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Adjusting the Rules: What Bankruptcy Reform Will Mean for Financial Market Contracts

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On April 20th, President Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Bankruptcy Act of 2005). These revisions to the Bankruptcy Code and other laws are the most far-reaching changes to U.S. insolvency laws in more than 20 years. Many commentators have argued the merits of the consumer bankruptcy provisions of the Bankruptcy Act of 2005 and the effect these changes will have on the use of bankruptcy as an opportunity for a fresh start after financial difficulties or as a tool to avoid financial responsibility. What is safe to say is that many of these provisions make bankruptcy less attractive for consumers and that the interpretation of the new law will engage the courts for some time to come. Although the application and effects of the Bankruptcy Act of 2005 remain to be determined, it is likely that creditors, including bankers and the Federal Deposit Insurance Corporation (FDIC) when appointed receiver for failed banks, may benefit from the improved ability to collect on banking assets.

While much has been written about the consumer bankruptcy parts of the Bankruptcy Act of 2005, other key parts of the bill have received little attention. For example, Title VIII adopts a new chapter 15 of the Bankruptcy Code that should make the administration of international bankruptcies much more predictable and effective. Title VIII, however, is probably not the most significant non-consumer part of the Act. That label better applies to Title IX and its restructuring of U.S. insolvency laws governing the financial markets.

What is Title IX? In short, Title IX updates, clarifies, and strengthens the existing laws that determine what happens to financial market contracts when a market participant fails. Title IX accomplishes four key goals. First, it comprehensively harmonizes all of the principal laws that could come into play in insolvencies of market participants, including banks, thrifts, credit unions, broker-dealers, investment banks, and other companies. Second, it updates and modernizes those laws to accommodate innovations in the markets. Third, it expands the availability of the risk-reduction benefits of financial contract netting by ensuring that market participants can net across different types of contracts. Finally, Title IX strengthens and clarifies the powers of the FDIC to preserve asset value and to limit market disruptions by fashioning a flexible resolution of a failing bank or thrift. The power to transfer derivative contracts to another financial institution allows the FDIC the flexibility to choose a strategy to maximize the value of a portfolio of QFCs through an immediate sale or a more gradual resolution. The statutory balance between market participants' contractual rights to terminate and net their exposures and the FDIC's need for flexible resolution strategies could be crucial in periods of market disruption.

The resilience of a financial system is measured by how well it deals with adversity. As financial markets have become more complex and interrelated, legal certainty about how derivatives and other financial contracts will be netted and settled in an insolvency has become a prerequisite for dealing effectively with financial distress.

Greater legal certainty on these issues has far-reaching effects in the economy by allowing banks and other financial market participants to better assess and more effectively manage their risks which provides a more stable and resilient market environment. The new Bankruptcy Act of 2005 is a landmark in this respect, marking the culmination of a more than 20-year legislative trend to reduce the risk of systemic crises in financial markets by defining rules for the prompt settlement and netting of claims. This paper summarizes how the Act harmonizes counterparty rights and insolvency procedures, and reaffirms the special flexibilities the FDIC would have to minimize the systemic disruptions arising from a bank failure. While some inconsistencies do remain, the trend towards statutory harmonization also is reflected in the legislative proposals to create a new regulator for government sponsored enterprises, which include provisions parallel to those in the FDI Act.

Background

To better explain why these changes are so significant, it is helpful to examine the interconnections between the role of derivatives in managing risk and the laws governing how these contracts will be handled in the event of an insolvency of a derivatives counterparty. Not only are these rules vital in the case of an actual insolvency, but even in the absence of an insolvency they determine, in large part, how market participants manage credit and market risks. The rapid and accelerating growth and innovation in the financial markets over the past two decades has placed a new impetus on the drive for clearer insolvency rules.

A *financial derivative* is a contract whose value derives from the value of an underlying asset, such as a cash instrument, or an underlying reference rate or index. Derivative transactions are typically traded either through established exchanges or as over-the-counter (OTC) transactions. Although different types of derivatives bear a variety of labels, the basic building blocks of all of these contracts are options and forwards. An *option* is a contract in which the buyer pays a certain amount or premium to the seller to obtain the right, but not the obligation, to buy (in a call) or sell (in a put) a specific asset at an agreed price at or before a certain time. The buyer pays the premium at inception and has no further financial obligation unless the option is exercised. A *forward* is a sales contract between a buyer (holding the long position) and a seller (holding the short position) for an asset with delivery deferred until a future date. The buyer agrees to pay a fixed price at the agreed future date and the seller agrees to deliver the asset. A *swap* can be defined as a custom forward contract to exchange cash flows for a specific time based on a notional amount. A common example is the interest rate swap which, in a simple form, may involve a swap of fixed-rate cash flows for variable-rate cash flows. *Futures contracts* are standardized forward contracts traded on organized exchanges.

Why have these investment and hedging vehicles grown so rapidly as risk management tools for banks and corporations? In short, *derivatives* offer the opportunity to construct innovative asset and liability structures that achieve a combination of risk and return that would be unavailable through more traditional financial instruments, such as bonds and equity securities. Like more traditional financial instruments such as bonds and certificates of deposit, derivatives can be used to control a business risk by hedging or taking a countervailing position in the market. However, unlike traditional bonds and equity securities, an institution seeking the hedge does not need to purchase a cash instrument; it can simply pay a premium to replicate the cash flows desired. A common derivative hedge employed by banks is the *interest rate swap*, which permits a bank lending at a fixed rate to hedge against the risk of adverse interest rate movements by

exchanging its fixed interest rate payments on those loan assets for floating rate payments. Thus, the interest rate swap simply fixes a portion of the risk of adverse interest rate movements through hedging with floating rate payments.

Nonetheless, these benefits do not come without a cost. As the past difficulties of Long-Term Capital Management, Barings, and Bankers Trust illustrate, both the dealer and end user of financial derivative investments must take care to manage the risks to avoid the descent from prudent hedging to speculative losses. For these reasons, the risks posed by financial derivatives have been the subject of Congressional hearings, review by international banking supervisors and careful study by United States' banking, securities, and commodities regulators.

As with other financial instruments, including bonds and equity securities, derivatives pose credit, market, liquidity, operating, legal, settlement, and interconnection risks. One of the primary ways to reduce the risks to individual parties in derivative or other financial contracts is the ability to settle the transactions by payment of a single net amount. Netting is simply taking what I owe you and what you owe me and subtracting to yield a single amount that should be paid by one of us. *Netting* can be a valuable credit risk management tool in all multiple transaction relationships by reducing the credit and liquidity exposures by eliminating large funds transfers for each transaction in favor of a smaller net payment.

Close-out netting, or the ability to terminate financial market contracts, determine a net amount due, and liquidate any pledged collateral, is a valuable tool to protect against credit and market risks in cases of default. This is particularly important in the financial markets because, unlike loans or many other financial contracts, the value of derivatives and other financial market contracts are based principally on their fluctuating market value. If one of the parties to a derivative or other financial market contract is placed into bankruptcy or receivership, the normal stays on termination of contracts and liquidation of collateral could create escalating losses due to changes in market prices. As a result, the ability to terminate the contract and net exposures quickly can be crucial to limit the losses to the non-defaulting party because such contracts can change in value rapidly due to market fluctuations.

In response to questions about the adequacy of regulation for the derivatives markets, the President's Working Group on Financial Markets began a review of derivatives instruments and the legal framework for netting and the insolvency treatment of such instruments during the mid-1990s. This review indicated a growing need to update the insolvency laws governing the financial markets and the potential for problems in risk management, creditor strategies, regulatory responses, and market responses from ambiguities and inconsistencies in the laws for banks and other market participants. As a result, under the auspices of the President's Working Group on Financial Markets, representatives of the Treasury Department, the Federal Reserve, the Office of the Comptroller of the Currency, the Commodities Future Trading Commission, the Securities and Exchange Commission, the Federal Reserve Bank of New York, and the FDIC worked to craft statutory proposals to address these issues. An important part of that work was a close collaboration with legal and industry experts, such as the International Swaps and Derivatives Association (ISDA) and the Bond Market Association, to ensure that any new proposals responded to the needs of the markets while ensuring effective regulatory action. Finally, in February 1998, then-Treasury Secretary Robert Rubin submitted proposed amendments to Congress. While final enactment did not occur until 2005, the amendments always had the support of the industry,

key Congressional committees, and regulators. The delay in final enactment was solely the result of the many issues presented by other provisions of the larger bankruptcy legislation.

Understanding Insolvency Rules

A full appreciation of the improvements in Title IX requires an understanding of the normal rules that affect contracts in insolvency proceedings and the special protections provided under prior law for certain financial contracts. In general, American insolvency laws seek to either rehabilitate or liquidate the insolvent entity's affairs through a restructuring of business operations to establish a productive business if a rehabilitation is possible or, if not, to equitably distribute losses to creditors. Fundamental principles under either approach are to stop the accrual of new claims, preserve the value of existing contracts and assets, resolve claims, and distribute available money to creditors. The Bankruptcy Code and the insolvency laws for banking and other credit institutions, such as the FDI Act, include similar procedures to achieve these goals. In this article, for simplicity I will focus on the specific rights and duties under the FDI Act for insured banks and thrifts.

Under the FDI Act, the FDIC may be appointed receiver of any federally insured depository institution. As receiver, the FDIC has statutory authority to marshal the failed institution's assets, determine its liabilities, and resolve its affairs in order to pay creditors. First, there are a number of statutory powers that allow the receiver to retain valuable contract rights and eliminate unneeded agreements. While there is no automatic stay, most contracts with the failed bank or thrift cannot be terminated or accelerated by the other party based solely on the appointment of a conservator or receiver for the bank.[1] As a result, the clauses common in many leases and other contracts that accelerate payments or terminate the contract upon insolvency are unenforceable. Finally, the receiver also has the power to repudiate or disaffirm burdensome contracts, such as leases for unneeded branches, if that promotes the orderly resolution of the failed bank or thrift.[2]

Second, the FDI Act allows the receiver to avoid pre-insolvency transfers made with "the intent to hinder, delay or defraud" the bank, the FDIC as conservator or receiver, or other regulators.[3] The Bankruptcy Code also grants a trustee the power to avoid fraudulent transfers, but includes more expansive powers to avoid other pre-bankruptcy payments or other transfers and requires the return of the transferred property to the bankruptcy estate. For example, the Bankruptcy Code, although generally permitting the set-off or netting of pre-petition mutual debts, bars set-off during the 90-day period preceding bankruptcy if the creditor improved its position by the set-off compared to its claim in bankruptcy.[4] These provisions are all designed to protect the rights of creditors of the bankruptcy estate from dilution through special arrangements with certain creditors.

Third, the FDI Act includes detailed procedures that require creditors of the failed institution to file claims with the receiver before filing litigation.[5] This allows the receiver an opportunity to resolve competing claims, cut off claims that are not pursued within the statutory process, and more effectively administer the resolution process.

Fourth, the FDI Act includes a priority for payment for deposit claims in a receivership. As a result, unsecured creditors of the bank are subordinated to deposit claims and generally cannot set off their claims against the failed bank. In most cases, unsecured, non-deposit creditors often receive very little for their claims.[6] This underscores one of the major differences between the FDI Act and

the Bankruptcy Code—the emphasis in the FDI Act on protecting depositors and the deposit insurance funds managed by the FDIC.

Insolvency Rules for Financial Contracts

In order to reduce systemic risks, however, both the Bankruptcy Code and the FDI Act have long provided exceptions from many of these restrictions for certain defined financial contracts—securities contracts, commodity contracts, forward contracts, repurchase agreements and swap agreements. In the FDI Act, these contracts are defined as *qualified financial contracts*, or QFCs. The statutory safe harbors allow parties to these contracts, with some exceptions, to terminate and net their exposures and liquidate any pledged collateral to protect them from losses that could result from market fluctuations if the counterparties were subject to lengthy insolvency proceedings.

Under the FDI Act and other U.S. insolvency laws, a party to a derivative contract has four key rights after commencement of insolvency proceedings. First, the counterparty can exercise contractual rights to terminate the derivative contract and offset or net out any termination values, payment amounts, or other transfer obligations under the agreement. Subject to certain limitations, this right is immediate under the Bankruptcy Code.[7] Under the FDI Act, the only limitation on this right is that the counterparty must wait until the business day after appointment of the receiver to exercise its contractual netting rights.[8] Second, the receiver or conservator may not avoid any transfer of money or other property in connection with the derivative contract, unless the transferee had actual intent to hinder, delay or defraud the institution, the creditors of the institution or any receiver or conservator of the institution.[9] Third, if the receiver is to transfer any QFCs to a third party, the receiver must transfer all QFCs with the same counterparty (including its affiliates) to one depository institution transferee and notify the QFC counterparty of transfer by a specific deadline on the business day after appointment of the receiver.[10] Finally, the damages available if the receiver repudiates a QFC are more expansive than those allowed for other contracts.[11] If a QFC is repudiated, damages accrue to date of repudiation, rather than to date of appointment of receiver, and damages include normal and reasonable costs of cover or other reasonable measures of damages utilized in the industries for such contract claims.

Within these similar approaches, however, before the Bankruptcy Reform Act of 2005 there were a few key differences between the Bankruptcy Code and the FDI Act. While any counterparty under the FDI Act or any "financial institution" under FDICIA can exercise contractual rights to terminate and net its positions, the Bankruptcy Code limits these rights to specific types of counterparties for securities contracts, commodity contracts, and forward contracts.

In addition, the definitions of the contracts that can be terminated and netted upon insolvency differed between the FDI Act and the Bankruptcy Code. Both statutes define five types of contracts that receive special treatment—repurchase agreements, securities contracts, commodity contracts, forward contracts, and swap agreements—but the Bankruptcy Code does not include some agreements that are included within the FDI Act definitions. The FDI Act includes mortgage loans, interests in mortgage loans, and mortgage-related securities in its definitions for repurchase agreements and securities contracts. In addition, the broader netting rights provided by the FDICIA provisions have created some ambiguity about whether termination and netting rights are limited to the five types of contracts enumerated in the FDI Act and Bankruptcy Code. Perhaps most importantly, the financial contracts traded in the markets of 2005 have evolved new

forms that, while "similar agreements" to those contained in the statutory listings, were not clearly encompassed within those 1980s-era definitions.

Finally, while the FDI Act permits the receiver for a failed insured bank or thrift to transfer QFCs to new counterparties or to disaffirm the contracts and, thereby, limit the liability of the receivership estate, the Bankruptcy Code does not provide any similarly effective rights to a bankruptcy trustee. The immediate transfer and repudiation rights provided to the FDIC as receiver for a failed bank or thrift give receivers greater flexibility and allows the FDIC to capture the value in a derivatives portfolio. While these powers are crucial to reduce losses to the deposit insurance funds and implement the least costly resolution strategy, they also can reduce the risks of market disruptions by providing a mechanism to maintain ongoing hedge transactions or other derivatives that continue to benefit the solvent counterparties as well as the receivership. This distinction between the FDI Act and the Bankruptcy Code could be significant in the insolvency of a major participant in the financial markets during times of market instability because the risk of market disruption could be greater from a failing non-bank participant since its counterparties would have no option but to immediately liquidate their contracts and dump collateral on the markets.[12] This difference remains after Title IX.

Another statute bears mentioning because it both illustrates the possible interplay between different laws affecting derivatives and netting and emphasizes the need for clarity. In 1991, the Federal Deposit Insurance Corporation Improvement Act became law. Among its provisions were the additional protections for netting. FDICIA confirmed the enforceability of the netting of payment obligations among "financial institutions" under a "netting contract."[13] FDICIA was particularly significant because it (unlike the FDI Act and the Bankruptcy Code) was not linked to specific types of contracts. As a result, it could be interpreted to provide broader netting rights than either the Bankruptcy Code or the FDI Act.

The breadth of FDICIA's protection for netting contracts, however, could have been interpreted as impairing the FDIC's power to repudiate QFCs and to require counterparties to delay netting until after the business day following appointment of the receiver. While the FDIC took the informal position that it retained its receivership powers because the FDI Act is the more specific statute governing insured bank and thrift receiverships, the breadth of FDICIA's language—"[n]otwithstanding any other provision of law"—created questions.

Benefits of Title IX

Since the Bankruptcy Code and FDI Act safe harbor provisions were enacted during the 1980s, the financial markets have grown tremendously in importance, size and concentration. While the relevant laws were broadly consistent, there were inconsistencies and gaps in application of the protections for netting that could create unnecessary confusion. Title IX of the Bankruptcy Act of 2005 addresses these issues. In summary, the new rules of the game accomplish four key goals:

1. Harmonize the key statutes governing the insolvency of financial market participants so that all participants in the markets will be able to better assess and manage risks.
2. Update and expand the definitions of the protected contracts to accommodate developments in the marketplace.
3. Expand the availability of cross-product netting under the FDI Act and the

Bankruptcy Code.

4. Clarify the powers of the FDIC as conservator or receiver for a failed bank to maximize the value of the QFC portfolio and, where appropriate, minimize the impact on other market participants by transferring QFCs to open institutions or to a bridge bank.

Harmonization of Insolvency Laws

One of the principal goals of Title IX was to create an insolvency system that provided similar rights under derivative contracts irrespective of whether you were dealing with a bank, a corporation, and any other debtor. The more harmonious insolvency system provided by Title IX will promote more effective risk management and provide a more level playing field. This goal is achieved through uniform definitions of the protected contracts and greater consistency in the availability of close-out netting.

After Title IX, the statutory definitions for securities contracts, swap agreements, repurchase agreements, commodities contracts, and forward agreements are virtually identical in the FDI Act, the Bankruptcy Code, and the Federal Credit Union Act (FCUA). To provide a common approach to these transactions, these new definitions are incorporated into the insolvency laws governing uninsured national banks, uninsured federal branches and agencies, certain uninsured state banks that are members of the Federal Reserve System, and Edge Act Corporations. As a result, the safe harbors contained in federal insolvency law will have the same basic coverage. One remaining difference between the FDI Act and Bankruptcy Code definitions is that the FDIC's Board will retain its authority to expand the definition of qualified financial contract by regulation, resolution or order.

The most significant remaining difference between most other federal insolvency laws and the Bankruptcy Code are the counterparty limitations contained in the Bankruptcy Code. Before Title IX, any counterparty under the FDI Act and generally any "financial institution" under FDICIA could exercise contractual rights to terminate and net its positions. However, under the pre-Title IX Bankruptcy Code these rights were limited to specific types of counterparties for securities contracts, commodity contracts, and forward contracts. As a result, some uncertainty existed about the ability of some counterparties to exercise close-out netting in a bankruptcy.

Title IX significantly reduces these differences. The new amendments to the Bankruptcy Code allow netting by a new type of counterparty, a "financial participant," which is defined as any party with transactions with a total gross dollar value of at least $1 billion in notional or actual principal amount outstanding on any day during the previous 15-month period, or has gross mark-to-market positions of at least $100 million (aggregated across counterparties) in one or more agreements or transactions on any day during the previous 15-month period. "Clearing organizations" under FDICIA also are included as "financial participants." In addition, Title IX expanded the availability of netting by protecting parties to master netting agreements through a new definition for "master netting agreement participant." Combined with an expanded definition of financial institution, these changes will allow any significant market participant to exercise close-out netting rights with bankrupt debtors' entities even if the creditor could not qualify as, for example, a commodity broker.[14] These changes will reduce systemic risk by providing greater clarity to the rights available to larger participants in the markets.

Modernization and Expansion of Netting Protection

Title IX also modernizes the netting rules to accommodate the significant changes to the marketplace in recent years. An important Working Group goal was to ensure that U.S. law kept pace with the increasing statutory protection for netting around the world. A quick overview of some of the changes will illustrate two countervailing principles—netting protection should be assured for significant components of the market which are subject to its risks, but netting protection does not extend to normal lending or credit transactions no matter how documented.

The definition of *swap agreement* in Title IX includes a number of additional types of agreements, such as "spot, same day-tomorrow, tomorrow-next, forward or other foreign exchange agreement[s]," weather derivatives, equity swaps, and debt swaps. Perhaps the most significant addition to the category of swap agreements are "total return, credit spread or credit swap, option, future, or forward agreements" in view of the rapid expansion of the credit derivatives market in recent years. Overall, the swap agreement definition rearranges the prior definition by ordering the references to swap transactions in a sequence of related types of swaps, options, futures, and forwards, such as interest rate transactions and credit transactions.

Similarly, the definition of *securities contract* clarifies the treatment of several transactions and components of transactions actively traded in the financial markets. Perhaps the most significant addition to the already broad definition of securities contract is the addition of "repurchase or reverse repurchase transactions" if the transaction is based on the types of agreements otherwise forming a securities contract.[15] This is significant because the definition of repurchase agreement is subject to some specific limitations on the underlying assets and on the length of the agreement. However, the market has developed a significant volume of repos on other types of assets and, to a lesser degree, for terms longer than one year. Now, under Title IX a "repurchase or reverse repurchase transaction" on a "security, certificate of deposit, mortgage loan, interest, group or index, or option" may be a QFC as a securities contract even if it does not fall within the definition of repurchase agreement. Despite these expansions, the repurchase agreement definition remains significant because, under the Bankruptcy Code, certain rights to terminate and net repurchase agreements are limited to "repo participants" unless the counterparty is a "financial participant" or "master netting agreement participant."[16]

The securities contract definition also includes *margin loans*. Such loans have become significant in financing market operations for a variety of participants. However, there are clear limitations to what can be legitimately defined as margin loans. Throughout Title IX, the governing principle has been to encompass only those agreements that are important parts of the financial markets and are subject to the market risks in those markets. The changes are not intended to include normal credit transactions. For example, an agreement that is documented as a swap, but which involves a commercial transaction, such as a supply agreement, or another non-financial market transaction will not be treated as a swap agreement or QFC simply because the transactions are documented or labeled as swaps. Similarly, defining margin loans as securities contracts does not encompass all loans that happen to be secured by securities collateral. As used in the new definition, margin loans is intended to include only those loans commonly known in the industry as margin loans, which extend credit for the purchase, sale, carrying or trading of securities. From the FDIC's perspective, it is important that the QFC definitions not embrace the normal lending and credit transactions that form the backbone of the traditional banking business.[17]

An important part of the protection of netting rights is the protection of the right to liquidate collateral or gain payment through other credit enhancements to pay any net amount due. Some examples of securities arrangements and credit enhancements are pledging of collateral, guarantees, rights of set-off, letters of credit, and similar agreements. Collateral or other credit enhancements are a widely used technique to reduce effective credit exposures. Title IX extends this protection by defining such credit enhancements as part of the protected contract. In addition, an amendment to FDICIA ensures that such credit enhancements are enforceable under bilateral and clearing house netting agreements.[18]

Title IX's modernization of the prior statutory protections for netting financial contracts would not have been complete without some mechanism for accommodation of legitimate innovation in the markets. The pre-existing definitions for several of the contracts included the phrase "or any other similar agreement" in order to permit such innovation. The Working Group similarly included this phrase in the definition for forward contracts and the phrase "similar to any agreement or transaction referred to" in the definitions for securities contract, swap agreement, and commodity contract. An important caveat for the safe harbor available for innovative swap agreements is the requirement that the "similar" agreement must be "of a type that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap markets" and relates to the types of transactions already identified in the definition. This caveat is designed, as noted above, to avoid claims that all transactions that can be documented as swaps suddenly become swaps protected by the safe harbors. As the final report from the House Financial Services Committee makes clear, "[t]raditional commercial arrangements, such as supply agreements or other non-financial market transactions, such as commercial, residential or consumer loans, cannot be treated as ‘swaps' under the FDIA, the FCUA, or the Bankruptcy Code simply because the parties purport to document or label the transactions as ‘swap agreements.'" These cautions are important safeguards for the principles of shared losses embodied in U.S. insolvency laws and the priority for protection of depositors, and the deposit insurance funds, codified in the FDI Act.

Enhanced Protection for Cross-Product Netting

Another important part of Title IX is the expanded protection provided to cross-product netting under the FDI Act and the Bankruptcy Code. *Cross-product netting* simply allows a bank or other market participant to reduce their credit exposures by netting all QFCs, such as interest rate swaps, repos, and securities contracts, under a single master agreement. The use of ISDA master agreements covering most types of financial market contracts to expand the benefits of netting has grown rapidly in recent years. Title IX simply ensures that the risk-reduction benefits of this development is legally protected under U.S. insolvency laws.

Protection for cross-product netting is provided by including within the definitions of the component contracts "a master agreement" for QFCs. Title IX then includes a new definition of master agreement under the FDI Act and master netting agreement under the Bankruptcy Code.[19] These definitions ensure that all QFCs may be documented and netted under a single master agreement. In addition, the definitions enhance protection for cross-product netting by defining "any combination" of the listed transactions and a master agreement for those transactions as QFCs. Finally, to address the issues created by some of the counterparty limitations contained in the Bankruptcy Code, Title IX also adds a new definition of "master netting agreement participant."

The effect of these revisions of current law is to confirm that the availability of

cross-product netting under the FDI Act extends to all QFCs. Before Title IX, FDI Act protections for netting across products under master agreements formally extended only to swap agreements.[20] However, preexisting FDI Act provisions did not draw distinctions between types of QFCs in authorizing close-out netting of individual QFCs (which was defined to include all five types of component agreements) under section 11(e)(8)(A). The FDI Act's authorization for netting of "1 or more contracts and agreements" defined as QFCs probably already permitted cross-product netting.

Under the Bankruptcy Code, these changes will significantly expand the availability of cross-product netting. In the past, netting across different types of contracts, such as repurchase agreements, swap agreements and other contracts, under a master netting agreement was limited under the Bankruptcy Code. Both the counterparty limitations and the specific netting exemptions from the automatic stay called into question the enforceability of such cross-product netting agreements in bankruptcy.[21] The new definitions of master netting agreement and master netting agreement participant will protect the ability to close out cross-product contracts both for master agreements across contracts and for master agreements across separate master agreements.

These provisions, however, do not provide QFC treatment to non-QFC agreements simply because they might be covered by the master agreement. If the master agreement includes such non-QFC agreements, then the master agreement receives QFC treatment only for those agreements that would otherwise be QFCs. This limitation will prevent bundling of non-QFC agreements under a master agreement in order to provide special QFC treatment to those agreements.

Clarification of the FDIC's Powers

As receiver or conservator, the FDIC has a variety of statutory powers to assist it in resolving failing insured banks and thrifts in a manner that minimizes the costs to the deposit insurance funds as well as disruption to depositors and other customers. Like FIRREA, the new provisions carefully balance the importance of close-out netting for counterparties with the maintenance of market stability through a responsive resolution process and the reduction of losses for the deposit insurance funds. Title IX clarifies and strengthens the FDIC's powers to resolve the derivatives held by a failed insured bank or thrift by retaining valuable QFCs held by an institution in a conservatorship, selling or transferring QFCs to another financial institution or a FDIC-owned bridge bank, or terminating unneeded QFCs in a receivership. The FDIC's ability to retain the value in a derivatives portfolio and fashion a flexible resolution strategy could be a crucial element in limiting the potential market disruption from a bank's failure during a period of market instability.[22]

Title IX clarifies the powers of conservators and receivers in five key ways. First, Title IX eliminates some ambiguities in prior law that could be used to argue that counterparties could terminate agreements and destroy any value to a receiver. One key provision bars the use of walkaway clauses that could eliminate remaining value in a QFC portfolio. Walkaway clauses would suspend or extinguish a net payment right or otherwise allow an institution's counterparty to avoid any net payment solely because of the status of the failed insured bank or thrift as a defaulting party under the contract. If used against a bank or thrift placed into receivership or conservatorship, these clauses would destroy any net value due to the institution and increase losses to the insurance funds—in effect, shifting all net obligations onto the insurance funds. This was recognized as bad public policy and the regulators and industry agreed that such clauses should be unenforceable

against a conservator or receiver. The clear intent of new section 1821(e)(8)(G) is to make unenforceable any clause of a financial market contract that would have the effect of denying to the FDIC as receiver or conservator a net payment otherwise available solely because the bank or thrift was the defaulting party.

Second, Title IX confirms that the FDIC continues to have the power to repudiate or transfer QFCs within one business day after the failure. Title IX confirms that "no provision of law shall be construed as limiting the right or power of the Corporation" to transfer or repudiate any QFC.[23] While this has always been the FDIC's interpretation, the FDICIA language: "Notwithstanding any other provision of law," 12 U.S.C. §§ 4403, 4404, created some ambiguity. Title IX specifically makes the bilateral and clearing organization netting rights provided by FDICIA subject to the sections of the FDI Act, the Federal Credit Union Act, Securities Investor Protection Act of 1970, and the Bankruptcy Code governing QFCs.[24] Similarly, Title IX includes a provision confirming that rights to terminate, liquidate or net out cannot be exercised solely due to appointment of a conservator.[25]

Third, the amendments expand the potential transferees of QFCs after the FDIC is appointed receiver in several significant ways. Title IX allows the FDIC to transfer QFCs to banks, as under prior law, and to all "financial institutions," which are defined to include broker-dealers, future commission merchants or other institutions defined as financial institutions by the FDIC through a regulation, resolution, or order. In addition, Title IX includes provisions ensuring that the FDIC may transfer QFCs to a bridge bank or an institution in conservatorship.[26] Similarly, Title IX provides the FDIC with some flexibility in transferring QFCs to foreign banks and in transferring QFCs subject to the rules of a clearing house. The FDIC can transfer QFCs to a foreign bank or to the branch or agency of a foreign bank if the contractual rights of the parties to those QFCs are enforceable "substantially to the same extent" as under the FDI Act after the transfer. The FDIC also could transfer QFCs subject to clearing house rules to non-clearing house members, but the transfer would not require the clearing house to accept the transferee as a member.

Fourth, the new provisions prohibit the enforcement of rights of termination or liquidation that arise solely because of the insolvency of the institution or are based on the financial condition of the depository institution in receivership or conservatorship. Contractual rights to declare a default based on credit downgrades or other facts reflecting the financial condition of the failed institution or incidental to the appointment of a conservator or receiver are unenforceable. This also would apply to cross-defaults if the original default was based on such unenforceable contractual provisions. Thus, Title IX bars a premature termination of the QFC if incidental to the appointment or if based on the "insolvency or financial condition of the depository institution." In addition, the new FDI Act bars termination of an agreement which purports to be for a ground other than appointment of the conservator or receiver if the termination is based upon the exercise of rights or powers of the conservator or receiver.[27] This latter provision is a significant strengthening of the receiver's protection from arguments that contracts can be terminated despite the transfer of the QFCs to a purchasing bank or to a bridge bank. This does not mean, however, that a bank or thrift in receivership or conservatorship can refuse to make required payments or collateral calls or meet other contractual requirements. If the default is based on such failures to meet the contractual terms, it should not be deemed to be based solely on financial condition for purposes of this provision and would remain enforceable. These changes help confirm the ability of the FDIC to complete an orderly

resolution of the institution.

Fifth, the new amendments give the FDIC somewhat greater flexibility in providing notice of any transfer of QFCs in conformity with the FDIC's December 12, 1989 statement of policy, which sought to correct errors in the FDI Act. Thus, Title IX, allows the FDIC until 5:00 p.m. (Eastern Time), rather than by 12:00 noon, on the business day following the date of the appointment of the FDIC to provide notice of the transfer. In addition, the notice will be deemed sufficient if the FDIC has taken steps to notify the counterparty "reasonably calculated to provide notice" by the deadline. This could be an important clarification to allow the FDIC the flexibility to use the communication tools most appropriate under the circumstances that could exist shortly after a closing.

Implications of Title IX

The growing interrelationships between banks, securities brokers, insurers, and other financial market participants as well as the development of financial products that do not fit neatly within traditional descriptions of banking, insurance, or securities have changed our financial system. The myriad connections between firms involved in the markets allow both greater diversification of risks and greater risks of contagion. When the initial Bankruptcy Code provisions protecting close-out netting were adopted in the early 1980s and the first bank insolvency protections were enacted in 1989, the financial markets were far smaller and played a less important role in the financial services industry. Today, financial market contracts are used by many insured banks and thrifts, agribusinesses, exporters, insurers, and other companies for their valuable hedging and risk management features. While the end-users of derivatives are diverse and widespread, the market is concentrated in a handful of very large investment and commercial banking firms.

Together these developments have focused even greater industry and regulatory attention on effective risk management and the use of risk-reduction techniques, such as close-out netting. Title IX of the Bankruptcy Reform Act of 2005 is a response to those growing connections and to the need for an updated and more harmonious set of insolvency rules to cover all participants in the financial markets. The new amendments to the U.S. insolvency laws provide a common set of rules for the failure of a derivatives counterparty and will help all market participants better manage their risks by allowing participants to exercise a virtually uniform right to terminate and close-out net their exposures to an insolvent contracting party. A more uniform approach to netting, irrespective of whether the counterparty is a bank, broker-dealer, manufacturer, or some other type of company, recognizes the role of the many different players in the markets.

Equally important, Title IX clarifies and expands the availability of close-out netting to accommodate rapidly growing components of the financial markets, such as credit derivatives, and future market innovations. A vital aspect of this clarification of existing law is the enhanced protection of the ability to recover net claims through collateral and other credit enhancements. Clearer protection for cross-product netting is an additional significant accomplishment for Title IX because it allows market participants to maximize the risk-reduction benefits of close-out netting across QFCs with counterparties, thereby reducing payments flows and the resultant credit and operational risks.

Finally, Title IX reconfirms that the FDIC can use its powers to fashion a flexible resolution for a bank with derivatives. The FDIC's power to transfer QFCs to another open bank or to an FDIC-owned bridge bank within a business day after

appointment of the FDIC as receiver allows the FDIC the flexibility to choose a resolution strategy that may retain the value in a portfolio of QFCs or maximize its value through more gradual sale. In addition, a transfer of QFCs to another bank or to a bridge bank also may avoid the potential market disruption that could result from an immediate liquidation of a large portfolio. This flexibility is one way in which the FDI Act continues to differ with the Bankruptcy Code, which allows counterparties the immediate right to terminate and close-out net their financial market contracts. This difference reflects the importance that U.S. law has on flexibility in bank resolutions principally to limit the losses to depositors and the deposit insurance funds, but also to reduce the potential for disruption caused by bank failures.

Title IX is a significant advance in the protection provided by U.S. insolvency laws for close-out netting of financial market contracts. By providing netting protection comparable to other major derivatives trading nations, Title IX ensures that American markets and banks can fully benefit from the reduced risks and improved risk management available from netting. Title IX also preserves and strengthens the flexibility available under the FDI Act to limit disruption from bank failures to the value of a failed bank's QFC portfolios and to the markets.

Endnotes

[1]See 12 U.S.C. § 1821(e)(12). The Bankruptcy Code imposes an "automatic stay" that immediately bars a wide variety of actions and activities that could affect the ownership or value of the bankrupt's assets once a bankruptcy petition is filed. See 11 U.S.C. § 362.

[2]See 12 U.S.C. § 1821(e)(1).

[3]See 12 U.S.C. §1821(d)(17). As conservator or receiver, the FDIC also can use other state or federal fraudulent conveyance powers. See 12 U.S.C. §§ 1821(c)(2)(B) and (3)(B).

[4]See 12 U.S.C. § 548(a).

[5]See 12 U.S.C.§§ 1821(d)(5) – (13).

[6]See 12 U.S.C. § 1821(d)(11). The Bankruptcy Code also contains a priority order for payment of claims focused on distinctions between different types of unsecured claims. See 11 U.S.C. §507. Under both systems, secured claims are paid from the collateral to the extent of the collateral.

[7]See 11 U.S.C. §§ 362(b)(6), (7), and (17); 555; 556; 559; and 560.

[8]See 12 U.S.C. § 1821(e)(9), (10). A December 12, 1989, FDIC Policy Statement on QFCs provided the FDIC interpretation of the statutory provisions. The new Bankruptcy Reform Act of 2005 incorporates this interpretation and extends the deadline for notice until 5:00 p.m. on the business day after appointment of the receiver.

[9]See 12 U.S.C. § 1821(e)(8)(C)(i), (ii). This section specifically overrides 12 U.S.C. §1821(e)(11), which gives the receiver the right to avoid a security interest taken in

contemplation of insolvency. If a transfer was made or a security interest was created with intent to hinder, delay or defraud the institution or the creditors of the institution the receiver could avoid the transfer or security interest. Analogous rights are provided by the Bankruptcy Code, but those rights are somewhat more limited. For example, the limitation on the trustee's avoidance powers requires, in part, that the transfer qualify as a "margin payment" or "settlement payment" to specified recipients. See 11 U.S.C. §§ 546(e) and (f); see also 11 U.S.C. §§ 546(g); 548(d)(2).

[10]See 12 U.S.C. §§ 1821(e)(9) and (10).

[11]See 12 U.S.C. § 1821(e)(3)(A)(ii)(II) and (C).

[12]See The President's Working Group on Financial Markets, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," appendix E at E-6 to E-7 (April 1999).

[13]These terms are broadly defined. A "financial institution" includes broker-dealers, depository institutions, future commissions merchants, and other entities recognized by Federal Reserve regulation. On March 7, 1994, the Federal Reserve expanded the definition of "financial institution" to include most significant participants in the financial markets. See Regulation EE, 12 C.F.R. Part 231.

[14]See 11 U.S.C. §§ 101(22), (22A), (26), and (38B), as amended or added by Title IX, section 907(b) and (d).

[15]The definition of "forward contract" already included repurchase transactions and reverse repurchase transactions based on the purchase, sale or transfer of a commodity. See 11 U.S.C. § 101(25).

[16]See 11 U.S.C. §§ 548(d)(2)(C), 559, and 753, as amended by Bankruptcy Act of 2005, Title IX, section 907.

[17]See House Report accompanying H.R. 685.

[18]See Title IX sections 901, 906(b) and 907.

[19]See Title IX, sections 905 and 907(c), codified at 12 U.S.C. § 1821(e)(8)(D)(vii) and 11 U.S.C. § 101(38A), respectively.

[20]See 12 U.S.C. § 1821(e)(8)(D)(vii) (treating all swap agreements under a master agreement as "1 swap agreement").

[21]Prior to Title IX, Bankruptcy Code sections 362(b)(6), 362(b)(7), and 362(b)(17), probably allowed enforcement of a single net agreement for commodity contracts, forward contracts, and securities contracts between the same parties. However, sections 362(b)(7) and 362(b)(17) treated swap agreements and repurchase agreements separately and included no provisions indicative of a right to net across those contracts.

[22]Compare this with the President's Working Group on Financial Markets, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," appendix E at E-6 (April 1999). The President's Working Group's report describes the

difficulties of controlling the impact on the markets of the liquidation of large positions in a bankruptcy proceeding.

[23]New subparagraph (F) to 12 U.S.C. § 1821(e)(8), as amended by Title IX, section 902(a)(1).

[24]See 12 U.S.C. §§ 1821(e)(10)(B), 4403 and 4404, as amended by Title IX, section 903(a)(3) and 906, respectively.

[25]See 12 U.S.C. § 1821(e)(12), as amended by Title IX, section 903(a)(3).

[26]See 12 U.S.C. § 1821(e)(10)(C), as amended by Title IX, section 903(a)(3).

[27]See 12 U.S.C. §§ 1821(e)(10)(B) and 1821(e)(12)(A), as amended by Title IX, sections 903 and 902, respectively.

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