Exploring Temporary Stays of Early Termination Rights
Of Qualified Financial Contracts

By Lorraine McGowen and Joanna McDonald

Under the Bankruptcy Code (Title 11, U.S.C., §§ 101 et seq., the “Bankruptcy Code”) non-debtor counterparties to qualified financial contracts generally are not subject to the automatic stay under section 362 and the prohibition on ipso facto clauses under section 365(e). As a result, upon the commencement of a bankruptcy case under the Bankruptcy Code, counterparties are able to exercise their contractual right to cause the liquidation, termination or acceleration of the transactions under qualified financial covenants.

The same is not necessarily true when a bank, insurance company or other similar regulated entity becomes insolvent. Such entities are not eligible to be debtors under the Bankruptcy Code. While the insolvency regimes for such entities do not provide for an automatic injunction barring creditor remedies, the insolvency regime will provide a brief stay preventing counterparties to qualified financial contracts with such entity from terminating, liquidating or accelerating a qualified financial contract during such period.

The American Bankruptcy Institute recently released its Chapter 11 Reform Report. The Reform Report proposed a number of revisions to Chapter 11 related to confirmation, valuation, financing and asset sales, among others. The Reform Report also proposed a number of revisions to the safe harbor protections, which were discussed in Part II of Orrick’s Restructuring Team’s summary and analysis of the Reform Report. As mentioned in the summary of the proposed changes to the safe harbor protections, the Commission considered, but rejected, incorporating a temporary stay on the exercise by a non-debtor counterparty of its contractual rights to terminate and liquidate qualified financial contracts.

Look Carefully—Temporary Stays May Limit Enforcement of Your Creditor Remedies. While a stay may not exist under the Bankruptcy Code, other statutory regimes may prevent you from exercising your contractual termination rights and other remedies immediately upon the insolvency of your counterparty. A non-bankrupt counterparty is subject to a temporary stay of their remedial rights (i) if the Federal Deposit Insurance Corporation (FDIC) is appointed as receiver for a national bank, or (ii) in an insolvency proceeding involving a systemically

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1 Section 109 of the Bankruptcy Code explicitly provides that insurance companies, savings banks, cooperative banks, banks, savings and loan associations, building and loan associations, homestead associations, and credit unions are not eligible debtors for the purposes of liquidation or reorganization under Chapters 7 and 11 of the Bankruptcy Code. Thus, for insurance companies one has to look to the provisions of the applicable state law to determine what happens upon the insolvency of an insurance company.

2 12 U.S.C. § 1821(e) provides that liquidation, termination, netting and offset rights cannot be exercised solely due to the appointment of a receiver if by 5 p.m. on the business day following the
significant party under the Dodd-Frank Orderly Liquidation Authority\textsuperscript{3}, which expands the reach of the FDIC to resolve large non-bank financial institutions. The Orderly Liquidation Authority applies only to certain “covered” financial companies as to which the Secretary of the Treasury has made a systemic risk determination. Counterparties also may be temporarily stayed under applicable state law when an insurance company or a non-federally insured bank becomes insolvent.

In the wake of the 2008 financial crisis, regulators in several jurisdictions adopted “special resolution regimes,” which are designed to enable regulators to direct an orderly resolution of a distressed financial institution. Legislation has been proposed to address systemically important financial institutions under federal bankruptcy law that would impose a 48-hour stay before counterparties could exercise any of their contractual rights.\textsuperscript{4}

More recently certain financial institutions have voluntarily adopted a resolution protocol (Stay Protocol) promulgated by the International Swaps and Derivatives Association (ISDA), incorporating contractual stays on cross-default and termination rights (but not direct default rights) that would apply under certain cross-border resolution regimes. These stays are intended to give regulators time to facilitate an orderly resolution of a troubled financial institution. The Stay Protocol was addressed in our article in \textit{Derivatives in Review, Major Banks Agree to Protocol “Staying” Exercise of Termination Rights}, dated October 29, 2014.

If a counterparty opts into the Stay Protocol (becomes an “adhering party”), the adhering party incorporates suspension terms into their qualified financial contract, thereby recognizing the stays under various statutory resolution regimes. The Stay Protocol initially covers the existing resolution regimes in the United Kingdom, Germany, Switzerland, Japan or France, and regimes of other jurisdictions as may be added, but only if the regimes meet certain creditor protection safeguards (e.g., a stay period of no more than two business days and protection of netting). The Stay Protocol will apply to all ISDA master agreements between the adhering party and any other adhering party.

If an adhering party becomes subject to a resolution under a covered special resolution regime proceeding, the adhering parties agree to be stayed for the longer of one business day and 48 hours. The Stay Protocol also limits the ability of a non-defaulting party to exercise remedies in the event that a guarantor, parent or receiver’s appointment the creditor receives notice of transfer to another financial institution of all qualified financial contracts between the counterparty, its affiliates and the failed institution to another financial institution.


\textsuperscript{4} Taxpayer Protection and Responsible Resolution Act of 2014, S. 1861, 113\textsuperscript{th} Cong. § 1407 (2014) (adopting a proposal commonly referred to as “chapter 14”); Financial Institution Bankruptcy Act of 2014, H. 2421, 113\textsuperscript{th} Cong. § 1187 (2014) (adopting a proposal commonly referred to as a “subchapter V”).

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affiliate of an adhering party’s obligations becomes bankrupt under the Bankruptcy Code.

The following is a summary of the temporary stays of termination rights that currently apply when a counterparty becomes insolvent. The Stay Protocol anticipates that jurisdictions will adopt regulations that will require all financial institutions to incorporate the terms of the Stay Protocol into their qualified financial contracts.

**Stay of Termination Rights of Qualified Financial Contracts**

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<tr>
<th>Law or Publication</th>
<th>Citation</th>
<th>Duration of Stay</th>
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| Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Orderly Liquidation Authority for Systemically Important Financial Institutions) | 12 U.S.C. § 5390(c)(10)(B) | • 24-hour stay (5:00 p.m. (eastern time) on the business day following the date of appointment of a receiver); or  
• after notice that the contract has been transferred from the defaulting systemically important bank holding company to another financial institution |
| Securities Investor Protection Act of 1970⁵ | 15 U.S.C. § 78eee(C)(i) | N/A  
Neither the filing of an application nor any order or decree will operate as a stay of any contractual rights of a creditor to liquidate, terminate, or accelerate a securities contract, commodity contract, forward contract, repurchase agreement, swap agreement, or master netting agreement, to offset or foreclose on, or dispose of, securities collateral pledged by the debtor, securities sold by the debtor under a repurchase agreement, and securities loaned under a securities lending agreement. SIPC provides that upon commencement of a proceeding, counterparty may:  
• declare an event of default on the repo that would fix the parties obligations and terminate any obligation to perform;  
• exercise any applicable offset rights; and  
• foreclose upon any cash collateral. |

⁵ SIPC or trustee may request the court to stay for a fixed period the ability of a counterparty to foreclose on, or dispose of, securities collateral pledged by the debtor, securities sold by the debtor under a repurchase agreement, and securities loaned under a securities lending agreement. SIPC provides that upon commencement of a proceeding, counterparty may:
<table>
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<tr>
<th>Regulation/Protocol</th>
<th>Statute/Regulation</th>
<th>Provision Details</th>
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| Federal Deposit Insurance Act                         | 12 U.S.C. § 1821(e)(8) | Payment or delivery obligations due from a party pursuant to a derivative contract are suspended from the time the receiver is appointed until the earlier of:  
  - the time such party receives notice that such contract has been transferred from the institution in receivership to another institution not in receivership or other insolvency proceedings; or  
  - 5:00 p.m. (eastern time) on the business day following the date of the appointment of the receiver.                                                                                                                                                                                                                                                                                     |
| New York Banking Law                                  | N/A                | N/A<sup>6</sup>                                                                                                                                                                                                                                                                                                                                                                                                                                                                 |
| New York Insurance Law                                 | N/A                | N/A<sup>7</sup>                                                                                                                                                                                                                                                                                                                                                                                                                                                                 |
  The 18 banks that have agreed to sign the ISDA Protocol are:  
  - Bank of America Merrill Lynch;  
  - Bank of Tokyo-Mitsubishi UFJ;  
  - Barclays;                                                                                                                                                                                                                                                                                                                                 |

<sup>6</sup> New York Banking Law does not stay the termination, liquidation, closeout and netting, etc. of derivative contracts. In fact, N.Y. Bnk. Law § 619 1.(d)(2)(i) exempts derivatives from the stay otherwise imposed under section 619. In addition, N.Y. Bnk. Law § 618-a(2)(d) states that in the liquidation of the New York branch or agency of a foreign bank, a party to a derivative contract with such branch or agency may retain and apply the collateral.

On a related note, under N.Y. Bnk. Law § 618-a(1), the superintendent of banks may assume or repudiate contracts and unexpired leases of the banking organization of which the superintendent has taken possession. However, the superintendent may not assume or repudiate any qualified financial contract which is subject to an arrangement that provides for multi-branch netting of present or future payment obligations.

<sup>7</sup> N.Y. Ins. Law § 7437(b)(1) states that insolvency, financial condition, default and commencement of any proceeding under New York Insurance Law shall not stay the termination, liquidation, close-out and netting, etc. of derivative contracts.
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- BNP Paribas;
- Citigroup;
- Crédit Agricole;
- Credit Suisse;
- Deutsche Bank;
- Goldman Sachs;
- HSBC;
- JP Morgan Chase;
- Mizuho Financial Group;
- Morgan Stanley;
- Nomura;
- Royal Bank of Scotland;
- Société Générale;
- Sumitomo Mitsui Financial Group; and
- UBS.