 Reform Report. In part one we looked at issues related to confirmation, valuation, financing and asset sales. This second part focuses on modifications to the Bankruptcy Code’s “safe harbors” for derivatives and other complex financial transactions. The final part will focus on professional compensation, treatment of executory contracts and other interesting topics.

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Current State of the Law

The Bankruptcy Code affords special treatment for specified entities, such as stockbrokers, repo participants, swap participants and financial institutions with respect to “repurchase agreements,” “securities contracts” “swap agreements” and certain other financial contracts. Under the Bankruptcy Code, if an agreement falls within the defined term “repurchase agreement”, “swap agreement” or “securities contract”, then a non-debtor stockbroker, financial institution, repo participant or swap participant, as applicable, would not be enjoined (or stayed by the operation of Bankruptcy Code § 362(a)) from exercising its contractual right to terminate, accelerate or liquidate such agreement or from offsetting or netting out any termination values or payment amounts owed to it under such agreement despite the counter-party's bankruptcy or insolvency or financial condition. These special protections essentially supersede the limitation in Section 365(e)(1) of the Bankruptcy Code, which invalidates bankruptcy termination clauses (sometimes referred to as ipso facto clauses). These ipso facto clauses typically provide that a contract can be terminated or modified based upon the bankruptcy, insolvency or financial condition of one of the parties.

In 2005, the Bankruptcy Code was amended to expand the type of investments protected by the safe harbor provisions to include repurchase agreements and securities contracts relating to mortgage loans, mortgage-backed securities or any interests in mortgage loans or mortgaged-backed securities or options on such mortgage loans or mortgaged-backed securities.

Commission Recommendations

While the Commission did not propose eliminating the safe harbor protections, the Commission made a number of recommendations aimed at rolling back, limiting and clarifying the safe harbor protections.

• Rolling Back Safe Harbor Protections. The Commission recommends that the safe harbor protections for repurchase agreements and securities contracts should revert to their respective pre-2005 definitions thereby eliminating the safe harbor protections for mortgages and mortgaged-backed securities. Alternatively, the Commission recommends that, at the very least, the safe harbor protections should exclude repurchase agreements and securities contracts that have the “economic attributes of traditional mortgage warehouse facilities”, that are more akin to committed secured financing arrangements than so-called “true repurchase agreements”. Report at 99.

While recognizing the importance of the repurchase agreements in both domestic and global portfolios, some of the Commissioners believed that “inclusion of these repurchase agreements encouraged runs on debtor originators and accelerated (rather than reduced) contagion.” Report at 101. The Commissioners agreed that the safe harbors should not protect disguised mortgage warehouse arrangements. The Commission proposed that “committed mortgage loan repurchase agreement facilities that function as mortgage warehouse facilities” should be expressly excluded from the definition of repurchase agreements and securities contracts. Report at 102.

Query: What is a “disguised mortgage warehouse arrangement” and how is it distinguished from a “true repurchase agreement”? The Commission noted that in order to obtain short-term financing until the mortgage loans be deposited into a securitization pool, the “the loan originator obtains short-term financing from a lender through a credit facility or similar arrangement secured by a pledge of mortgage
or other assets owned by the originator.” Report at 100. If adopted, the Commission’s recommendation likely will impact the $4 trillion repurchase agreement market and, more particularly, mortgage loan financing and securitization.

**Limiting Safe Harbor Protections.** The Commission recommends limiting the safe harbor protection of certain transfers from avoidance as a fraudulent transfer. Under Bankruptcy Code section 546(e), a trustee or debtor in possession cannot avoid prepetition settlement payments or margin payments except for transfers made with actual fraudulent intent. The Commission recommends excluding settlement payments made to beneficiaries of leveraged buyouts and similar transactions (i.e., prepetition transactions in which some or all of the debtor’s assets are being used to facilitate the transaction) if the securities were privately issued. Some courts (Third, Sixth and Eighth Circuits) have held that settlement payments to beneficial owners of publicly and privately held securities are protected from avoidance except for actual fraud. Section 546(e) would continue to protect settlement payments for publicly issued securities and security industry participants who act as mere conduits. The Commission recommends that conduits should be expressly covered by section 546(e) to avoid any uncertainty that might implicate the financial markets. Report at 97.

The Commission also recommends expanding the actual fraud exception from the safe harbor protections of Section 546(e) to include applicable state fraudulent conveyance laws. The Commission noted that currently the courts are split on whether the safe harbor protections are limited to fraudulent transfer actions under Bankruptcy Code section 548 or whether they extend to such actions under state law that are avoidable by the trustee under section 544(b) or by a litigation trust or individual creditors after confirmation of a chapter 11 plan. Report at 98.

The Commission notes that it is “difficult to reconcile the protections that courts were affording the beneficial owners of privately issued securities with the original purpose of the legislation [namely, to insulate the securities transfer system from fraudulent conveyance and preference actions].” Report at 97. As the court stated in *In re American Home Mortgage Inc.*, 379 B.R. 503, 516-17 (Bankr. D. Del. 2008, “if the definition of ‘repurchase agreement’ is met, the section 559 safe harbor provisions apply, period. Similarly, if the definitions of ‘securities contract’ and ‘financial institution’ are met, the section 555 safe harbor applies, period. This conclusion is compelled by the plain meaning of the statute and is consistent with the policy and legislative history underlying the relevant provisions of the Bankruptcy Code.”).

We expect debtors, creditor committees and litigation trusts will continue to prosecute actions (particularly in cases pending outside of the Third, Sixth and Eighth Circuits) seeking to recover payments as fraudulent transfers made to beneficial holders of privately issued securities under federal (Bankruptcy Code section 548) and state law. The clawback period under the Bankruptcy Code is two years, but is four or six years or longer under some state law provisions.

**Clarifying Revisions.** The Commission also recommends a few changes that will clarify the scope of the safe harbor protections for derivative transactions. Specifically, the Commission proposes the following:

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Walkaway Clauses Unenforceable. The Commission recommends amending the safe harbor protections to make walkaway provisions unenforceable, which would bring the Bankruptcy Code into conformity with the Federal Deposit Insurance Act and the Orderly Liquidation Authority. Termination clauses in most derivative agreements generally call for one of two options in the event of termination following default. The first is called a “one way settlement provision” where the non-defaulting party can walk away even if “out of the money”. This is also called the “first method” and “limited two-way payments method.” The other method called the “second method” is where the defaulting party is credited for its “in the money” positions and the non-defaulting party must pay the defaulting party whatever the defaulting party is owed.

Congress expressly invalidated these provisions for qualified financial contracts involving insured depositary institutions where the FDIC is appointed as conservator or receiver. However, such provisions were not invalidated for cases under the Bankruptcy Code. It was left to the courts to apply applicable state law to determine if the termination clause is enforceable. Some courts have held that the provision is an unenforceable liquidated damage provision because the non-defaulting party is getting the windfall of not having to pay back the defaulting party even if it is “out of the money”. Report at 106-07.

In the absence of adoption of the Commission’s recommendations, we expect that debtors will continue to litigate the enforceability of these walkaway clauses.

Ordinary Supply Contracts Not Protected. The Commission recommends that the Bankruptcy Code should be amended to prevent nondealer counterparties to physical supply contracts from benefitting from the safe harbor protections, including contracts for the supply of natural gas and electricity. Some courts have held that, as written, ordinary supply agreements may constitute a qualified financial contract entitled to the benefits of the Bankruptcy Code safe harbor provisions. (See, e.g., In re Nat’l Gas Distribs, 556 F.3d 247, 259 (4th Cir. 2009) (natural gas supply contract could constitute a commodities forward contract and, as such, a swap agreement under the Bankruptcy Code).

Some courts have narrowly interpreted the application of these safe-harbor provisions to cases in which the clearance and settlement of these types of transactions (without the risk that they may be subsequently undone or avoided) is necessary to the stability and smooth operation of the financial markets. The Commissioners noted that the legislative history of the safe harbors “establishes a desire to protect the securities transfer system and promote market stability”. Subjecting a nondebtor party to an ordinary supply contract to the automatic stay and other provisions of the Bankruptcy Code would be “highly unlikely” to cause market instability. Report at 107-08.

Query: What makes a long-term supply contract an “ordinary supply agreement”? The Commission notes that distinguishing an “ordinary” supply agreement from a “qualified financial contract” may be difficult. The court will not be bound by the form of the contract, but instead, will look to its substance. Courts will need to analyze:

(i) does the contract involve a dealer, market maker or other party;

(ii) does the contract provide for the physical delivery of goods used, traded, or produced by the debtor in the ordinary course of business?
• **Calculation of Damages.** The Commission recommends amending section 562(b) to define “commercially reasonable determinants of value” as those specified in the contract that are not manifestly unreasonable or, in the absence of such determinations of value, commercially reasonable market prices. Report at 104.

In 2005, the Bankruptcy Code was amended to add a new section (Section 562) to the Bankruptcy Code to fix the date on which damages will be measured if a debtor rejects, or a non-debtor counterparty terminates, a swap agreement, repurchase agreement or securities contract. Under section 562, damages will be measured as of the earlier of (1) the date of such rejection or (2) the date or dates of such liquidation, termination or acceleration. If no commercially reasonable determinants of value exist on that date, section 562(b) provides that damages should be measured as soon as commercially reasonable determinants of value are available.

The Commissioners note that issues have arisen as to the methodology to be used in calculating damages. Mindful of the policies of promoting “market stability and respecting prepetition bargains whenever possible”, the Commission recommends that the contract terms should govern the damages upon termination. Alternatively, commercially reasonable market prices should be used to calculate termination values if the contract is silent or the contract terms are determined to be manifestly unreasonable. The Commissioners used the “manifestly unreasonable” standard as exists under Section 9-603 of the Uniform Commercial Code. Report at 105.

We expect non-debtor counterparties to use the Commission’s recommendations to assert that the contract terms should be respected to govern damage calculations. In the absence of contract terms or, if the contract terms are determined to be manifestly unreasonable, counterparties will seek to use commercially reasonable market prices.

• **Other Changes.** The Commission considered, but rejected at this time, a proposal to apply a short-term stay that would have allowed the debtor to assume and assign derivative agreements before counterparties can terminate, liquidate or close them out. The Commissioners note the existence of short stays under the FDIA and OLA, but did not believe that imposing such a stay would help the debtor’s rehabilitation efforts. The Commissioners questioned the debtor’s ability to review its derivative agreements in a meaningful and expeditious manner, and to structure and fund a transaction early in the chapter 11 case.

The Commission noted that legislation is pending to impose a short stay for financial institutions determined to be systemically important. Report at 103-04.
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