

***DERIVATIVE EXPOSURE AND COUNTERPARTY  
INSOLVENCY: LESSONS LEARNED IN THE CURRENT  
MARKET***

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## **I. Introduction**

Almost all large (and many small) companies in today's economy use derivatives in one way or another to hedge against future risk. Hedging allows a business to limit potential exposure to market fluctuation upfront (for a price) and instead focus on its strengths and core competencies. In the past, parties entering into derivative contracts faced the risk of the counterparty filing for bankruptcy protection and effectively blocking the non-defaulting counterparty from terminating the derivative contract and/or collecting the underlying collateral. Realizing the potential ripple effect that could result throughout the financial markets, Congress sought to provide security to derivative market participants by exempting certain transactions from the reach of the "automatic stay" and avoidance provisions of the United States Bankruptcy Code (the "Bankruptcy Code").

In 2005, Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "BAPCPA") which took effect on October 17, 2005. On December 12, 2006, the President signed into law the Financial Netting Improvements Act of 2006 (the "Act"). The amendments set forth in BAPCPA and the Act (referred to together as the "Amendments") materially affected the Bankruptcy Code's treatment of securities and derivatives transactions through broad substantive modifications and expansive definitional amendments. Specifically, Congress sought to clarify and, in certain respects, expand upon the protections already accorded to derivative transactions in the Bankruptcy Code. The overall effect of the Amendments was to extend the Bankruptcy Code's preexisting "safe harbor" provisions to additional parties and additional types of financial market contracts by expanding the Bankruptcy Code's

definitions to include new kinds of derivatives and new types of transactions encompassed in derivatives.

The protections provided by the safe harbor provisions are substantial. While all other creditors must sit by and wait for administration of the debtor's bankruptcy estate, these "protected parties" can simply continue with business as usual and, in some instances, terminate the contract and foreclose on the underlying collateral. Additionally, the "protected parties" can keep payments from the debtors without worry of future preference litigation from the trustee or debtor-in-possession. It is up to a company seeking to hedge (and its lawyers) to ensure that the company and its contracts fit neatly within the safe harbor language of the Code in order to take full advantage of the protections afforded therein. Derivative contracts must be thoroughly negotiated and meticulously drafted on the front-end so that when a counterparty files for bankruptcy, the non-defaulting counterparty is able to act swiftly and with confidence in terminating the derivative and/or foreclosing on underlying collateral.

## **II. Historical Treatment of Derivatives**

Under the Bankruptcy Code, the filing of a bankruptcy case imposes an injunction—the "automatic stay"—on most debt collection activities related to the debtor.<sup>1</sup> The Bankruptcy Code, however, provides certain exceptions to this automatic stay. For example, the filing of a petition does not stay criminal proceedings against the debtor, governmental tax audits, or actions by the .<sup>2</sup> The Bankruptcy Code also provides exceptions related to commodities and derivatives contracts.<sup>3</sup>

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<sup>1</sup> 11 U.S.C. § 362(a) (2008).

<sup>2</sup> See 11 U.S.C. § 362(b)(1), (b)(2).

<sup>3</sup> See 11 U.S.C. § 362(b)(6), (b)(7), (b)(17).

Additionally, the Bankruptcy Code grants a debtor-in-possession and/or trustee significant power to recover certain payments previously made by the debtor.<sup>4</sup> For example, under section 547, the trustee may recover any transfer of property of the debtor's estate or payment made on or within ninety (90) days of the petition date if such payment were made while the debtor was insolvent and the payment would allow the payee-creditor to recover more than it would receive pro-rata after liquidation of the debtor.<sup>5</sup> Additionally, section 548 allows the trustee to avoid and recover certain fraudulent payments that were made within two years of the petition date.<sup>6</sup>

The commodities and financial markets are particularly volatile and require extreme fluidity to function. Initially, the "safe harbors" provisions exempted only certain margin payments to commodity brokers from the trustee's avoidance powers. Recognizing the devastating effect that the automatic stay and avoidance provisions could have on the financial markets as a whole, Congress has granted special treatment to certain derivative transactions since the enactment of the Bankruptcy Code in 1978.<sup>7</sup> The fear that this "ripple effect" could cripple affected markets has led Congress to amend the Code several times to add additional protections related to derivatives.<sup>8</sup> In 1982, Congress extended the safe harbor protections to securities and forward contracts. Again,

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<sup>4</sup> See, e.g., 11 U.S.C. §§ 544-547. A debtor-in-possession is granted the powers of a trustee under 11 U.S.C. § 1107; however, for ease of reference, this article will refer only to the trustee's powers.

<sup>5</sup> 11 U.S.C. § 547.

<sup>6</sup> 11 U.S.C. § 548.

<sup>7</sup> See *Hutson v. E.I. du Pont de Nemours and Co., et al. (In re Nat'l Gas Distribs., LLC)*, 556 F.3d 247, 253 (4th Cir. 2009) (quoting the legislative history to the initial act and subsequent amendments); see also *In re Enron Corp.*, 341 B.R. 451, 456 (Bankr. S.D.N.Y. 2006) (holding that the purpose of section 546 is to protect the nation's financial markets from the instability caused by the reversal of settled securities transactions).

<sup>8</sup> See Johathon Keath Hance, *Derivatives at Bankruptcy: Lifesaving Knowledge for the Small Firm*, 65 WASH. & LEE L. REV. 711, 737-58 (2008) (providing an excellent discussion of the referenced amendments); see also Christopher J. Redd, *Treatment of Securities and Derivatives Transactions in Bankruptcy Part I*, 24-6 AM. BANKR. INST. J. 36, 37 (2005) (discussing the various derivative-related amendments to the Bankruptcy Code).

in 1984, Congress extended the protections to repurchase agreements and in 1990 to swap agreements. The Amendments are the latest attempt by Congress to provide additional safeguards related to derivatives trading by expanding the safe harbor language to additional parties and more contracts.

### **III. The “Safe Harbor” Provisions**

Generally, the “safe harbor” provisions protect from the stringent requirements or prohibitions of the Bankruptcy Code certain payments or transfers, related to certain contracts, made by or to certain parties. To qualify for this preferential treatment, the specific transactions and parties involved must fit within the definitions contained in the Bankruptcy Code.

#### **a. Protected Parties**

The Bankruptcy Code specifically sets forth the “protected parties” that qualify for the safe harbor protections. The requirements for qualifying as a protected party vary widely depending on the applicable definition. Some parties qualify for the safe harbor protections merely by being a party to a certain type of contract (e.g., repo participants, swap participants and master netting agreement participants).<sup>9</sup> Other parties qualify as protected parties because of their participation in the applicable market (e.g., forward contract merchant, stockbrokers, commodity brokers, etc.).<sup>10</sup>

BAPCPA expanded the safe harbor protections by essentially adding a “sophisticated parties” or “too large to fail” exception by adding “financial participant” to the list of “protected parties.” A financial participant includes any entity that, on the

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<sup>9</sup> 11 U.S.C. § 101(46), (53)(C), (38B).

<sup>10</sup> 11 U.S.C. § 101(26), (53A), (6); *see also* *Mirant Ams. Energy Mktg., L.P. v. Kern Oil & Ref. Co. (In re Mirant Corp.)*, 310 B.R. 548, 567 (Bankr. N.D. Tex. 2004) (discussing this “market participation” qualification for safe harbor protection).

petition date or any day within fifteen (15) months before either the petition date or the date it enters into a securities contract, commodity contract, swap agreement, repurchase agreement, or forward contract, has one or more of such agreements with a total gross dollar value of not less than \$1 billion in notional or actual principal amount outstanding, or gross mark-to-market positions of not less than \$100 million, aggregated across all counterparties.<sup>11</sup> The effect of this new definition is to essentially exempt sophisticated parties and very large financial institutions from the reach of the restrictive Bankruptcy Code's provisions, with respect to its derivative contracts, by virtue of the financial participant's sheer volume of business.

Although the protected party analysis is fairly straightforward, a court determines whether a person qualifies as a protected party on a case-by-case basis. Some pre-BAPCPA courts have held that the person or entity claiming safe harbor protection must be acting as a protected party in the relevant transactions with the debtor.<sup>12</sup> Therefore, it is possible that a court may determine that a non-debtor party that obtains a pre-petition payment under a contract outside of the ordinary course of business by debt-collection efforts is an ordinary creditor and not a protected party.<sup>13</sup>

#### **b. Protected Contracts**

The underlying contract at issue must fit into one of the five expansive and overlapping definitions provided in the Bankruptcy Code. That is, the contract must qualify as a securities contract, commodities contract, forward contract, repurchase

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<sup>11</sup> 11 U.S.C. § 101(22A)(A).

<sup>12</sup> See *In re Mirant Corp.*, 310 B.R. at 569 (discussing the proposition that the non-debtor party must be acting as a protected party in its transactions with the debtor (citing *In re Olympic Natural Gas Co.*, 294 F.3d 737, 740 (5th Cir. 2002))).

<sup>13</sup> Redd, *supra* note 8, at 37.

agreement, or swap agreement.<sup>14</sup> As noted above, merely being a party to one of these protected contracts may allow a party to enjoy the safe harbor protections. It appears that Congress intentionally drafted these safe harbor protections as broadly as possible in order to provide maximum protection to the affected markets.

### **i. Repurchase Agreements**

Prior to BAPCPA, “repurchase agreements” included only agreements for the transfer of certificates of deposit, bankers’ acceptances, or government securities. BAPCPA significantly expanded this definition to include: mortgage-related securities, mortgage loans, interests in mortgage-related securities or mortgage loans, qualified foreign government securities, and securities guaranteed by the United States.<sup>15</sup> Additionally, the definition includes any combination, option, master agreement, and security agreement or arrangement related to such agreements, however, the definition specifically excludes repurchase obligations under a participation in a commercial mortgage loan.<sup>16</sup>

### **ii. Securities Contract**

BAPCPA also made sweeping changes to the definition of “securities contracts,” which now includes any contract for the purchase, sale or lease of a security, a certificate of deposit, mortgage loan or any interest therein, and a group, index or option of any of the foregoing.<sup>17</sup> The definition also includes options, guaranties by or to a securities clearing house, margin loans, extensions of credit to clear or settle securities transactions, loan transactions coupled with a securities collar, prepaid forwards, and swap

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<sup>14</sup> 11 U.S.C. §§ 741(7), 761(4), 101(25), 101(47), 101(53B).

<sup>15</sup> 11 U.S.C. § 101(47).

<sup>16</sup> *Id.*

<sup>17</sup> 11 U.S.C. § 741(7).

transactions coupled with a securities sale.<sup>18</sup> Additionally any agreement similar to a listed agreement, or any combination, option, master or security agreement qualifies as a “securities contract.”<sup>19</sup> Like the definition of repurchase agreement, a securities contract expressly excludes any purchase, sale or repurchase obligation under a participation in a commercial mortgage loan.

### **iii. Swap Agreement**

The definition of swap agreement contains an extremely long laundry list of what constitutes a “swap agreement,” plus any similar agreement and any combination, option, master agreement or security agreement related to an agreement contained in the laundry list.<sup>20</sup> The laundry list includes: interest rate swaps, options, futures, or forward agreements, a spot, currency swap, equity index, debt index or debt swap, total return, credit spread or credit swap, commodity index, weather swap, emissions swap, and inflation swap.<sup>21</sup> The definition of swap agreement is extremely expansive and overlaps the other definitions of protected contracts on numerous occasions, however, the definition is limited to application under the Bankruptcy Code and may not be used to challenge treatment of a swap agreement under any other statute, rule or regulation.<sup>22</sup>

### **iv. Forward Contract and Commodities Contract**

The definitions of “forward contract” and “commodities contract” remained relatively unchanged, although Congress added to the definition, all combination, options or master agreements related to forward contracts or commodities contract.<sup>23</sup>

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<sup>18</sup> 11 U.S.C. § 741(7)(A).

<sup>19</sup> 11 U.S.C. § 741(7)(B).

<sup>20</sup> 11 U.S.C. § 101(53B).

<sup>21</sup> *Id.*

<sup>22</sup> 11 U.S.C. § 101(53B)(B).

<sup>23</sup> 11 U.S.C. § 101(25).

Additionally, any security agreement or arrangement, or other credit enhancement related to any of the foregoing qualifies as a forward contract or commodities contract.<sup>24</sup>

**v. The Modifiers—“Any Other Similar Agreement” and “Related To”**

It seems as though Congress may have grown tired of amending the definitions that relate to the safe harbor language and sought to provide definitions expansive enough to forego additional amendments, as reflected by the legislative history to the Amendments.<sup>25</sup> While some of the definitions started out very narrow, simply naming what does and what does not constitute a defined term, Congress has now added the terms “similar agreement” or “related to” to practically every definition. It is now in the hands of the United States Bankruptcy Courts to put the rubber to the road and decide just how far the newly expanded definitions reach.

**c. Protected Payments**

Additionally, any payments or transfers under a protected contract must qualify as a margin payment or settlement payment in order to be granted safe harbor protection.<sup>26</sup> Some courts have found these definitions entirely circular and have looked to the relevant market to determine whether a particular payment constitutes a “margin payment” or “settlement payment.”<sup>27</sup> Furthermore, the terms “margin payment” and “settlement payment” are each defined multiple times in the Bankruptcy Code, leading to more

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<sup>24</sup> *Id.*

<sup>25</sup> See Rhett G. Campbell, *Financial Markets Contracts and BAPCPA*, 79 AM. BANKR. L.J. 697, 704-05 (2005).

<sup>26</sup> 11 U.S.C. § 101(38), (51A).

<sup>27</sup> *Enron Corp. v. JP Morgan Sec., Inc. (In re Enron Corp.)*, No. 01-16034, 2008 U.S. Dist. LEXIS 7340, at \*11-12 (S.D.N.Y. Jan. 25, 2008); *see also* *Kipperman v. Circle Trust (In re Grafton Partners, L.P.)*, 321 B.R. 527, 538 (B.A.P. 9th Cir. 2005) (holding that the definition of settlement payment in 741(8) is circular and looking to its usage in the industry); *Jackson v. Mishkin (In re Adler, Coleman Clearing Corp.)*, 263 B.R. 406, 475-83 (S.D.N.Y. 2001) (holding that the definition of settlement payment and margin payment under 546(e) are circular and cryptic).

confusion and causing the courts to have to look to the industry standards to determine what fits within the definitions.

#### **d. Master Netting Agreements**

The Amendments allow for another safe harbor protection that is slightly different than the usual situation. A Master Netting Agreement is not a protected contract, per se, but is a contract defining parties obligations with respect to protected contracts and is afforded many of the same protections as protected contracts. A Master Netting Agreement, added by BAPCPA, is defined as an agreement providing for the exercise of rights, including rights of netting, setoff, liquidation, termination, acceleration, or close out, under or in connection with a securities contract, commodity contract, forward contract, repurchase agreement, or swap agreement, or any security agreement or arrangement or other credit enhancement related to one or more of the foregoing.<sup>28</sup> Additionally, an agreement will be treated as a master netting agreement only to the extent that it relates to the above specified contracts and agreements.<sup>29</sup> The Bankruptcy Code now specifically allows for “cross-product” netting, to the extent that the products relate to protected contracts.<sup>30</sup>

#### **IV. Effect of Qualifying for Safe Harbor Protection**

The safe harbor protections afford very real benefits to a non-defaulting counterparty. As noted earlier, “protected parties” are the only creditors that Congress has given authority to effectively ignore the automatic stay, including the right to setoff

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<sup>28</sup> 11 U.S.C. § 101(38A)(A).

<sup>29</sup> 11 U.S.C. § 101(38A)(B).

<sup>30</sup> See Campbell, *supra* note 25, at 705-06, for an excellent discussion of “cross-product” netting.

and net certain obligations to the debtor, and to enforce *ipso facto* clauses.<sup>31</sup> All other creditors must wait for administration of the estate and/or petition the court to lift the stay before proceeding. Additionally, certain payments to protected parties are exempted from the trustee or debtor-in-possession's avoidance powers.

#### **a. Right to Setoff**

Protected parties are allowed to setoff, or net out, any termination value, payment amount, or other transfer obligation arising under the protected contract.<sup>32</sup> Additionally, master netting agreement participants are allowed to setoff, or net out, any termination value, payment amount or other transfer obligation to the extent that such participant is eligible to do so for each individual contract covered by the master netting agreement at issue.<sup>33</sup> To add even more weight to the safe harbor protection, Congress stripped the bankruptcy courts of the power to alter these rights by order – setoff rights under the safe harbor provisions can not be “stayed by any order of a court or administrative agency in any proceeding under this title.”<sup>34</sup> BAPCPA expanded the setoff protections by adding “financial participant” to the list of automatic stay exemptions and expanding setoff protections beyond margin or settlement payments. The Act took this expansion a step further by removing the “mutuality” requirement, which seemed to clear the way for setoff between a counterparty and multiple debtors, or “cross-party netting,” although at least one court has held that mutuality is still required by section 553.<sup>35</sup>

#### **b. *Ipso Facto* Clauses**

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<sup>31</sup> See generally Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment*, 22 YALE J. ON REG. 91, 92-94 (Winter 2005) (discussing this “super-priority” status given to counterparties to derivative contracts).

<sup>32</sup> 11 U.S.C. § 362(b)(6), (b)(7), (b)(17).

<sup>33</sup> 11 U.S.C. § 362(b)(27).

<sup>34</sup> 11 U.S.C. § 362(o).

<sup>35</sup> See discussion *infra* Part V.b (discussing the recent *In re SemCrude*, L.P. case).

Contracts often include provisions that allow a non-defaulting counterparty to terminate the contract upon the filing for bankruptcy protection by the counterparty. As a general rule, these “*ipso facto*” clauses are unenforceable in bankruptcy.<sup>36</sup> The Bankruptcy Code, however, provides protected parties express authority to enforce *ipso facto* provisions with respect to protected contracts by causing the liquidation, termination or acceleration of the protected contract.<sup>37</sup> In addition, a protected party can enforce an *ipso facto* provision arising from a master netting agreement to the extent that the party could have exercised a right under the underlying contract.<sup>38</sup> The *ipso facto* provisions also prohibit the court from staying, avoiding or otherwise limiting the protected party’s ability to liquidate, terminate or accelerate the protected contract.

**c. Exemptions from Avoidance**

Trustees and debtors-in-possession are given significant powers under the Bankruptcy Code to avoid certain transfers made by the debtor within certain time frames.<sup>39</sup> The Bankruptcy Code also provides certain exceptions to a trustee’s avoidance powers and the Amendments have expanded these exceptions immensely as they pertain to derivative contracts. Under the current language of the Bankruptcy Code, a trustee essentially may not avoid a transfer that qualifies as protected payments made by, to, or for the benefit of, a protected party, in connection with a protected contract, unless such transfer was intentionally fraudulent.<sup>40</sup> The protected party can, in essence, ignore the avoidance powers of the trustee with regard to transfers that were made within two years of the petition date (unless the transfer was made with actual intent to hinder, delay or

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<sup>36</sup> See 11 U.S.C. 365(e)(1).

<sup>37</sup> See 11 U.S.C. §§ 555, 556, 559, 560.

<sup>38</sup> See 11 U.S.C. § 561.

<sup>39</sup> See, e.g., 11 U.S.C. §§ 544, 545, 547, 548.

<sup>40</sup> 11 U.S.C. § 546(e).

defraud a creditor of the bankruptcy estate). This protection is very attractive because preference litigation is often very fact-intensive which can lead to extremely costly litigation and drag out for years after plan confirmation. This “by or to (or for the benefit) of” language could potentially encompass transfers in which neither the debtor nor the counterparty are protected parties. As with all other amendments, it will be up to the bankruptcy courts to decide just how far Congress intended the definitions to reach.

Furthermore, the trustee cannot avoid any transfer by, to (or for the benefit) of a master netting agreement participant under or in connection with any master netting agreement or any individual contract covered under the master netting agreement, to the extent that the individual contract qualifies as a protected contract notwithstanding the master netting agreement, unless the transfer was intentionally fraudulent.<sup>41</sup>

The Amendments also expand the protections of a good faith purchaser for value by deeming any payment or transfer to a protected party pursuant to a protected contract having been taken “for value,” essentially establishing one of the two prongs of the defense.<sup>42</sup>

## **V. Recent Decisions**

### **a. In re National Gas Distributors<sup>43</sup>**

The United States Bankruptcy Court for the Eastern District of North Carolina was presented with the first opportunity to interpret the new and improved definition of “swap agreements” when the Trustee sought to avoid as fraudulent conveyances

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<sup>41</sup> 11 U.S.C. § 546(j).

<sup>42</sup> 11 U.S.C. § 548(d)(2).

<sup>43</sup> *Hutson v. E.I. du Pont de Nemours and Co. (In re Nat’l Gas Distribs., LLC)*, 556 F.3d 247 (4th Cir. 2009).

numerous natural gas supply contracts.<sup>44</sup> The customers argued that the contracts were “commodity forward agreements,” and therefore fell within the definition of “swap agreements” and the safe harbor protections.<sup>45</sup> The bankruptcy court rejected the customers’ argument because the contracts were “physically settled and not traded in financial markets,” thus, exempting these types of contracts “would not further Congress’ intentions of protecting the financial markets from the destabilizing effects of bankruptcy.”<sup>46</sup>

The Fourth Circuit disagreed. After providing an in depth analysis of Congress’ expansion of the protections of the safe harbor provisions over the past three decades, the Fourth Circuit held that neither the Bankruptcy Code nor its legislative history (1) requires that forward agreements be traded on a financial market, or (2) precludes a forward agreement from involving the actual delivery of the commodity.<sup>47</sup> Although the Court declined to define “commodity forward agreement,” it did outline four nonexclusive elements required by the statutory language:

- (1) The subject of a commodity forward agreement must be a commodity.
- (2) A forward commodity contract must have a maturity date in the future – that is, the contract must require a payment for the commodity at a fixed price for delivery more than two days after the contract date.
- (3) The quantity and time must be fixed at the time of contracting.

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<sup>44</sup> *Id.* at 249-50.

<sup>45</sup> *Id.* at 250.

<sup>46</sup> *Id.*

<sup>47</sup> *Id.* at 255-58.

(4) Lastly, forward contracts are generally not assignable.<sup>48</sup>

The Fourth Circuit concluded that the definition of swap agreements is expansive enough to include the contracts at issue, however, the Fourth Circuit did not find that the supply contracts at issue constituted commodity forward agreements or swap agreements. The court merely remanded to the bankruptcy court with instruction to consider the factors outlined above and allow the customers the opportunity to demonstrate both factually and legally that the gas supply contracts were swap agreements.<sup>49</sup>

**b. In re SemCrude, L.P.**<sup>50</sup>

In *In re SemCrude, L.P.*, Chevron was party to certain contracts with debtors SemCrude, SemFuel and SemStream for the sale or purchase of multiple petroleum related products.<sup>51</sup> As of the petition date, Chevron owed a balance of \$1,405,878.40 to SemCrude, however, SemFuel and SemStream owed Chevron \$10,228,439.34 and \$3,302,806.03, respectively. Chevron sought leave from the automatic stay to exercise its contractual setoff rights pursuant to a pre-petition “Net Settlement Agreement” executed by Chevron and the debtors.<sup>52</sup> The debtors, the Official Committee of Unsecured Creditors, and additional creditors filed objections on the grounds that the debts did not satisfy the “mutuality” requirement of section 553 of the Bankruptcy Code.<sup>53</sup>

In denying Chevron’s motion for leave, the bankruptcy court held that the Bankruptcy Code prohibits this type of “triangular setoff” as a matter of law, because of

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<sup>48</sup> *Id.* at 59-60.

<sup>49</sup> *Id.* at 259.

<sup>50</sup> *In re SemCrude, L.P.*, 399 B.R. 388, (Bankr. D. Del. 2009).

<sup>51</sup> *Id.* at 391.

<sup>52</sup> *Id.*

<sup>53</sup> *Id.* at 392.

the lack of mutuality, and that neither the Code nor caselaw provides a “contract exception” to the mutuality requirement of section 553.<sup>54</sup> The court held that allowing parties to contract around the mutuality requirement of section 553 could upset its purpose of ensuring that similarly-situated creditors receive fair treatment and equal distribution from a debtor.<sup>55</sup> Therefore, the court held that an exception to mutuality cannot be conferred on the parties by private agreements, such as the “Net Settlement Agreement” in this case.<sup>56</sup>

It is interesting to note that Chevron did not attempt to argue that the contracts were entitled to safe harbor protection as either forward contracts or swap agreements. Chevron subsequently filed a motion for reconsideration on these bases which was denied by the bankruptcy court; therefore, we do not know how the court would have ruled on such arguments. It is also interesting to consider whether the court’s ruling would have been different if each of the three debtors had guaranteed the debts of the others. In a footnote, the court implies that a guaranty may create mutuality for purposes of section 553.<sup>57</sup>

## **VI. Other Issues**

### **a. Damage Measures**

A trustee or debtor-in-possession generally can reject any executory contract to which the debtor is a party.<sup>58</sup> Upon rejection, the debtor is deemed to have breached the contract immediately prior to the petition date and the counterparty has a general,

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<sup>54</sup> *Id.* at 396-99.

<sup>55</sup> *Id.* at 399.

<sup>56</sup> *Id.*

<sup>57</sup> *Id.* at 397 n.7.

<sup>58</sup> 11 U.S.C. § 365(a).

unsecured claim for its breach of contract damages.<sup>59</sup> The counterparty may find it difficult or impossible to value a rejected derivatives contract because there simply may be no market for such derivative at the time it is deemed rejected.

Congress sought to provide some guidance in the valuation realm by adding section 562 to the Bankruptcy Code as part of BAPCPA. Under section 562, damages shall be measured as of the earlier of the date a trustee or debtor-in-possession rejects a protected contract or master netting agreement, or the date a protected party liquidates, terminates or accelerates such protected contract or master netting agreement.<sup>60</sup> Congress also provided for the “no-market” contingency – if there is no “commercially reasonable” method of calculating the value as of either of the above-referenced dates, the damages are to be measured at the earliest subsequent date on which there is a commercially reasonable method of calculating the value.<sup>61</sup> Realizing that such valuation system could lead to parties “playing the market” and attempting to improve its position by valuing the derivative down the road, Congress added a deterrent – if the damages are not measured as of the dates provided above, and either the trustee or the protected party objects to the timing of the measurement of damages, the burden falls on the other party to prove that there was no commercially reasonable method of calculating the value of the derivative as of the dates specified above.<sup>62</sup> We will have to wait and see just how effective this new valuation system proves. At least one esteemed commentator

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<sup>59</sup> 11 U.S.C. § 365(g).

<sup>60</sup> 11 U.S.C. § 562(a).

<sup>61</sup> 11 U.S.C. § 562(b).

<sup>62</sup> 11 U.S.C. § 562(c).

believes there are still substantial difficulties involved in valuing derivatives in bankruptcy.<sup>63</sup>

#### **b. Jurisdictional Issues Unaddressed**

While the Amendments lend a higher degree of certainty to the treatment of derivative transactions under the Bankruptcy Code, there remain unanswered questions regarding bankruptcy jurisdiction over certain energy related financial contracts. Specifically, the question has arisen regarding whether there is bankruptcy jurisdiction over the question of whether a debtor is permitted to reject financial contracts regulated by the Federal Energy Regulatory Commission (“FERC”). In two recent cases, the United States Court of Appeals for the Fifth Circuit and the District Court for the Southern District of New York have reached different decisions on this issue.

##### **i. *In re Mirant***<sup>64</sup>

In 2003, Mirant Corporation (“Mirant”), one of the largest regulated public utilities in the U.S. and 82 of its subsidiaries (collectively, “Mirant”) filed voluntary chapter 11 petitions in the Northern District of Texas. In the bankruptcy case, Mirant sought to reject certain power purchase agreements under Section 365 of the Bankruptcy Code. After withdrawing the reference to the bankruptcy court and holding new hearings, the district court held that the United States Federal Power Act (“FPA”) deprived the bankruptcy court of jurisdiction over the matter and that Mirant must seek relief from the filed rate in a proceeding before the FERC.<sup>65</sup>

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<sup>63</sup> See generally Honorable Sarah Sharer Curley, *Where to Hide? How Valuation of Derivatives Haunts the Courts—Even After BAPCPA*, 83 AM. BANKR. L.J. 297 (2009) (discussing the difficulty involved in valuing derivatives).

<sup>64</sup> Official Comm. of Unsecured Creditors of Mirant Corp. v. Potomac Elec. Power Co. (*In re Mirant Corp.*), 378 F.3d 511, 516 (5th Cir. 2004).

<sup>65</sup> *Id.* at 516-17.

In reversing the District Court’s decision, the United States Court of Appeals for the Fifth Circuit held that rejection of an FERC-approved contract does not constitute a collateral attack upon the rate set by the FERC because “the rate is given full effect when determining breach of contract damages resulting from the rejection.”<sup>66</sup> Therefore, the bankruptcy court has jurisdiction to authorize a debtor to reject a contract governed by the FPA, and to accelerate damages under such contract, so long as the bankruptcy court uses the FERC-approved rate in calculating rejection damages.<sup>67</sup> The Court of Appeals concluded that Congress clearly intended section 365(a) rejection authority to apply to FERC regulated contracts.<sup>68</sup>

**ii. *In re Calpine***<sup>69</sup>

In early 2006, the United States District Court for the Southern District of New York was faced with the same dilemma – does the FPA preempt a bankruptcy court from authorizing rejection of a contract approved by the FERC? In 2005, numerous counterparties filed petitioned the FERC to compel Calpine to perform under certain long-term power agreements.<sup>70</sup> After filing bankruptcy, Calpine sought to enjoin the FERC from requiring Calpine’s performance under the contracts. Additionally, Calpine sought authority to reject the power agreements.<sup>71</sup>

The District Court withdrew the reference to the bankruptcy court in order to interpret the scope and possible conflict between the FPA and the Bankruptcy Code.<sup>72</sup>

The District Court held that, while the Bankruptcy Code provides “substantial”

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<sup>66</sup> *Id.* at 522.

<sup>67</sup> *Id.*

<sup>68</sup> *Id.*

<sup>69</sup> Cal. Dep’t of Water Res. v. Calpine Corp. (*In re Calpine Corp.*), 337 B.R. 27 (S.D.N.Y. 2006).

<sup>70</sup> *Id.* at 30.

<sup>71</sup> *Id.* at 30-31.

<sup>72</sup> *Id.* at 31.

jurisdiction to the bankruptcy courts, absent “overriding language,” the Code should not be read to interfere with FERC jurisdiction.<sup>73</sup> The District Court further held that authorizing rejection of the power contracts would directly interfere with FERC’s jurisdiction, therefore, “the power of the bankruptcy court must yield to that of the federal agency.”<sup>74</sup>

The District Court acknowledged that its holding was obviously at odds with the Fifth Circuit’s decision in *Mirant*.<sup>75</sup> The District Court distinguished *Mirant* because the justification for rejection of the energy contracts in *Mirant* was not the disparity between contract and market rates (as here), but the fact that *Mirant* did not need the energy at all. The District Court went on to hold that it would find preemption even were it to adopt and apply the *Mirant* decision because, as the Fifth Circuit noted, it would not have jurisdiction where the debtor “merely seeks rate relief.”<sup>76</sup>

Technically, *Mirant* and *Calpine* are distinguishable, although realistically, the District Court in *Calpine* interpreted FERC’s jurisdiction under the FPA much more broadly. It is now up to the courts to determine which opinion rests on the more sound reasoning.

## **VII. Mitigation Strategies**

Notwithstanding the expansive statutory definitions, and Congress’ express intent to afford these protections to an expansive audience, the aforementioned cases illustrate that bankruptcy courts are still reticent to grant broad exceptions to established bankruptcy principles such as the automatic stay and avoidance powers. It is up to the

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<sup>73</sup> *Id.* at 33.

<sup>74</sup> *Id.* at 34-36.

<sup>75</sup> *Id.* at 37.

<sup>76</sup> *Id.*

party seeking safe harbor protection to ensure that it fits within the safe harbor definitions so that it can act with speed and confidence once a counterparty to a derivative contract files for bankruptcy. The key to such action is up-front, meticulous contract drafting.

**a. Track the Statutory Language**

As mentioned throughout this paper, the safe harbor protections extend to protected payments, related to protected contracts, by, to, or in some cases for the benefit of, protected parties. Congress defined the vast majority of these terms in the Bankruptcy Code by providing examples and/or guidelines for qualifying for each protected category. Ultimately, a non-defaulting counterparty may have to prove to a court of law that it fits within these definitions and therefore is entitled to the safe harbor protections. The most fail-safe method of proving that a transaction fits within a statutory definition is to include in contractual terms the actual statutory language of each applicable definition.

**b. Make Use of Industry Forms**

The International Swaps and Derivatives Association, Inc. provides a Master Agreement for use in derivative transactions. The purpose of this ISDA Master Agreement is to standardize such transactions within the industry and provide certainty to the market. The ISDA Master Agreement provides some very useful language, including, among other provisions, the right to early termination, netting provisions, and an *ipso facto* clause. Almost all sophisticated parties use an un-altered version of the ISDA Master Agreement as the derivatives contract and add deal-specific terms to a Supplement to the Master Agreement. This Supplement is an excellent place to track the statutory language and add safe harbor definitions.

In addition to the ISDA, certain other market forms have become standard in derivative transactions such as the Master Repurchase Agreement developed by the Bond Market Association and the International Securities Market Association. These types of “standard” agreements present a great starting place in negotiating derivative transactions.

**c. Include *Ipsa Facto* Clause**

As noted above, while *ipso facto* clauses are generally unenforceable under Bankruptcy Code section 365(e)(1), Congress has expressly granted an exception to the enforcement of *ipso facto* clauses in the derivative context due to the potentially catastrophic effect that the automatic stay could have on financial markets. Therefore, parties to derivative contracts should take advantage of this exception and include the bankruptcy, insolvency or dissolution of a counterparty as an event of default in all derivative contracts.<sup>77</sup>

**d. Express Guaranties**

When dealing with multiple, related counterparties, a party to a derivatives transaction may consider requiring the counterparties to expressly guarantee the debts of the others, especially where those counterparties are related. As noted in *In re SemCrude, L.P.*, section 553 of the Bankruptcy Code requires mutuality in order to setoff certain obligations between a counterparty and a debtor. The Bankruptcy Court for the District of Delaware noted that an express guaranty creates an obligation in the guarantor and *may* satisfy mutuality for purposes of section 553. Therefore, depending on the jurisdiction, an express guaranty may satisfy mutuality under section 553 and allow for setoff under an otherwise unenforceable triangular setoff agreement.

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<sup>77</sup> As noted above, the 2002 ISDA Master Agreement includes an *ipso facto* clause.

#### **e. Collateralize the Swap**

Generally, one counterparty to a swap agreement provides some sort of immediate benefit in exchange for a promise from the other counterparty to perform in the future. The counterparty incurring the risk of the other's future performance could "collateralize" the swap agreement by requiring the other counterparty to post collateral equal to the value of the risk incurred. Historically, counterparties have required collateral in the form of cash or cash equivalent, such as treasuries, bonds, or some other financial instrument that could be quickly and easily liquidated into cash. The problem with this approach is that often the counterparty seeking to hedge may not have sufficient cash available to effectively collateralize the swap and offset the risk. In a number of transactions, counterparties have been requiring non-cash assets, such as oil and gas properties, to be pledged as collateral for the hedge obligation. The safe harbor provisions appear to allow the non-defaulting counterparty to proceed to foreclose upon collateral without recourse to the bankruptcy court, however, there is a complete lack of caselaw on the subject. Until the bankruptcy courts demonstrate a willingness to allow foreclosure on non-cash assets by a non-defaulting counterparty, there will remain some risk associated with collateralizing a swap agreement with non-cash collateral.

#### **f. Third Party Custodian**

A party entering a derivatives transaction may consider demanding that any collateral required under the derivatives contract be held by a third party custodian. Where the collateral is held by the counterparty, the counterparty may commingle the collateral in a common account or re-hypothecate the collateral to third parties. Either of these scenarios can make it extremely difficult to foreclose on the collateral in the

situation where the counterparty files for bankruptcy protection or otherwise defaults under the derivatives contract. Even in the situation where the non-defaulting party eventually recovers 100% of the collateral it is entitled to, the delay and expense in collecting could nullify any benefits otherwise gained through the derivatives transaction. It must be noted that the counterparties to these complex derivative transactions are often extremely large financial institutions with a relatively high bargaining position. These financial institutions favor having control over the collateral and may flatly reject the proposal of a third party custodian, or may demand such a premium as to make the derivative financially unattractive.

**g. Choice of Law/Choice of Venue Provisions**

As illustrated by the *Mirant* and *Calpine* decisions, choice of law and/or choice of venue provisions are of paramount importance in the derivative arena, especially when dealing with contracts regulated by the FERC. While the decisions are technically distinguishable (and therefore not in conflict), the Fifth Circuit clearly interpreted the FERC's jurisdiction under the FPA more narrowly than did the United States District Court for the Southern District of New York. Therefore, a party should decide which jurisdiction is the most advantageous and seek to negotiate a choice of law provision establishing that jurisdiction as the governing law of the contract. Additionally, a party should attempt to fix venue within the jurisdiction, although such provision may be ignored or waived in bankruptcy.

**h. "Commercially Reasonable"**

Congress sought to offer guidance with respect to valuing derivatives by adding section 562 to the Bankruptcy Code. The valuation system provided by Congress turns

on whether or not “commercially reasonable determinants of value” exist as of the rejection or termination date. The statute does not define “commercially reasonable,” therefore the courts will be charged with developing a definition as parties disagree on whether or not a valuation method is “commercially reasonable.” Parties to a derivative contract may be able to bypass unnecessary litigation by defining the term “commercially reasonable” within the contract and including within the contract what “commercially reasonable” methods or determinants will be used in valuing the derivatives. The court may or may not accept the agreed upon definition, but it will at least evidence the parties’ intent.

### **VIII. Conclusion**

Time and again over the last three decades Congress has sought to provide protection to participants in the derivative markets due to the volatility and importance of such markets in today’s economy. Despite Congress’ intentions, it remains the duty of the party entering into the derivative contract to understand and take full advantage of the protections offered by Congress. The derivative markets require speed and liquidity in order to function. The participants do not have the luxury of waiting on a court to determine whether or not a counterparty has the power to terminate a derivative contract. Instead the party should unambiguously draft its contract to fit within the safe harbor protections afforded by Congress and leave nothing to chance.