

Market Practices for Settling Derivatives in Bankruptcy: Part II

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When derivatives transactions are an element of bankruptcy, the nondefaulting party's goals should be to replace each position at no economic cost, calculate all valuations and losses in a commercially-reasonable manner and adhere to a calculation method that can withstand attack in future litigation. If a company is considering restructuring or insolvency, it should evaluate existing derivatives relative to current risk and, if possible, restructure any ongoing derivatives positions by optimizing costs relative to risks hedged, given credit and risk constraints. In either case, achieving these goals requires an interdisciplinary approach, utilizing a high degree of specialized knowledge and collaboration by legal, business and finance experts.



Phil Weeber

The first part of this two-part series examined the contracts that govern derivatives transactions, the procedure upon the insolvency of a party thereto and the courts' interpretations of several key

definitions. This second part will describe the treatment of derivatives contracts in bankruptcy and also present specific examples using the market quotation, loss and close-out calculation methods in determining early termination amounts.

Treatment of Derivatives Contracts under the Code

The International Swaps and Derivatives Association (ISDA) master

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agreement's termination procedure is only the starting point for a party seeking to terminate its derivatives contracts with a counterparty that is a debtor in bankruptcy. The application of the U.S. Bankruptcy Code¹ adds a complicated layer to the process. Most derivatives contracts, and certain nondefaulting parties to them, as specifically identified in the Code (the protected participants) enjoy special treatment under specific "safe harbor"

protection are now extended to virtually all transfers made by a debtor to a protected participant in connection with commodity contracts, securities contracts, forward contracts, swap agreements, repurchase agreements (repos) and reverse repos and master netting agreements (as each of these terms is defined in the Code, a protected contract).



Matthew E. Hoffman

The Code's special treatment does not provide any substantive rights to the protected participants, but rather, in certain circumstances, it allows parties to enforce certain rights they had prior to the counterparty's bankruptcy (*i.e.*, contractual rights created by the ISDA master agreement and schedules). Certain academics criticize the safe-harbor provisions and question the

Feature

provisions. Since the introduction of these safe-harbor provisions in 1978, Congress has amended them no fewer than five times, such that various forms of

extent to which they actually mitigate what they call "systemic risk."² While a full discussion of the Code's treatment

¹ 11 U.S.C. §§101, *et seq.*

² See, *e.g.*, Franklin R. Edwards and Edward R. Morrison, "Derivatives and the Bankruptcy Code: Why the Special Treatment?," 22 *Yale J. on Reg.* 91 (2005).

Table 1: Material Terms for a Hypothetical Interest Rate Swap

Key Economic Terms	
Notional Amount	\$100M
Maturity Date	June 15, 2019
Swap Rate	4.50%
Key CSA Terms	
Independent Amount	\$0
Threshold Amount	\$1,000,000
Additional Information	
Current Mark-to-Market (MTM)	-\$11,400,000
Amount of Collateral Posted	\$11,400,000

of derivatives in bankruptcy is beyond the scope of this article, the safe-harbor provisions generally operate to exclude the exercise of certain remedial rights under certain derivatives contracts from several important provisions of the Code.

The Automatic Stay



Edward S. Robson

Upon commencement of a bankruptcy case, whether voluntary or involuntary, the Code immediately imposes an “automatic stay” that generally prohibits creditors from acting to recover prepetition claims against the debtor.³ Although the stay of creditor behavior stymies the efforts of all creditors, the specific prohibitions against seizure of assets⁴ and netting/set-off⁵ would be the most serious for the nondefaulting swap participant because the ISDA master agreement relies on these tools to satisfy amounts owed upon termination.⁶

The Bankruptcy Code excepts from stay the use of these tools by protected participants to protected contracts. For example, notwithstanding the automatic stay, the Code allows a counterparty to a swap agreement to utilize the netting/set-off provision in the ISDA master agreement to recoup amounts owed from the debtor.⁷ In other words, claims for payments made pursuant to these protected contracts may be set off against cash, securities or other property due from, held by or pledged to a protected participant, even after a bankruptcy case has commenced. Similarly, a protected participant may net out obligations it is owed by a debtor from its obligations owed to the debtor, even across products, so long as such netting is provided for by contract (including a master-netting agreement), exchange rule or bylaw, common law, law merchant or “normal business practice.”⁸ To make clear its intention, Congress added a provision that explicitly prohibits a judge from issuing any order in any bankruptcy case that would impede a protected participant from accessing its collateral or exercising

its rights of set-off or netting.⁹ The Code also permits a protected participant to seize the collateral posted by the defaulting party pursuant to the Credit Support Annex.¹⁰

Ipsa Facto Clauses

The Bankruptcy Code also generally prohibits the enforcement of *ipso facto* clauses,¹¹ which provide for certain remedies, including termination of a contract upon, among other things, a party’s bankruptcy.¹² The ISDA master agreement includes an *ipso facto* clause that permits a party to terminate the agreement if the counterparty seeks bankruptcy relief.¹³

The Code excepts protected contracts from the general prohibition against enforcement of *ipso facto* clauses. For example, a protected participant may enforce a contractual right to close out, terminate and accelerate all amounts owed under a swap agreement on the grounds set forth in §365(e)(1) (*e.g.*, because its counterparty files a petition for bankruptcy relief).¹⁴ The Code also prohibits any judicial interference with the exercise of such contractual rights.¹⁵ If a protected participant elects not to terminate a protected contract upon a counterparty’s bankruptcy, the protected contract will likely be treated as an executory contract subject to assumption or rejection by a debtor. Damages arising from a debtor’s rejection of a contract, or a nondebtor counterparty’s termination thereof, are measured as of the rejection or termination date.

Avoidance Actions

Code provisions give the trustee in a bankruptcy various powers to

avoid or undo transfers by a debtor to a creditor prior to the bankruptcy.¹⁶ These avoidance powers can add a significant degree of uncertainty for parties closing out transactions prior to bankruptcy because they may be forced to return payments received.

Various Code provisions limit the trustee’s ability to avoid an otherwise avoidable prepetition transfer made by, to or for the benefit of a protected participant under a protected contract.¹⁷ For example, a trustee cannot avoid a transfer made to or for the benefit of a swap participant or financial participant under or in connection with any swap agreement.¹⁸ However, intentionally fraudulent transfers, even if made by, to or for the benefit of a protected participant under a protected contract, are not subject to these limitations.¹⁹ Certain Code provisions establish one of the two prongs of the “good-faith transferee for value” defense to a fraudulent-transfer action²⁰ by providing that a protected participant is deemed to have taken “for value” to the extent it received payment under a protected contract.²¹ Thus, a swap participant receiving termination payments under the ISDA master agreement can generally be confident that such payments will not be recalled at a later date.

Examples of Calculating Early Termination Amounts

As described in Part I, the governing ISDA master agreement specifies the procedures for early termination in the case of an event of default (specifically bankruptcy). If the 1992 ISDA master agreement governs, terminations will follow the market quotation or loss method, except in the rare instance that an agreement specifies the first method or

¹⁶ See generally 11 U.S.C. §§544, 545, 547, 548 and 549.

¹⁷ See 11 U.S.C. §§546(e)-(g), (j) and 553(b)(1).

¹⁸ See 11 U.S.C. §546(g).

¹⁹ See 11 U.S.C. §§546(e)-(g), (j) and 548(a)(1)(A).

²⁰ See 11 U.S.C. §548(c).

²¹ See 11 U.S.C. § 548(d)(2)(B)-(E).

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³ See generally 11 U.S.C. §362(a).

⁴ See 11 U.S.C. §362(a)(4).

⁵ See 11 U.S.C. §362(a)(7).

⁶ See 1992 Agreement §§2(c) (permitting netting) and 6(e) (permitting setoff). See also 2002 Agreement §§2(c) (permitting netting) and 6(f) (permitting setoff).

⁷ See 11 U.S.C. §362(b)(17). See also 11 U.S.C. §362(b)(6) (exception for counterparties to commodity contracts, forwards and securities contracts), (b)(7) (exception for counterparties to repos) and (b)(27) (exception for counterparties to master netting agreements).

⁸ See 11 U.S.C. §561.

⁹ See 11 U.S.C. §362(o).

¹⁰ See 11 U.S.C. §362(b)(6), (7) and (17).

¹¹ Translated from Latin as “because of the fact,” an *ipso facto* clause allows for termination of a contract simply because an outside event occurs (*e.g.*, a party seeks bankruptcy relief).

¹² See generally 11 U.S.C. §365(e)(1).

¹³ See 1992 Agreement, §5(a)(vii); 2002 Agreement, §5(a)(vii).

¹⁴ See 11 U.S.C. §560. See also 11 U.S.C. §§555 (exception for counterparties to securities contracts), 556 (exception for counterparties to commodities contracts and forwards), 559 (exception for counterparties to repos) and 561 (exception for counterparties to master netting agreements).

¹⁵ See *id.*

Table 2: Hypothetical Quotes for Market Quotation

Reference Market Makers	
ACE Bank	Would not bid
BETA Bank	\$6,000,000
CAP Bank	\$8,000,000
DDD Bank	\$8,000,000
Market Quotation Amount	
	\$8,000,000

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an alternative remedy. If the 2002 ISDA master agreement governs, terminations will follow the close-out amount method. The application of the different methods can quickly become nuanced. To this end, we will provide examples in order to facilitate discussion and provide clarity.

The following hypothetical interest-rate swap highlights derivatives in bankruptcy and the potential complications in calculating the early termination amount. Assume Company DuJour pays a fixed swap rate to Counterparty Bank in return for receiving one month LIBOR. Assume the replacement swap would have a swap rate of 3 percent; therefore, the example swap is a liability to Company DuJour. The material terms for discussion in this article are identified in Table 1.

Market Quotation Example

If Company DuJour is the nondefaulting party and its agreement specifies market quotation, they would solicit market quotations from at least four leading dealers. Hypothetical quotes are listed in Table 2.

The low bid and one of the duplicate high bids would be discarded, resulting in a market quotation amount of \$8 million. Company DuJour would deliver notice of the market quotation amount and request a return of \$3.4 million in collateral from Counterparty Bank (\$11.4 million posted, less the \$8 million market quotation amount). Company DuJour could enter into a replacement swap with CAP Bank or DDD Bank and receive an up-front payment of \$8 million. The replacement counterparty would then request collateral in the amount of \$11.4 million (the current

MTM) from Company DuJour. Company DuJour would need to fund \$3.4 million (\$11.4 million margin call, less \$8 million upfront payment received) while waiting for the return of collateral from the insolvent counterparty.

While Company DuJour has found a replacement swap provider, they will be forced to allocate funds in order to post collateral with the replacement counterparty. Company DuJour will also have an unsecured claim against the bankrupt entity for the return of excess collateral.

Loss Example

To highlight the difficulties of the loss calculations, let's continue the example. Assume that only one market quotation of \$6 million was received from BETA Bank. The termination calculation would therefore follow the loss method.²² It is important to note that many of the derivatives now being terminated due to insolvency and bankruptcy were agreed upon during a period of more lenient credit terms. Due to capital restraints and increased credit concerns, banks may only be willing to enter into at-market swaps that are secured by collateral, so we will assume that CAP provided the quote identified in Table 3 for at-market replacement swap.

The calculation of loss allows the nondefaulting party to quantify the economic difference between the terms of the original derivative transaction and the possible replacement transactions.²³ First, a new credit charge must be paid when entering into the replacement transaction. The present value of each

basis point in the swap rate (e.g., the difference between paying 3 percent and 3.01 percent) is worth approximately \$76,000. Multiplying the value of a basis point by the replacement swap's credit charge yields an incurred economic loss. Second, posting new or additional collateral has an opportunity cost for the nondefaulting party. Third, legal and financial advisor fees associated with the replacement transaction are an economic loss and allowed to be reimbursed.²⁴ The cost of a replacement derivative, the cost of funding and expenses can be quantified as shown in Table 4. The two resultant alternatives are as follows:

- Enter into 4.50 percent swap with BETA Bank; receive \$6 million per its market quotation bid, post \$11.4 million collateral with BETA Bank; present a calculated early termination amount of \$6 million to the defaulting party and request the return of \$6.4 million of collateral; or
- Enter into 3.10 percent swap with CAP Bank; post \$10 million independent amount; present a calculated early termination amount of \$2.9 million (\$11.4 million MTM less \$8.5 million total quantified loss) to defaulting party and request return of \$8.5 million (\$11.4 million posted less \$2.9 million).

As previously stated, ISDA does not specify the method for calculating loss; rather, it merely provides the "commercially reasonable" standard. Company DuJour is faced with two decisions: (1) which loss calculation should be used and (2) which replacement hedge is the best decision for its business. While the two decisions may be the same, ISDA does not require them to be. The best alternative for Company DuJour likely will be different than the best alternative for the defaulting party, especially if claims against the defaulting party are not expected to have significant value.

Close-Out Example

The 2002 agreement incorporates the market quotation and loss concepts into the more flexible framework of "close-out amount."²⁵ In calculating the close-out amount, the nondefaulting party may consider replacement quotations (either

²⁴ See 1992 Agreement, §11.

²⁵ See 2002 Agreement, §14 (defining "close-out amount").

Table 3: Hypothetical Quote for an At-market Replacement Swap

	CAP Bank
Credit Charge for a Replacement Swap (added to at-market swap rate)	10 basis points
Key ISDA Terms	
Additional Termination Events	None added
Guarantor	Parent entity
Key CSA Terms	
Independent Amount	\$10,000,000

firm or indicative), information from third parties and internal information used in the regular course of its business for the valuation of similar transactions.²⁶

The additional permitted methods may produce disparate results. Returning to the example swap, assume that ACE Bank, who would not provide a market quotation, provides an indicative replacement quotation of paying \$8 million. BETA Bank provides a firm replacement quotation of \$6 million. CAP Bank provides the same at-market replacement swap as described in the loss example above. As a fourth valuation, Company DuJour has been using an internal fair-market valuation of the derivative of \$7 million, which contemplates both its credit risk and the credit risk of its counterparty. The four resultant alternatives are:

- Use the ACE Bank indication of \$8 million as the early termination amount; request the return of \$3.4 million of collateral (\$11.4 million posted less \$8 million early termination amount owed) from the defaulted counterparty;
- Enter into a 4.50 percent swap with BETA Bank; receive \$6 million per the market quotation bid, post \$11.4 million collateral with BETA Bank; present a calculated early termination amount of \$6 million to defaulting party and request a return of \$5.4 million of collateral (\$11.4 million posted less \$6 million early termination amount owed);
- Enter into 3.10 percent swap with CAP Bank; post \$10 million independent amount; present a calculated early termination amount of \$2.9 million (\$11.4 million MTM less \$8.5 million total quantified loss) to defaulting party and request return of \$8.5 million (\$11.4 million posted less \$2.9 million loss amount); or

- Use the internal fair-market valuation of \$7 million; present a calculated early termination amount of \$7 million to defaulting party and request a return of \$4.1 million of collateral.

The four alternatives demonstrate the varied economic and cash-flow impact to Company DuJour as well as different ongoing claims against the defaulted party. In the two cases in which a replacement swap is not entered into (ACE Bank indication and fair-market valuation), Company DuJour eliminates its swap liability but has no ongoing derivative position. The broader framework of the close-out method can clearly produce a wide range of results. The interpretation of “commercially reasonable” will be critical in determining the final early termination amount.

Conclusion

Derivatives are useful financial instruments for hedging and taking

calculated, concentrated risk. Currently, derivatives are the point of scrutiny as a component of bank failures and excessive, concentrated risk. Derivatives are also wrapped into many bankruptcy proceedings and the calculation of termination amounts is economically significant. We expect, regardless of the additional derivatives regulations being debated, that derivatives will continue to be prevalent not only with financial institutions, but throughout corporate America. Bankruptcy and other events of default are also certain to continue to be an ongoing reality. The plight of derivatives in bankruptcy signals the need for added clarity regarding the intersection of ISDA master agreements and the Bankruptcy Code as well as the refinement of loosely defined terms such as “loss,” “close-out” and “commercially reasonable.” It is likely that bankruptcy courts will provide the first levels of such clarity. ■

Table 4: Costs Associated with Replacing a Derivative

	CAP Bank
Credit Charge cost (Value of a basis point times number of basis points charged)	\$760,000
Opportunity Cost of Funds	
Independent Amount	\$10,000,000
Company DuJour Cost of Funds	15%
Months Remaining in Swap	120
	\$7,690,000
Legal and Financial Advisor	\$50,000
Total Quantified Loss	\$8,500,000

²⁶ See *id.*