Derivatives in Bankruptcy:
Latest Lessons From Lehman
Minimizing Risks When a Counterparty Becomes Insolvent

A Live 90-Minute Teleconference/Webinar with Interactive Q&A

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DERIVATIVES TREATMENT IN BANKRUPTCY PROCEEDINGS

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OVERVIEW OF DOCUMENTATION

- OTC derivatives are generally governed by a 1992 or 2002 ISDA Master Agreement.

- Key differences between 1992 and 2002 versions:
  - Shorter grace periods in 2002.
  - Termination values: Market Quotation or Loss (1992); Close-out Amount (2002).
  - Specified Transactions expanded in 2002 to include repos and securities lending transactions.
  - 2002 added: change of control as trigger for Credit Event Upon Merger; setoff provision; force majeure termination event.
- Bankruptcy / insolvency event of default
  - Trigger events: insolvency; commencement of bankruptcy proceedings (with a cure period for involuntary commencement); appointment of administrator, receiver, or liquidator.
  - Trigger event may occur with respect to a party, a Credit Support Provider, or a Specified Entity.

- Credit Support (current practice)
  - May be in the form of a guaranty or in the form of collateral (cash, Treasuries, sometimes letters of credit).
  - Cash / securities collateral usually governed by ISDA Credit Support Annex.
Components of collateral calculation: Exposure (mark to market value of transactions), Independent Amount, Threshold Amount.

- Secured Party usually has the right to rehypothecate collateral.

- Credit Support Annex provides that upon default by a party, the non-defaulting party can:
  - net obligations owed by the defaulting party against collateral pledged to the defaulting party.
  - net obligations owed by the non-defaulting party against collateral pledged to the defaulting party.
OVERVIEW OF BANKRUPTCY SAFE HARBORS

The bankruptcy safe harbor for derivatives protect (i) certain rights of (ii) certain kinds of parties to (iii) certain kinds of contracts.

- Kinds of protected contracts:
  - Swaps
  - Repos
  - Securities contracts
  - Certain grain contracts
  - Master netting agreements
  - Forward contracts

- Legislative history and statute make clear that the definitions are intended to be broad and self-defining. There is flexibility for them to change over time as the industry evolves.
Kinds of protected parties:

- Swap participants
- Repo participants
- Commodity brokers
- Forward contract merchants
- Stock brokers
- Securities clearing agencies
- Financial institutions
- Financial participants (a catch all – covers parties with total gross dollar value of subject transactions of not less than $1,000,000,000 in notional or actual principal amount outstanding (aggregated across counterparties) at the date of the bankruptcy filing or on any day within 15 months of the bankruptcy filing, or has gross mark-to-market positions of not less than $100,000,000)
Kinds of rights protected:

- Liquidation
- Termination
- Acceleration
- Offset
- Setoff
- Exercise of other remedies
- Protections from preference and other kinds of avoidance actions (except in case of actual fraud)
Some initial thoughts on the coverage of the statute:

- Broadly defines protected contracts.
- Fairly broadly defines parties entitled to protection under the safe harbor (particularly with the inclusion of the “financial participant” provision).
- More narrowly defines protected rights.
  - There is no catch-all for non-enumerated activities as there is with protected contracts and protected parties.
  - The safe harbors are being interpreted by bankruptcy judges who tend to bring a perspective to judging that can be focused on reorganizing or otherwise maximizing the value of the debtor’s estate.

The *Lehman Brothers* bankruptcy presents a very significant challenge or test case for the safe harbors.

- The parties running the Lehman Brothers liquidation are attempting to limit the scope and coverage of the safe harbors (or otherwise have them interpreted in a narrow way) to maximize the recovery for the Lehman Brothers bankruptcy estate.
LESSONS LEARNED FROM THE LEHMAN BANKRUPTCY: CURRENT LAW AND MARKET PRACTICE

- Counterparty credit risk
  - Counterparty credit risk is present, even in the good times. Particularly so if the transactions will be long term.
  - Protections against counterparty credit risk:
    - Reevaluate counterparty credit risk periodically, and renegotiate Master Agreement if necessary.
    - Bilateral collateral.
    - Collateral instead of (or in addition to) guaranty. Parent and subsidiary may both be insolvent.
    - Events of default and/or termination events which relate to capital, reserves and/or regulatory rating.
Safe harbor protections under the Bankruptcy Code do not create a general priority status for derivatives counterparties.

What the safe harbors do:

- Protect the right to terminate derivatives transactions and net termination amounts, even after commencement of bankruptcy/insolvency proceedings.
- Protect counterparty’s right to net obligations against collateral.
- Protect the counterparty from a claim that transfers in connection with derivatives before commencement of bankruptcy proceedings are preferential.
Bank insolvency: treatment of derivatives under bank insolvency law is similar to treatment under the Bankruptcy Code. Key differences:

- If a bank is in receivership, the receiver has one day to transfer derivatives contracts before non-defaulting party’s right to terminate can be exercised.
- If a bank is in conservatorship, the non-defaulting party may not terminate transactions solely on the basis of appointment of the conservator.
- Requirement for bank records regarding board approval.

Bilateral netting: FDICIA ensures enforceability of bilateral netting contracts between financial institutions, whether the institutions are ongoing or failed.
Claim for return of excess collateral held by the insolvent entity is likely to be an unsecured claim.

- Most agreements allow for rehypothecation, which means collateral may be commingled with assets of the secured party.
- Dealers and some counterparties want the right to rehypothecate so they can use the collateral in other parts of their business.
- Minimize risk that excess collateral won’t be returned by:
  - Placing collateral in a protected account, not commingled, at a third party. Third party custodial arrangements entail fees and more work operationally. Adds credit risk of custodian.
  - Setting Independent Amount at zero.
Claim for payment of obligations in excess of collateral posted by the insolvent entity will be an unsecured claim.

- Minimize risk of undercollateralization by:
  - Setting collateral Threshold for the other party at zero.
  - Minimizing transfer time for delivery of collateral.

Legal developments lag behind business developments.

- Debtor counsel’s role is to maximize size of the bankruptcy estate. Structures not contemplated at the time laws are put in place are fodder for challenge by creative bankruptcy counsel.
- At the start of a new transaction, evaluate its structure under all bankruptcy scenarios.
Major dealers and their trading relationships are global when times are good but segregated when things unravel.

- Dealers book transactions in various affiliates, so a counterparty may face several members of the dealer’s worldwide group.
- The dealer will want netting and setoff across the full relationship, allowing the dealer to reduce its overall exposure to the counterparty.
- Upon dealer insolvency, the counterparty may be involved in multiple bankruptcy proceedings in several jurisdictions, with no assurance of consistent treatment of netting.
- Bankruptcy proceedings among jurisdictions may not be coordinated. Courts may not work towards a global solution.
Address the risk of segregated unwind by:

- Putting in place a master netting agreement. Confirm it is enforceable in all relevant jurisdictions. Adhere to the procedures established in the agreement.

  - Traders and operational units may modify or try to streamline processes set out in the agreement.

    - Provide a template for interaction with dealer affiliates – notices and transfers.
    - Periodically review compliance with terms of the agreement. Obtain approval from all parties for variations from established procedures.
Where are the funds?

- Dealers may engage in transactions through an unregulated entity, so no customer protection rule applies (e.g., Rule 15c3-3 for broker-dealer).
- No regulatory requirement for banks to segregate collateral.
- Funds may be transferred outside the dealer organization and/or outside the country.
- Enhance risk management by diversifying across numerous trading counterparties so not all operational funds are hung up upon insolvency of a major dealer.
Market participants expected a softening of credit requirements by major dealers in the aftermath of Lehman. That has not materialized.

Many out-of-the-money counterparties to Lehman did not terminate transactions upon Lehman bankruptcy (so as not to trigger a termination payment obligation), but relied on the condition precedent in Section 2(a)(iii) of the ISDA Master Agreement to stop making periodic payments. Legal basis for that position is unclear.

- One 2003 Australian case (Enron Australia v TXU Electricity) upheld that course of action by the non-defaulting party.
- Different result in a US case (Metavante), but little guidance from the bankruptcy judge. Parties settled during appeal.
- Some market participants include a provision in Master Agreements requiring a non-defaulting party to terminate quickly or lose its right to withhold periodic payments.
The process for determining termination payments under the 1992 version of the ISDA Master Agreement has not always been easy.

- Market Quotation approach was developed when transactions were much simpler.
- Quotations on plain vanilla, liquid contracts are likely to be close. Outliers are addressed through the ISDA process by excluding the high and low quotations.
- Obtaining quotations on structured transactions in times of financial crisis may prove difficult if not impossible, resulting in more disputes.
With greater complexity of transactions, it is more likely the parties will disagree whether quotations obtained (if any) are “commercially reasonable.”

There is very little case law on interpreting the calculation of termination values under the ISDA Master Agreement. It is likely that litigation will come out of the Lehman bankruptcy.

- Balance between business advantage and legal risk in derivatives is complex and should be monitored and reevaluated frequently.

- Look beyond the specific transactions to the dealer’s activities as a whole. Do you have an accurate picture of the dealer’s financial situation?
LEGISLATIVE AND REGULATORY CHANGES

- Proposed legislation for regulation of over-the-counter derivatives – two bills currently in Congress:
  - As of May 3, 2010 Senate had not passed a bill. Joint proposal from Banking, Housing and Urban Affairs Committee (Senator Dodd) and Senate Committee on Agriculture, Nutrition and Forestry (Senator Lincoln) under consideration.

- Dealers and major swap participants will have capital requirements – may reduce counterparty credit risk.
Clearing requirement and margin requirements:

- Most standardized derivatives contracts will have to be cleared.
- Margin requirements will apply to derivatives, with higher requirements applicable to uncleared contracts.
- Segregation of margin is required in both bills, although the bills differ in details.
  
  - Cleared swaps: segregation and protection of customer funds required; regulators to set details on requirements.

- Who faces the clearing entity?
- Where is counterparty’s margin – at dealer; at clearing entity?
Safety of funds is a core principle for clearing entities.

Credit risk of clearing entity.

Uncleared swaps: segregation with independent third party required if counterparty requests.

Independent amount only?

Custodial risk.

Systemically important financial institutions may be subject to special liquidation procedures, but safe harbor treatment of derivatives largely unchanged.
CFTC Rules – priority of margin for cleared OTC derivatives upon bankruptcy of futures commission merchant.

- Margin for futures must be segregated and not commingled with assets of futures commission merchant; investment restrictions; daily calculation and top-up of segregated amount. (Commodity Exchange Act Sec. 4d, CFTC Rules 1.20 – 1.30)
- Futures commission merchant must maintain funds or property to cover its obligations in connection with foreign exchanges; the secured funds must be segregated. (CFTC Rule 30.7)
- Until recently, cleared OTC products were not explicitly addressed by statute or regulation.
  - Some exchanges obtained “4d orders” giving cleared OTC products segregation protection.
Some futures commission merchants kept margin for cleared OTC products with Rule 30.7 secured funds.

- Recent change to CFTC Rule 190, effective May 6, 2010, creates a separate account class for cleared OTC contracts and related collateral to bring greater certainty to the treatment of cleared OTC contracts upon futures commission merchant bankruptcy.
  
  - Exchanges must adopt rules implementing the new account class.
  
  - 4d order needed to invoke Rules 1.20-1.30.

- Question whether the Bankruptcy Code should be amended for greater certainty.
Lehman – Proposed Treatment of Guarantee Claims under the Plan

- Lehman Brothers Holdings, Inc. ("LBHI") regularly guaranteed the obligations of subsidiaries in derivatives transactions.
- LBHI estimates that creditors with guarantee claims have filed $254 billion in claims related to guarantees.
- These creditors are competing with other “direct” creditors of LBHI (such as noteholders) for distributions from LBHI.
- In a U.S. bankruptcy case, guarantee claims may be subject to greater scrutiny and challenge than direct claims.
Potential challenges to guarantee claims in a U.S. bankruptcy proceeding:

- “Substantive consolidation” of the primary debtor with the guarantee debtor
  - Substantive consolidation is the pooling of assets and liabilities of two separate entities
  - When two bankruptcy estates are pooled, intercompany claims between the entities are cancelled and guarantees are cancelled.
- Parties may assert that the debtor – LBHI – did not receive sufficient value in exchange for its guarantee
  - LBHI’s only interest in these transactions is its equity value in its subsidiary that is the counterparty to the transaction.
    - Separate issue – even greater risk in a transaction where the Credit Support Provider is not a direct or indirect parent (e.g., a subsidiary or a brother/sister corporate relationship)
  - In contrast, direct creditors generally provided value directly to LBHI
Under the recently proposed plan in *Lehman*, LBHI is proposing an “economic resolution” of issues related to guarantee claims.

Under this proposed resolution, creditors with guarantee claims will be paid on their “permitted” claims rather than on their “allowed” claims.

- An “allowed” claim is the full amount of the claim that is allowed under non-bankruptcy law.
- A “permitted” claim is a construct of LBHI that may limit the amount of certain guarantee claims against LBHI (which will benefit its direct creditors at the expense of guarantee creditors).
  - The definition and calculation of a “permitted claim” is beyond the scope of this presentation and will be set forth in a separate memo.
  - LBHI currently estimates that creditors whose underlying obligation is owed by LBIE will *not* be subject to a limitation under the “permitted” claims concept.
Current status of the Plan
- It is at the very beginning stages.
- Likely to be months or longer before a plan is ultimately confirmed.

Issues related to the Plan and the U.S. bankruptcy process related to Credit Support Providers
- Guarantee claims will always be subject to greater scrutiny than direct claims in a U.S. bankruptcy case.
- They may be eliminated through substantive consolidation or other methods.
- Corporate structure is important.
  - Subsidiary or brother/sister guarantees are more exposed than parent guarantees.
- Even when a guarantee claim is recognized, it may be subject to potential limitations as Lehman is currently proposing.
Lehman v. BNY Corporate Trust

- Lehman v. BNY Corporate Trust ("BNY") is one of a number of cases challenging the subordination of a swap counterparty in a structured transaction after the swap counterparty files for bankruptcy.
  - Other cases include the Ballyrock case

- Relevant facts:
  - Lehman Brothers Special Finance ("LBSF") was a swap counterparty and LBHI was a credit support provider
  - Under the transaction documents, LBSF was entitled to a priority payment from the trust unless it filed for bankruptcy, in which case its distribution was subordinated
  - LBHI filed for bankruptcy on 9/15/2008 and LBSF filed on 10/3/2008
  - Thereafter BNY terminated the swap with LBSF
Issue being litigated in *BNY* (as well as *Ballyrock* and other cases):

- Is the subordination of the swap counterparty’s interest enforceable or is it void?

On summary judgment, the U.S. Bankruptcy Court decides that the subordination is unenforceable.

- This decision directly conflicts with a contrary decision by the English courts in the same transaction

The Bankruptcy Court decided that:

- the subordination provision was an unenforceable *ipso facto* provision, and
- the derivatives safe harbor did not protect the subordination.
"Ipso facto" provisions:
- An "ipso facto" provision is any provision in a contract that purports to terminate the contract because of a bankruptcy filing or other financial condition of the debtor
- Generally, *ipso facto* provisions are not enforceable in a bankruptcy
- *Ipso facto* provisions are enforceable in derivatives safe harbor transactions for specified actions

Relevant determinations the Bankruptcy Judge made in the BNY decision:
- LBSF could be the beneficiary of the *ipso facto* limitation imposed by the LBHI bankruptcy even though LBSF was not in bankruptcy at the time
- The subordination provision was not entitled to safe harbor protection because it was not within the swap agreement itself, but was in other transaction documents
Current status of *BNY*:
- The judge has issued a decision but has not entered an order.
- The judge is attempting to harmonize conflicting positions between U.S. and U.K. courts before entering an order.

Lessons from *BNY*:
- The scope of the decision is probably somewhat limited
  - Highly structured transaction
  - Unique bankruptcy filing circumstances
- The decision may still be important for future transactions
  - It was significant that the subordination provision was set forth outside of the swap agreement
  - Potentially a different result if the subordination was contained in the ISDA rather than other transaction documents.