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Derivatives in Bankruptcy: Safe Harbors, Dodd-Frank, and the Orderly Liquidation Authority

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Today's faculty features:

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Derivatives in Bankruptcy: Safe Harbors, Dodd-Frank, and the Orderly Liquidation Authority

April 15, 2020

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Setting the stage

General Themes

1. Key Bankruptcy Code principles
2. Automatic Stay
3. Safe Harbors as Exceptions to key Bankruptcy Code principles
 - Rationale for treating QFCs differently
4. Stays of Exercise of Safe Harbor Rights
5. Pre- and Post-Dodd Frank – Now, Orderly Liquidation Authority (OLA) for certain large, interconnected financial firms
6. International Considerations
7. ISDA Protocols

Bankruptcy Code Background

- Key Bankruptcy Code principles –
 - (1) Based On Reorganization of Debtor – “Fresh Start”
 - (2) Creditors’ Interests In A Fast Recovery Are Balanced Against Debtors Reorganization
- Automatic Stay - Intended to Provide Debtor with Fresh Start
- Stays substantially all litigation and other actions to obtain property of the Debtor’s estate

Bankruptcy Code Background

Safe Harbors

- Types of qualified financial contracts, or QFCs (but Bankruptcy Code doesn't use the term):
 - Swap Agreements,
 - Repurchase Agreements,
 - Securities Contracts,
 - Forward Contracts,
 - Commodity Contracts
- Generally All QFCs Are Viewed As Executory Contracts
- What This Means *Absent* Safe Harbors
 - Issue in Bankruptcy of Automatic Stay
 - Risk of Avoidance and Claw Back

Bankruptcy Code Background

Safe Harbors

- What the Safe Harbor Seeks to Accomplish
 - Crystallize positions
 - Avoid allowing Debtors to cherry-pick under master agreements
- Systemic Rationales
 - (1) Minimize systemic risk
 - (2) Avoid destabilizing financial contagion

Bankruptcy Code Background

Safe Harbors

- How the Safe Harbors Evolved
 - Initially limited to Commodities Contracts – § § 362(b)(6) and 746(c)
 - 1982 – § 546(e) (§ § 546(d) and 555)
 - 1984 – alter § § 546(e) and 555, and broaden to add “financial institution”
 - 1990 – add § § 362(b)(17), 546(g), 560
 - 2005 – § 362(b)(27), “financial participant”; § 546(j) and 561
- Section 562 – Timing of Calculations of Damages

Bankruptcy Code Background

Safe Harbors

- What are the Safe Harbors
 - Exception from the “automatic stay”
 - Excepted from restrictions on *ipso facto* clauses
 - But payment subordination is a different story – see *LBSF v. BNY*, *LBSF v. Bank of America*, and *Michigan State Housing Development Authority v. LBDP*
 - How does timing work and payment suspension? See *In re Mirant Corporation* and *In re Lehman Brothers Holdings, Inc.*

Bankruptcy Code Background

Safe Harbors

- Exempt from clawback provisions
 - See *FTI Consulting* for scope
- Set-Offs (not technically a safe harbor exclusive to derivatives, securities, and repos)
 - Strict mutuality is essential – See *In re Semcrude, L.P.* and *Swedbank AB v. LBHI*

Stays of Exercise of Safe Harbor Rights

- **Pre-Dodd Frank:**

- Bankruptcy v. Specialized Regimes – FDIC, SIPC, State Insurance Law
- Most specialized regimes have QFC safe harbors

- **Post-Dodd Frank:**

- Orderly Liquidation Authority – resolve (*i.e.*, reorganize or liquidate) large, complex financial companies (G-SIBs, or “global systemically important banking organizations”) that are outside scope of those Specialized Regimes
 - Avoid (i) destabilizing bankruptcies and (ii) taxpayer-funded bailouts
- Single-Point of Entry (SPOE) Strategy
- Temporary Stay on exercise of Safe Harbor rights – buy time to bridge

Stays of Exercise of Safe Harbor Rights

Overview of OLA

- Changes to improve resolvability of financial firms
 - Resolution planning process – “living wills”
 - Adoption of total loss absorbing capacity, long-term debt, and clean holding company requirements
 - Today’s Focus: Promote regulatory/private sector efforts to preserve derivatives and other QFCs in resolution – temporary stays on exercise of Safe Harbor rights
- One Business Day stay on enforcement of QFCs Safe Harbor rights following appointment of FDIC as receiver – preserve liquidity; avoid forced “fire sales” of assets and depressing prices
 - Limit effectiveness of “cross-default” provisions of subsidiaries of U.S. G-SIB holding cos.
 - Recognize power of FDIC to transfer assets to bridge company notwithstanding QFC contractual restrictions

Stays of Exercise of Safe Harbor Rights

- Overview of OLA (cont'd)
- International Considerations
- ISDA Protocols contractually bind adhering parties on a multilateral basis to –
 - Temporary stays of OLA and other temporary specialized regimes
 - Cover both legacy and future agreements
 - Bilateral negotiations seldom realistic
 - Limited consent to certain foreign resolution proceedings
- Issues?

Stays of Exercise of Safe Harbor Rights

Lehman Litigation

- **Metavante**
 - The “safe harbor” only allows a non-defaulting party to liquidate, terminate, accelerate, offset, net values and foreclose values but not withhold performance under a swap if the swap is not terminated
 - Court found that section 2(a)(iii) of ISDA Master, which excused performance based on bankruptcy of a counterparty or credit support provider, did not excuse performance in this case
 - Finds that 1 year is too long to wait to terminate an ISDA
 - Appeal is taken; case settled before appeal decided
- **Perpetual/Dante** (*Lehman Brothers Holdings Inc., et al., v. BNY*, 422 B.R. 407 (Bankr. S.D.N.Y 2010))
 - Case involves a credit-linked synthetic note
 - Court finds that a “flip provision” which reverses the priority of payment as a result of the filing of a bankruptcy by debtor or credit support provider are unenforceable *ipso facto clauses under section 365(e)(1) of the Bankruptcy Code*
 - Court’s decision was contrary to the holding of an English court which had interpreted the contract
 - Appeal is taken; case settles before appeal decided

Derivatives in Bankruptcy

REFERENCES

- For overview of Chapter 11 of the Bankruptcy Code, as well as derivatives generally, see Gary E. Kalbaugh, *Derivatives Law and Regulation* ch. 11 (2d ed., Carolina Academic Press 2018).
- On scope of safe harbors, see *In re National Gas Distributors, LLC*, 556 F.3d 247 (4th Cir. 2009).
- On treatment of payment subordination in relation to Code's prohibition of *ipso facto* clauses, see *Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Services Limited (In re Lehman Brothers Holdings Inc.)*, 2010 WL 10078354 (S.D.N.Y. Sept. 23, 2010).
- For timing requirements and treatment of payment suspension in relation to the *ipso facto* prohibition, see *In re Mirant Corporation*, 314 B.R. 347 (Bankr. N.D. Tex. 2004) and *In re Lehman Brothers Holdings, Inc.*, No. 08-13555 (JMP) (Bankr. S.D.N.Y. Sept. 15, 2009).
- For breadth of safe harbor from clawbacks), see *Merit Management Group, L.P. v. FTI Consulting, Inc.*, 138 S. Ct. 883 (2018).
- Regarding set-off rights, see *In re Semcrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009) and *Swedbank AB (PUBL) v. Lehman Brothers Holdings Inc.*, 445 B.R. 130 (S.D.N.Y. 2011).

Thank You

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