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**OTC Derivatives: Legal Risk, the Lehman Insolvency
and Derivative Documentation**

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Table of Contents

Part 1: An Overview of OTC Derivatives

- I. Definition of a Derivative
 - A. United States General Accounting Office Definition
 - B. Exchange Traded Derivatives
 - C. OTC Derivatives
- II. Exchange Derivatives versus OTC Derivatives
 - A. Regulation of Exchange Traded Derivatives
 - B. Regulation of OTC Derivatives
 - C. Standardization Versus Customization
- III. Development of the OTC Derivative Market
 - A. Volume
 - B. Dealers
 - C. Attraction of OTC Derivatives for Commercial Banks
 - D. Investment Banks
 - E. Insurance Companies
 - F. Trading Centers

- IV. Endusers
 - A. Definition
 - B. Size & Sophistication
 - C. Smaller Endusers
- V. Speculators
- VI. International Swaps & Derivatives Association
 - A. Generally
 - B. Standardization of Documentation
 - C. Lobbying
 - D. Legal Opinions
- VII. Fixed Income OTC Derivatives (Interest Rate Derivatives)
 - A. Generally
 - B. Plain Vanilla Interest Rate Swap
 - C. Interest Rate Caps
- VIII. Currency Derivatives
 - A. Generally
 - B. Currency Swap
- IX. Other Derivatives
 - A. Commodity
 - B. Equity Derivatives
 - C. Credit Derivatives
- X. Documentation Standardization
 - A. Historically
 - B. Importance of Standard Documentation
 - C. Role of ISDA in Standardizing Documentation
 - D. Types of Documents
 - E. Other ISDA Materials

Part 2: Understanding the Bankruptcy and Insolvency Law Treatment of OTC Derivatives

- I. Introduction
 - A. Historical Legal Uncertainty
 - B. Different Bankruptcy Regimes
 - C. Uncertain Legal Treatment
 - D. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005
- II. U.S. Bankruptcy Code Concerns
 - A. Historical Concerns
 - B. Swap Participant and Swap Agreement
 - C. The Automatic Stay
 - D. Terminating the ISDA Master Agreement
 - E. Netting and Cherry Picking
 - F. Preference Payments and Avoiding Power
- III. Insolvency of Depository Institutions
 - A. Overview of Regulatory Regime

- B. Definitions of QFCs and Swap Agreements in FDIA
- C. FDIA and Treatment of Typical Concerns in Insolvency
- D. Automatic Early Termination Under FDIA
- E. Walkaway Clauses
- F. Exemption from Contemporaneous Execution Requirement
- G. FDICIA

Part 1 (prepared by Christian Johnson)

AN OVERVIEW OF OTC DERIVATIVES

I. Definition of a Derivative

A. United States General Accounting Office Definition

GAO defined a derivative transaction as “a financial contract whose value depends on the values of one or more underlying assets or indices of asset values.” In other words, the contract’s fair market value will generally be determined based upon the movement of the values of the underlying asset or index that a particular contract references.

B. Exchange Traded Derivatives

1. Examples of Exchange Derivatives

- a. Futures Contracts
- b. Options on Futures Contracts
- c. Option Contracts

2. Exchanges - Examples

Chicago Board of Trade
Chicago Mercantile Exchange

C. OTC Derivatives

1. Statutory Listing of Derivatives

2. ISDA Master Agreement (Specified Transaction)

3. Categories

- a. Fixed Income (interest rate)
- b. Foreign Currency (swaps and spot trades)

- c. Credit Derivatives
- d. Equity Derivatives
- e. Energy Derivatives
- f. Weather Derivatives

II. Exchange Derivatives versus OTC Derivatives

A. Regulation of Exchange Traded Derivatives

Exchange derivatives are vigorously regulated by the Commodity Futures Trading Commission (“CFTC”) which has jurisdiction over all types of futures transactions under the Commodities Exchange Act (7 U.S.C. §§ 1 et. seq.). The CFTC not only regulates the futures exchanges themselves, but also the types of products they can offer. In addition, the CFTC also regulates the behavior and activities of participants that trade over the exchanges.

B. Regulation of OTC Derivatives

In contrast, the OTC derivatives market is regulated on a piecemeal and decentralized basis, not by the CFTC, but by the various regulatory agencies which regulate the parties involved, such as the various banking and insurance regulators and the Securities and Exchange Commission, among others.

C. Standardization Versus Customization

1. Exchange Derivatives - Standardization

The contractual differences between the exchange and OTC derivatives market are substantial. In an exchange market such as the Chicago Board of Trade, derivatives such as futures and options are highly standardized. The contract size, maturity, expiration date and underlying asset or index are all fixed in advance and traded through centralized markets. In addition, these exchange derivatives are settled through clearinghouses.

2. OTC derivatives - Customized

None of the business terms of an OTC derivative are standardized. A participant can enter into an OTC derivative based upon any amount, time frame, underlying index or price that can be negotiated with another party. In addition, all payments are made directly between the two parties, with no clearinghouse acting as an intermediary. Lastly, OTC derivatives can involve literally any rate, index or price involving interest rates, commodities or equities and are not limited to the CFTC approved products that are traded on the organized exchanges.

III. Development of the OTC Derivative Market

A. Volume

2007 ISDA Midyear Survey

Notional amount outstanding of interest rate derivatives grew by 22 percent to \$464 trillion in the first half of 2008. Notional amount outstanding of credit derivatives fell 12% in the first half of 2008 to a notional amount of \$54.6 trillion. See www.isda.org (2008 Mid-year market survey).

B. Dealers

The most active participants are dealers that act as intermediaries, although they may also periodically trade for their own account. In this capacity, the dealer acts as middleman between literally thousands of endusers on both sides of OTC derivatives. The dealer takes one side of a trade with one enduser and then enters into an offsetting trade with another enduser. The dealer typically profits both through fees and through the spread that it earns by acting as an intermediary between the various endusers needing OTC derivative products.

The largest dealers in the OTC market in the United States are the large money center and regional banks such as JP Morgan Chase, Bank of America, and Citibank. These banks have leveraged their knowledge of interest rate movements and large customer bases into highly profitable businesses. Foreign banks are also major participants. Some of the largest include Deutsche Bank, UBS AG, and Barclays Bank, among others.

C. Attraction of OTC Derivatives for Commercial Banks

Commercial banks acting as dealers entered the OTC derivatives market early and eagerly for several reasons. First, many of the earliest OTC derivative products dealt with interest rates, an area in which banks, by their nature, already had a strong presence. Second, because of their status as lenders, banks were already prepared to act as intermediaries for interest rate swaps and other products used to hedge borrowing activities.

In addition, these same banks already had customer contacts with thousands of potential endusers. Third, because of historical limitations on banks by the Glass-Steagall Act and other restrictions on them against doing business in the securities industry, OTC derivatives provided a unique opportunity for commercial banks to establish profitable trading activities not subject to securities regulation.

D. Investment Banks

In addition to commercial banks, large investment banks such as Morgan Stanley and Goldman Sachs are also prominent in derivatives. These investment banks are active in the market for many of the same reasons as banks. Although these investment banks typically do not act as lenders, they have a high degree of expertise owing to their activities in the worldwide financial markets. These investment banks also have extensive client relationships with major corporations throughout the world.

E. Insurance Companies

Finally, several large insurance companies (such as AIG) are also active as dealers in the OTC derivatives market.

F. Trading Centers

Most of the trading activity in the United States is concentrated in New York City, although significant trading and dealing also occurs in other large cities such as Charlotte and San Francisco. In addition, most large banks and investment banks have offices throughout the United States to promote their activities to customers. The majority of the foreign activity occurs in London, although trading is also done in other major cities in Europe and Asia. The majority of these dealers also have offices in New York.

IV. Endusers

A. Definition

Dealers' customers are generally referred to as endusers. Endusers enter into OTC derivative transactions for a specific purpose such as hedging a particular risk or managing their assets and liabilities. Endusers can range in size from Fortune 500 corporations to closely-held corporations with assets of as little as \$10 million. Endusers typically use OTC derivatives to hedge business risks such as the volatility of variable interest rates and commodity prices.

B. Size & Sophistication

The size and sophistication of the enduser will impact its approach to derivative transactions. The large sophisticated enduser often seeks out a dealer to provide it with a quotation on a particular type of transaction. Often, the enduser will also solicit competing quotations from a number of other dealers before entering into the transaction. Alternatively, a dealer may approach an enduser with a particular OTC derivative product that the dealer is trying to market.

C. Smaller Endusers

Smaller endusers typically use OTC derivatives to hedge interest rate risk. Often a smaller enduser is approached by its lending bank. The enduser may be required to enter into an OTC derivative such as an interest rate swap because the enduser's lending bank has made the terms of its loan to the enduser contingent upon the customer entering into an interest rate swap to hedge any interest rate risk from its borrowings. The OTC derivatives market should continue to grow and expand as more dealers enter the market and as lenders increasingly condition borrowing on an enduser hedging its interest rate and other business risks through OTC derivatives.

V. Speculators

A final group of participants speculate through the use of OTC derivatives, taking positions on the movement of various rates, prices and indices. This group typically includes hedge funds and other similar sophisticated financial institutions, but may also include dealers or endusers attempting to profit from market movements. The most prominent include hedge funds such as Long-Term Capital Management, and the proprietary trading operations at commercial or investment banks. Other endusers use however, have also taken unhedged market positions through the use of OTC derivatives, sometimes suffering severe losses such as those experienced by Procter & Gamble in the early 1990s.

VI. International Swaps & Derivatives Association

A. Generally

ISDA is also a major participant in the OTC derivatives industry—its influence and importance is impossible to overstate. ISDA is the principal trade group for the OTC derivatives industry, whose membership is composed of approximately 200 of the largest financial institutions in the world that act as dealers in the OTC derivatives market. Service firms such as law firms, software companies and accounting firms participate as associate members. Finally, non-dealers such as corporations, financial institutions and government entities can participate as subscriber members.

B. Standardization of Documentation

Through ISDA, participants in the market have developed standard forms of documentation for use in the OTC derivatives market. The ISDA Master Agreement in fact has become ubiquitous in the area, being used to document virtually every contractual relationship governing the use of OTC derivatives. In fact, it becomes impossible to discuss the legal issues and concerns in documenting OTC derivatives without referring to the provisions of the ISDA Master Agreement.

C. Lobbying

In addition to drafting standard forms of documentation, ISDA conducts significant worldwide lobbying activities on behalf of its members to lobby for important changes in laws and regulations governing OTC derivatives. ISDA also provides extensive training both for its members and for nonmembers in the OTC derivative area.

D. Legal Opinions

ISDA has also obtained legal opinions with respect to the enforceability (and related issues) of the ISDA Master Agreement in numerous foreign jurisdictions on behalf of its members, providing substantial help in understanding the risks of enforceability or other legal concerns in foreign jurisdictions.

VII. Fixed Income OTC Derivatives (*Interest Rate Derivatives*)

A. Generally

OTC derivatives are most typically used by endusers to hedge business risks such as the risk of fluctuations in interest rates or commodity and equity prices. Although there are innumerable forms of OTC derivatives, most endusers will use OTC derivatives such as swaps and caps to hedge the interest rate risk that an enduser takes on when it borrows on a variable rate basis.

B. *Plain Vanilla Interest Rate Swap*

In an OTC derivative swap, parties agree to exchange periodic payments. The payments are calculated by multiplying the notional amount of the transaction by a pre-agreed rate, price or index. The mechanics of the plain vanilla interest rate swap can be used to illustrate the mechanics of an OTC derivative swap.

In a plain vanilla interest rate swap, a dealer (“DealCo”) and an enduser (“EndCo”) agree to exchange payments based upon predetermined interest rates. For example, assume that EndCo has borrowed \$10 million at a variable interest rate equal to the prime rate then in effect, but would prefer to pay a fixed rate in order to limit the risk that interest rates will rise to a level that will exceed its ability to pay. DealCo could enter into an interest rate swap with EndCo to hedge that risk.

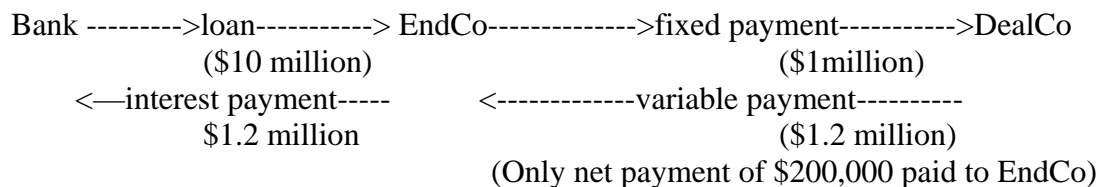
In an interest rate swap, parties agree to swap payment obligations based upon a specified notional amount. The notional amount is never exchanged between the parties, but is used to calculate the payment amounts. For example, because EndCo wants to hedge its variable interest rate risk under the loan, the parties would probably use \$10 million as the notional amount. In a plain vanilla interest

rate swap, EndCo would make a fixed payment to DealCo and the DealCo would make a variable rate payment to the EndCo.

Based on hypothetical current market conditions in this example, EndCo agrees to make a payment to DealCo equal to a fixed interest rate payment of ten percent (10%). DealCo agrees to make a payment equal to the prime rate in effect on the payment date. Assume that the parties entered the swap agreement on January 1st and agree to exchange payments annually on the last day of each year for five years.

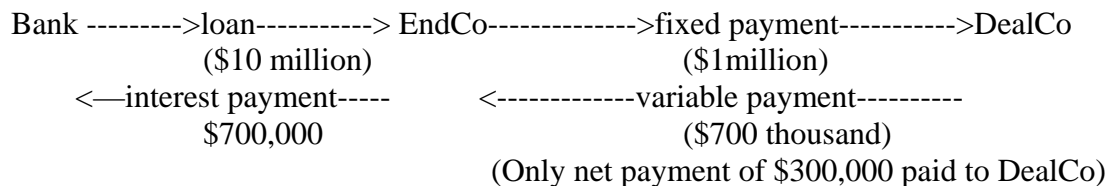
On December 31st of Year 1, assume that the prime rate was twelve percent (12%). DealCo would be obligated to make a payment to EndCo equal to \$1,200,000 (12% multiplied by \$10 million). EndCo would be obligated to make a payment to DealCo in the amount of \$1 million (10% multiplied by \$10 million). Typically, the terms of the swap agreement require that the payments be made on the same day and be netted against each other. In our example, DealCo would make a net \$200,000 payment to EndCo.

Interest Rate Swap Diagram
(Fixed Rate = 10% - Prime rate = 12%)



EndCo has met its hedging goal because it has avoided paying more than a net amount of 10% on its variable rate loan. EndCo would use the \$200,000 that it had received from DealCo to meet its variable interest rate payment of 12%. Of course, had the prime rate gone down, EndCo would still have had an effective interest rate cost of 10% equal to the 7% that it would pay to its lender under the loan and the \$300,000 net payment that it paid to DealCo.

Interest Rate Swap Diagram
(Fixed Rate = 10% - Prime rate = 7%)



Swaps, similar to the plain vanilla interest rate swap, also can be used to hedge the risk of the movement of a rate, index or price in other areas such as commodities and equities. For example, if a food processor wanted to hedge the risk against increases in wheat prices, it could enter into a swap in which it would agree to pay a fixed price for a bushel of wheat in exchange for payments based on the same bushel of wheat at the current spot price. Similarly, an investor could hedge the risk of its stock holdings by agreeing to pay a variable amount to a dealer based on increases in a particular stock price in exchange for payments based on changes in a stock index such as the S&P 500 from the dealer.

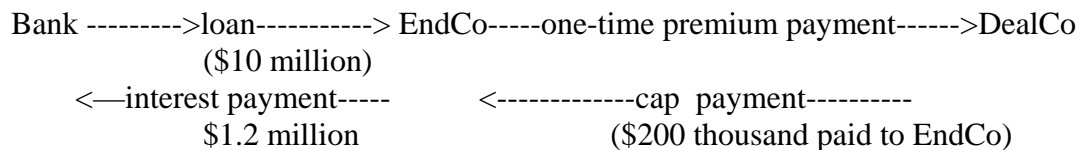
C. *Interest Rate Caps*

Participants can often achieve the same hedging results of a swap by entering into a “cap.” In a cap, an enduser typically makes a one time payment, referred to as a premium. In exchange, the dealer agrees to make periodic payments based on the relevant rate, price or index movement in the event that such rate, price or index exceeds what is referred to as the “strike” rate, price or index movement. The dealer would then make a payment equal to the difference between the actual rate, price or index and the strike rate, price or index movement, multiplied by the notional amount. As with a swap, a cap can be used to hedge market risks with respect to interest rates, commodities and equities, among others.

For some endusers, a cap may be easier to obtain than a swap because the dealer incurs no credit risk with a cap. The only performance required by an enduser in a cap is to make the premium payment at the inception of the transaction. In contrast to a cap, a dealer is concerned in a swap that an enduser will fail to make its periodic swap payments throughout the life of the swap.

In the above examples, EndCo could instead have hedged its interest rate exposure under its loan by purchasing a cap from DealCo. Based on hypothetical current market conditions in this example, EndCo would make a one-time premium payment to DealCo in exchange for the cap. Under the cap, DealCo agrees to make a payment to EndCo equal to the prime rate in effect at the relevant date less the strike rate, which in this case would be 10%. Assume that the parties entered the agreement on January 1st and DealCo agreed to make each payment annually on the last day of the year for five years. If the prime rate increased to 12% on December 31st of Year 1, for example, DealCo would make a payment equal to the product of the notional amount of \$10 million and 2% (12% less the strike price of 10%), or \$200,000.

Interest Rate Cap Diagram
 (Strike Rate = 10% - Prime rate = 12%)



EndCo has met its hedging goal because it has avoided paying more than a net amount of 10% on its variable rate loan. EndCo would use the \$200,000 that it had received from DealCo to meet its variable interest rate payment of 12%. As opposed to the swap, however, if prime had gone down to 7%, EndCo would benefit because it would only be required to make its 7% interest payment to its lender.

volatility of commodity prices makes OTC derivatives a natural choice to minimize such risks. OTC transactions have been designed to hedge the risk of volatile prices in everything from agricultural products to oil and gas. Recently, an active OTC derivatives market has developed with respect to electricity.

B. Equity Derivatives

OTC derivatives based on the movement in equity prices or movements in equity indices are becoming more prevalent. Equity OTC derivatives can take many forms, although the most common form in the OTC market would probably be an equity swap. First introduced in 1989 on a large scale, equity derivatives have become an important part of the OTC derivatives market.

An equity swap will be popular with an enduser that wants to enjoy many of the characteristics of owning particular equity securities without incurring the transaction costs of actually owning the subject equities themselves. For example, a party may be prohibited from purchasing a foreign stock, yet may be able to profit from movements in its price by entering into an OTC derivative (which would not require actual ownership of the foreign stock by the enduser).

An OTC equity derivative could also be used to protect a shareholder from decreases in the value of the shares held, although often at the cost of losing some upside potential. For example, an enduser may be prohibited from selling a newly issued stock that it owns. To hedge the risk that that stock may go down in price, an enduser could agree to make payments based on the price movement of the stock in exchange for receiving payments based on the movement of a popular stock index such as the S&P 500™.

C. *Credit Derivatives*

The most exotic OTC derivative recently developed is the credit derivative. Credit derivatives typically involve the exchange of payments referenced to the credit performance of various types of credit-sensitive assets. Credit derivatives have become popular as a way to hedge against the credit risk of a particular party. Credit derivatives have been created to minimize credit risk for the debt of sovereigns, individual corporations, and baskets of corporate debt and municipalities.

X. Documentation Standardization

A. Historically

The documentation of OTC derivative transactions was complicated and expensive. However, the documentation has become more standardized over time and currently almost every trading relationship between an enduser and a dealer is formalized by entering into a form of ISDA Master Agreement.

B. Importance of Standard Documentation

Standardized documentation in this area is important for several reasons. Prior to the standardized ISDA Master Agreement, the expense of creating new documentation for each transaction in this area caused participants to incur significant legal expenses. Negotiations over terms led to significant delays as parties and their lawyers attempted to draft new documentation for each new transaction. In addition, the wide variety of documentation used and more increasingly complex financial contracts created legal uncertainty.

C. Role of ISDA in Standardizing Documentation

Committees of dealers organized through ISDA have made significant progress in standardizing the more routine aspects of OTC derivatives. These efforts have significantly reduced the cost and time involved in negotiating OTC derivatives. Yet the standardized format still allows participants significant flexibility in negotiating transactions compared with the futures and options traded over the highly regulated exchanges.

D. Types of Documents

The standard ISDA forms include a draft form of *Confirmation*, an *ISDA Master Agreement*, and *Credit Support Documents* (involving collateral or guarantees). Many of these forms and documents are available through ISDA.

1. Confirmations

The Confirmation documents the economic terms and structure of each transaction and is considered a supplement to the ISDA Master Agreement. The Confirmation describes in detail the amount and timing of each payment under the transaction. In rare cases, a Confirmation may also contain other important contractual details such as covenants, events of default and methodologies for calculating damages typically found in the ISDA Master Agreement.

ISDA has drafted several standard forms of Confirmations that provide a template for parties to use when documenting the economic terms of their transactions. Standard forms are available for a variety of different transactions. To further simplify the process, ISDA has also developed standard definitions that can be used as shorthand to describe the transaction.

2. ISDA Master Agreement

The ISDA Master Agreement documents the important boilerplate contractual terms important to the parties other than the transaction's economic terms. These terms include choice of law provisions, representations, covenants and events of default, among others. The ISDA Master Agreement itself is a 17-page pre-printed document and is designed to be governed by either New York or English law.

3. Schedule

The ISDA Master Agreement can be tailored by the individual parties through the Schedule attached to the end of the Master Agreement as an annex or addendum. The Schedule attempts to fill in various elections, amendments, and other concerns that the counterparties may have with respect to the ISDA Master Agreement itself.

4. Credit Support Documents

If the parties are uncertain about each others' credit worthiness, the parties may consider entering into Credit Support Documents. The Credit Support Documents serve to collateralize or guarantee the transactions between the parties and minimize the risk that one party will fail to perform. The standard form of security agreement developed by ISDA is referred to as the Credit Support Annex (the "CSA").

The CSA governs the pledging of collateral to secure a party's obligations to make payments under an ISDA Master Agreement. The CSA is similar to the ISDA Master Agreement in that it consists of seven pages of pre-printed boilerplate language and can be customized or modified through an additional paragraph, referred to as Paragraph 13. Other credit support documents are commonly used finance agreements such as letters of credit, mortgages, security agreements, or guarantees.

E Other ISDA Materials

In addition to standardized documentation, ISDA also provides important other materials for its members and other participants. In addition to the definitional books described above, ISDA has published "User Guides" on the Master Agreement and CSA. ISDA has also solicited opinions from various law firms throughout the world on the enforceability of the ISDA

Master Agreement and other important legal issues, available only for its members.

Part 2

Understanding the Bankruptcy and Insolvency Law Treatment of OTC Derivatives

I. Introduction (prepared by Christian Johnson)

A. Historical Legal Uncertainty

There has been concern about the interaction of OTC derivatives and bankruptcy since the inception of the OTC derivatives industry. Continued growth of the OTC derivative industry in the United States depended on the resolution of these bankruptcy and banking insolvency issues. Legal uncertainty over these issues threatened to drive much of the U.S. OTC derivative industry to other foreign jurisdictions that had resolved these issues earlier. Fortunately, the majority of the issues and concerns have been resolved in the United States, primarily through statutory changes to the U.S. Bankruptcy Code (the “Code”) and banking insolvency law.

B. Different Bankruptcy Regimes

Unfortunately, the area is complicated by the number of different bankruptcy and insolvency law regimes in the United States. The majority of bankruptcies involving endusers will probably be governed by the Code. If the insolvent enduser or dealer is a financial institution with federally insured deposits, however, the treatment of the insolvent institution will likely be governed by the Federal Deposit Insurance Act (“FDIA”), as amended by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (“FIRREA”). There are also special insolvency provisions that will not be discussed here for, among others, broker dealers, insurance companies, and quasi-government agencies.

C. Uncertain Legal Treatment

1. Close out Netting

Prior to the amendments made to the Code and banking insolvency law, parties believed it was important to resolve legal uncertainties with respect to the effect of the bankruptcy and banking insolvency rules and how they relate to OTC derivatives. Parties were concerned that a court would not enforce the close-out and other netting provisions of the ISDA Master Agreement. The ability to

net both transaction and termination payments can influence the credit decisions a party makes and how the party manages the credit risk it undertakes when trading with another party. Failure by the courts and regulatory authorities to recognize those netting rights, or reclaiming pre-insolvency payments through a trustee's avoidance powers, would significantly disrupt the credit analysis and assumptions that rely upon those netting rights.

2. Termination

Parties were also concerned that bankruptcy and insolvency rules could delay the solvent party's right to terminate the ISDA Master Agreement or exercise self-help remedies, such as set-off and the liquidation of collateral pledged to secure the now bankrupt or insolvent party's obligations. As opposed to obligations under a loan agreement where the obligation of the bankrupt party will typically remain unchanged, payment obligations under OTC derivatives can fluctuate as the relevant markets move. It is important that a party be able to close-out its OTC derivative position as soon as possible in order to avoid additional losses from changing markets.

A party will also want to replace the terminated derivative transaction it had with the bankrupt or insolvent party as soon as possible in order to maintain any hedges that the party had in place with the bankrupt or insolvent counterparty. This requires that the solvent party be able to terminate the existing transactions as quickly as possible and use the proceeds from any collateral that it would be entitled to liquidate to finance those new transactions.

D. *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*

Congress made significant changes to both the U.S. bankruptcy Code and to banking insolvency law when it passed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 in April of 2005 ("2005 Act").

The following is a brief summary of the principal changes made by the 2005 Act to the US Bankruptcy Code and banking insolvency law:

- Broadened Definition of Swap Agreement
- Strengthened close-out netting
- Strengthened the exceptions from the automatic stay and avoidance powers

- Clarified damage measurement timing
- Expanded FDICIA protections
- Clarified FDICIA powers with FDIA
- Clarified the enforceability and netting for “Master Master” Agreements

II. **U.S. Bankruptcy Code Concerns** (prepared by Christian Johnson)

A. Historical Concerns

Prior to amendments to the Code, parties worried about how a U.S. bankruptcy court would resolve certain legal uncertainties surrounding the treatment of outstanding derivative transactions they had entered into with counterparties that later became bankrupt. The legislative history explaining amendments to the Code summarized many of these early concerns:

Concerns have been raised that under current bankruptcy law, termination and set-off of a swap agreement would be automatically stayed when one of the parties files a bankruptcy petition, whereupon the trustee, after indefinitely postponing termination of the swap agreement, could refuse set-off and unfairly “cherry pick” only the portions of the agreement advantageous to the debtor, while rejecting the portions unfavorable to the debtor.

Bankruptcy: Swap Agreements and Forward Contracts, House Report No. 101-484 at 3 (May 14, 1990).

The concerns identified by Congress and resolved through amendments to the Code can be broken down into three areas: (1) delays caused by the Automatic Stay; (2) the right to terminate the agreement and exercise close-out netting rights; and (3) the avoidance of pre-bankruptcy “preference” and other payments by the bankruptcy trustee.

B. *Swap Participant and Swap Agreement*

To understand the effect of the US bankruptcy Code, however, it is important to understand what is covered by the Code. In order to be

covered, a transaction must be entered into by a Swap Participant and must be characterized as a Swap Agreement.

1. Swap Participant.

The amended Code provisions apply to a “swap participant” which has entered into a “swap agreement” with a debtor that is now bankrupt. The Code defines a swap participant as “an entity that, at the time before the filing of the petition, has an outstanding swap agreement with the debtor” (11 U.S.C. § 101(53C)).

2. “Swap agreement”

Probably the most sweeping change in the recent bankruptcy amendments was the expansion of the definition of Swap Agreement. The new definition of swap agreement has recently been amended and significantly expanded as follows:

(53B) The term "swap agreement"--

(A) means--

(i) any agreement, including the terms and conditions incorporated by reference in such agreement, which is--

(I) an interest rate swap, option, future, or forward agreement, including a rate floor, rate cap, rate collar, cross-currency rate swap, and basis swap;

(II) a spot, same day-tomorrow, tomorrow-next, forward, or other foreign exchange or precious metals agreement;

(III) a currency swap, option, future, or forward agreement;

(IV) an equity index or equity swap, option, future, or forward agreement;

(V) a debt index or debt swap, option, future, or forward agreement;

(VI) a total return, credit spread or credit swap, option, future, or forward agreement;

(VII) a commodity index or a commodity swap, option, future, or forward agreement; or

(VIII) a weather swap, weather derivative, or weather option;

(ii) any agreement or transaction that is similar to any other agreement or transaction referred to in this paragraph and that--

(I) is of a type that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap markets (including terms and conditions incorporated by reference therein); and

(II) is a forward, swap, future, or option on one or more rates, currencies, commodities, equity securities, or other equity instruments, debt securities or other debt instruments, quantitative measures associated with an occurrence, extent of an occurrence, or contingency associated with a financial, commercial, or economic consequence, or economic or financial indices or measures of economic or financial risk or value;

(iii) any combination of agreements or transactions referred to in this subparagraph;

(iv) any option to enter into an agreement or transaction referred to in this subparagraph;

(v) a master agreement that provides for an agreement or transaction referred to in clause (i), (ii), (iii), or (iv), together with all supplements to any such master agreement, and without regard to whether the master agreement contains an agreement or transaction that is not a swap agreement under this paragraph, except that the master agreement shall be considered to be a swap agreement under this paragraph only with respect to each agreement or transaction under the master agreement that is referred to in clause (i),

(ii), (iii), or (iv); or

(vi) any security agreement or arrangement or other credit enhancement related to any agreements or transactions referred to in clause (i) through (v), including any guarantee or reimbursement obligation by or to a swap participant or financial participant in connection with any agreement or transaction referred to in any such clause, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with [section 562](#); and

(B) is applicable for purposes of this title only, and shall not be construed or applied so as to challenge or affect the characterization, definition, or treatment of any swap agreement under any other statute, regulation, or rule, including the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Investor Protection Act of 1970, the Commodity Exchange Act, the Gramm-Leach-Bliley Act, and the Legal Certainty for Bank Products Act of 2000. 11 U.S.C. § 101(53B).

The new expanded definition has eliminated many of the concerns as to whether a particular transaction was covered by the bankruptcy code provisions.

C. *The Automatic Stay*

1. Operation of the Automatic Stay.

Upon the filing of a bankruptcy petition, the automatic stay under Section 362 of the Code stays the creditor of a bankrupt debtor from exercising the majority of its legal rights and remedies against a bankrupt debtor. The automatic stay ordinarily remains in effect until the case is dismissed, completed, or the judge grants relief, unless a specific exemption from the automatic stay applies.

2. Problems of the Automatic Stay

For example, assuming there was no relevant exemption, upon the filing of a bankruptcy petition, a swap participant would normally be automatically stayed from exercising any of the self-help remedies found in the ISDA Master Agreement (and any Credit Support Document) against its bankrupt counterparty. Absent a specific exemption, the solvent party would be prevented from liquidating collateral or exercising its right to set-off amounts it owes the bankrupt counterparty under the ISDA Master Agreement against amounts the bankrupt counterparty owes it.

Delays caused by the potential application of the automatic stay would cause significant problems for a swap participant. During this delay, the amount owed to the swap participant under the ISDA Master Agreement could fluctuate as markets move, resulting in additional losses. Also, the value of collateral held by the swap participant could deteriorate as the party waits for permission to liquidate it.

3. Exemption from Automatic Stay for Swap Agreements

Section 362(b)(17) of the Code provides a specific exemption from the automatic stay for swap agreements. The exemption permits a swap participant to set-off any amounts that the bankrupt counterparty owes to it against any amounts that the swap participant owes the bankrupt counterparty under the ISDA Master Agreement. The exemption also permits a swap participant to liquidate any collateral or margin held to secure the bankrupt counterparty's obligation under a swap agreement, avoiding any potential future deterioration in the value of the collateral.

D. *Terminating the ISDA Master Agreement*

The ISDA Master Agreement provides that a party may terminate the ISDA Master Agreement upon the bankruptcy or insolvency of its counterparty. Under Section 365 of the Code, however, a party was ordinarily prevented from terminating the ISDA Master Agreement and the underlying transactions based solely upon a bankruptcy filing.

This restriction was problematic because of a swap participant's need to terminate the ISDA Master Agreement in order to exercise its remedies thereunder, to avoid any additional losses as markets fluctuated, and to replace the hedging positions held with the bankrupt counterparty. Now, section 560 of the Code permits a swap participant to exercise its rights under the ISDA Master Agreement to terminate the agreement and any underlying transactions upon the bankruptcy of its counterparty.

E. Netting and Cherry Picking

1. General Concerns

Swap participants were concerned about limitations on their close-out netting rights under the ISDA Master Agreement and the possibility of a bankruptcy trustee "cherry picking" among the various derivative transactions between the swap participant and its bankrupt counterparty. Cherry picking occurs when a bankruptcy trustee can terminate individual transactions for which the bankrupt counterparty was out-of-the-money (i.e., had payment obligations to the swap participant) and keep those transactions for which the bankrupt counterparty was in-the-money (i.e., was entitled to payments from the swap participant).

2. Operation of Section 365.

Under Section 365 of the Code, a bankruptcy trustee potentially had the power to cherry pick because of its power to accept or reject executory contracts. Executory contracts generally are contracts in which both sides still have obligations to perform under the contract. An OTC derivative contract could be characterized as an executory contract since, depending upon the relevant market movements, either side could be obligated to perform in the future.

Although the swap participant would be entitled to damages upon the termination of the out-of-the-money transactions, the swap participant would only be an unsecured creditor with respect to those damages absent any collateral. It would have lost the right to net out those amounts due to it under the transactions that were terminated, against those amounts it owed to the bankrupt

counterparty under those transactions that the bankruptcy trustee did not terminate.

3. Section 560

Congress resolved the cherry picking concern by first permitting swap participants to terminate the ISDA Master Agreement and all of the underlying transactions upon the filing of a bankruptcy petition, as discussed above. More important, Section 560 of the Code expressly permits what is commonly referred to as close-out netting. Close-out netting permits the swap participant to net together any amounts payable under all of the transactions to be terminated under the ISDA Master Agreement. This prevents the bankruptcy trustee from picking and choosing which transactions it wants to terminate or keep among the various transactions that it has outstanding with a particular swap participant.

F. *Preference Payments and Avoiding Power*

Upon the bankruptcy of a counterparty, a bankruptcy trustee has the power to reclaim or unwind pre-petition bankruptcy property transfers made to a creditor under certain situations. This is commonly referred to as a trustee's avoiding power. The avoiding power permits a trustee to reclaim preference payments made to a creditor up to 90 days prior to the filing of a bankruptcy petition (and up to one year in the case of transfers to insiders) (11 U.S.C. § 547(b)). Swap participants were concerned that this avoiding power was disruptive of a party's netting rights and collateral arrangements under the ISDA Master Agreement.

Congress resolved this by enacting Section 546(g) which generally exempts transfers made under a swap agreement from a trustee's avoiding powers, particularly with respect to preference payments.

Section 548(d)(2) also provides that a trustee cannot avoid a "fraudulent transfer" under a swap agreement because such transfer is always deemed to be made "for value to the extent of such payment."

III. **Insolvency of Depository Institutions** (prepared by Reggie O'Shields)

A. *Overview of Regulatory Regime*

Entities that accept federally insured deposits, such as banks, thrifts and savings associations ("depository institutions"), are not subject to the insolvency rules in the Code. These depository institutions are subject to the insolvency rules found in FDIA. Similar to parties dealing with entities subject to the Code, parties entering into ISDA Master Agreements with depository institutions were concerned that they would

not be able to terminate the ISDA Master Agreements and exercise close-out netting rights and self-help remedies, such as set-off and liquidation of collateral, if the depository institutions became insolvent. Fortunately, the amendments to FDIA made by FIRREA resolved many of these concerns. FDIA now provides that the solvent parties to “Qualified Financial Contracts” (QFCs) may terminate those contracts and enforce close-out netting rights and other self-help remedies with an insolvent depository institution. Amendments made to FDIA in 2006 expanded the definition of “persons” able to exercise these protections to include “government entities” as well.¹

B. Definitions of QFCs and Swap Agreements in FDIA

QFCs include “swap agreements,” among other types of financial contracts, such as securities contracts, commodity contracts, forward contracts, repurchase agreements and other similar contracts that the Federal Deposit Insurance Corporation (FDIC) determines by regulation to be QFCs.² Changes made in 2006 make it clear that repurchase or reverse repurchase transaction that qualifies as a securities contract or forward contract need not meet the definition of a repurchase agreement to be a QFC.³ Swap agreement is defined in a manner similar to the Code definition, and is broadly defined to include the majority of typical OTC derivatives, such as an interest rate, currency, equity, credit or commodity swaps, options, futures or forward agreements; and weather, emissions and inflation swaps, derivatives and options⁴.

“Swap Agreement” also includes any agreement or transaction that is similar to any other agreement or transaction referred to in the definition and that is of a type that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap or other derivatives⁵ market and that is a forward, swap, future or option on one or more rates, currencies, commodities, equity instruments, debt instruments, quantitative measures associated with an occurrence, extent of an occurrence, or contingency associated with a financial, commercial or economic consequence, or economic or financial indices or measures of economic or financial risk or value. This provision for future changes permits the definition of swap agreement to evolve with market advances.

Swap agreement also includes any combination of agreements or transactions referred to in the definition, and any option to enter into any such agreement or transaction. The definition of swap agreement includes

¹ 12 U.S.C. § 1821(e)(8)(D)(ix).

² 12 U.S.C. § 1821(e)(8)(D)(i).

³ See Sections 2(a) and (b) of the Financial Netting Improvements Act of 2006 (the “2006 Amendments”).

⁴ 12 U.S.C. § 1821(e)(8)(D)(vi), (vii).

⁵ The 2006 Amendments added the “or other derivatives” language to make even clearer the intent to allow for future market advances.

a master agreement and all supplements to such master agreement, even if the master agreement also covers transactions that would not constitute a swap agreement for purposes of the definition. However, the master agreement would be considered a QFC, and therefore subject to the protections for such contracts under FDIA, only with respect to transactions that would qualify as a swap agreement. Finally, security agreements and arrangements, and credit enhancement, such as guaranties and reimbursement obligations, are considered swap agreements under FDIA.

Increasingly, parties entering into not only OTC derivatives with each other, but also other types of transactions such as repurchase agreements, are entering into cross-product master agreements (often referred to as “master master agreements”). Under master master agreements, upon a default under one of the underlying master agreements (such as an ISDA Master Agreement or a Master Repurchase Agreement), the non-Defaulting Party would be able to terminate all of the underlying master agreements and net the termination payment amounts all together.

There has been some concern that FDIA would not permit close-out netting in such circumstances. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the “2005 Amendments”) revised the definition of swap agreement (and other QFCs) in FDIA in order to ensure that such cross-product netting is enforced to the extent that all of the underlying master agreements qualify as QFCs under FDIA.

C. FDIA and Treatment of Typical Concerns in Insolvency

1. Close-out Netting and Setoff

In an insolvency, the solvent party is concerned that it will have to make payments to the Federal Deposit Insurance Corporation (FDIC), as receiver or conservator for the insolvent depository institution, while remaining as a general creditor with respect to payments the insolvent depository institution owes to it. If these concerns materialize, the possibility of the solvent party collecting the amounts it is due is minimal. Close-out netting, as provided under the ISDA Master Agreement, eliminates much of this concern.

The close-out netting provisions provide that the solvent counterparty can terminate the ISDA Master Agreement upon the depository institution’s insolvency. As part of the termination and close-out of an ISDA Master Agreement, each included individual transaction is closed-out at its mark-to-market value. The mark-to-market value is usually equal to the cost of replacing the individual terminated transaction. The close-out netting provisions also provide that the solvent party can net the termination value

of any transaction for which it is out-of-the-money with the termination value of any transaction for which it is in-the-money.

Set-off rights are similar to close-out netting rights and generally are provided for under the ISDA Master Agreement. The terms set-off or offset refer to the right of the solvent party to contractually set-off or offset the net amount it owes to the insolvent party under the ISDA Master Agreement. Set-off occurs after close-out netting has been applied. Set-off applies against any other amounts that the insolvent party owes to the solvent party, or vice versa. For example, assume that the solvent party owes the insolvent bank a net amount of \$20 under the ISDA Master Agreement, and the insolvent bank owes the solvent party \$30 on a different transaction apart from the ISDA Master Agreement. The right of set-off under the ISDA Master Agreement would contractually permit the solvent party to set-off the \$20 that it owes the insolvent bank against the \$30 that the insolvent bank owes to the solvent party, with the result being that the insolvent bank owes the solvent party \$10.

2. Transfer Power of FDIC

Under FDIA, the FDIC may enforce a QFC with a solvent counterparty if the sole reason for the termination of the QFC is the appointment of the FDIC as the receiver or conservator.⁶ Upon the appointment of the FDIC as a receiver or as a conservator, the FDIC initially has the power to transfer *all* of the transactions under an ISDA Master Agreement to another “financial institution,” other than one for which a conservator, receiver, trustee in bankruptcy or other legal custodian has been appointed, or which is otherwise the subject of a bankruptcy or insolvency proceeding.⁷ There is no parallel to this power for the bankruptcy trustee of a debtor under the Code. This means that a solvent party cannot initially terminate the ISDA Master Agreement with an insolvent depository institution, and that it may end up with a different counterparty altogether. Although such transfers historically, and as a practical matter, are rare, FDIA invests this substantial power in the FDIC.

A concern for solvent parties with respect to close-out netting, especially when the FDIC is appointed as a conservator, is cherry picking. As stated above, the FDIA, however, has eliminated this risk. The FDIC must transfer *all* transactions under an ISDA Master Agreement to a *single* transferee. This is important because the solvent party’s credit analysis is dependent upon close-out netting between all of the transactions entered into with the bank.

⁶ 12 U.S.C. § 1821(e)(10).

⁷ 12 U.S.C. § 1821(e)(9).

The FDIA defines a swap agreement as including both an ISDA Master Agreement as well as each of the underlying transactions. Even though there may be hundreds of transactions entered under a single ISDA Master Agreement, FDIA treats it as one agreement. Consistent with this definition, if the FDIC elects to transfer an ISDA Agreement, it must also transfer all of the underlying transactions in the same ISDA Agreement to the same transferee.

The ability of the FDIC to transfer the ISDA Master Agreement to a “financial institution” was expanded in the 2005 Amendments. Previously, FDIC was limited in its power to transfer an ISDA Master Agreement to only insured depository institutions. “Financial institution” includes a broker or dealer, a depository institution, a futures commission merchant and any other institution determined by FDIC by regulation to be a financial institution.⁸ Previously, the FDIC also was not allowed to transfer the contracts to non-U.S. banks due to concerns that non-U.S. law would not provide the remaining solvent party with the same protections available under U.S. law. Now, FDIC may transfer the ISDA Master Agreement to a foreign bank, financial institution, or branch of such bank or institution, so long as the law applicable to such entity, its financial contracts, netting contracts, security arrangements and credit enhancement are enforceable substantially to the same extent as under FDIA.⁹

If the FDIC is a receiver, however, its transfer power must be exercised by 5:00 p.m. (eastern time) on the business day following its appointment as a receiver, or the solvent counterparty may terminate the ISDA Master Agreement.¹⁰ This closely resembles a solvent creditor’s rights under the Code, although there is still a one day delay for terminating the ISDA Master Agreement that does not occur under the Code.

A solvent counterparty’s termination rights under the ISDA Agreement are suspended if the FDIC is appointed as a conservator. Here, the FDIC as a conservator essentially steps into the shoes of the insolvent bank and assumes the rights and obligations of the insolvent bank. To terminate an ISDA Agreement after the appointment of the FDIC as a conservator, an Event of Default (other than an insolvency or insolvency related event) or a Termination Event would have to occur or the conservatorship would have to be replaced by a receivership. This is opposite from under the Code in which there is no stay on the solvent party from terminating the ISDA Agreement.

As a practical matter, the vast majority of U.S. banks are now put into receivership as opposed to conservatorship. It is unclear, however, how

⁸ 12 U.S.C. § 1821(e)(9)(D).

⁹ 12 U.S.C. § 1821(e)(9)(B).

¹⁰ 12 U.S.C. § 1821(e)(10).

the FDIC would deal with the insolvency of a large U.S. bank that was also acting as a derivatives dealer. By placing the dealer into a conservatorship, a solvent counterparty's rights to terminate the ISDA Agreement may be indefinitely suspended.

3. Interplay with FDICIA

Many practitioners once believed that a party's close-out netting rights could be enforced outside of the restrictions of FDIA under certain circumstances under the Federal Deposit Insurance Corporation Improvement Act (FDICIA)¹¹, which provides that "notwithstanding any other provision of law," a party may enforce the close-out netting terms of a netting contract entered into between financial institutions. The 2005 Amendments clarified the interaction of the two statutes. To the extent that a contract is a QFC, the protections afforded to netting contracts under FDICIA are limited by the transfer provisions of FDIA.¹²

4. Exercise of Set-Off of a QFC

Beyond close-out netting, FDIA expressly provides for set-off of the Early Termination Amount under the ISDA Master Agreement with amounts due under other QFCs. A party entering into a swap agreement with a depository institution may also have entered into other QFCs with that same depository institution that were not documented under the same ISDA Master Agreement. The contractual set-off provision found in an ISDA Master Agreement should be sufficient to permit a party, under FDIA, to set-off the amount owing under a swap agreement with amounts owing under any other QFCs entered into with the same party.

5. Set-Off Against Other Amounts

After exercising its close-out netting rights and setting-off any net amounts that the solvent party owes to the insolvent bank under QFCs, there may still be amounts owed by the solvent party to the insolvent depository institution under the ISDA Master Agreement. The solvent party would want to set-off such amount against any other amounts (apart from amounts under other QFCs) owed by the insolvent depository institution to it, such as deposits that the solvent party has with the depository institution.

Although the FDIC will generally recognize and will enforce a creditor's right of set-off against an insolvent depository institution, such rights may be severely limited because of application of the depositor preference liquidation provisions of FDIA. The FDIC would probably view these

¹¹ 12 U.S.C. § 4401 et. seq.

¹² 12 U.S.C. § 4403(a) and (f).

provisions as preempting such a set-off right. Under the depositor preference liquidation provisions, the FDIC, is required to distribute amounts collected from the liquidation or resolution of the insolvent depository institution and then pay off any remaining claims against the insolvent depository institution. Before the claims of general creditors are paid, the administrative expenses of the FDIC and any domestic deposit liabilities of the insolvent bank are paid off first.

If the solvent party were out-of-the-money, the FDIC would require the party first to pay in any amounts that such a party owed and would consider the solvent party to be a general creditor for any amounts owing to it by the insolvent depository institution.

Permitting the party to set-off any amounts owing to it by the insolvent depository institution that were not of the same preference would appear to violate the depositor preference provision. This is because an insolvent depository institution's obligation to a party with a low preference would be paid through application of the set-off prior to the other deposit liabilities with a higher preference being paid off. Effectively, the only opportunity to exercise a set-off right would appear to be a situation in which the solvent party that is out-of-the-money under the ISDA Master Agreement had insured deposits with the insolvent depository institution that would be paid by the FDIC.

6. Pre-Insolvency Payments

Paralleling parties' concerns under the Code, creditors of insolvent depository institutions worried that the FDIC might try to avoid certain payments made prior to the insolvency of the depository institution. FDIA, however, expressly provides that the pre-insolvency payments may not be avoided unless "the transferee had actual intent to hinder, delay, or defraud such instruction."¹³ However, prior to the 2005 Amendments, this provision did not explicitly state that it applied notwithstanding any other state or Federal law. This gave rise to arguments that provisions of the National Bank Act and state preference and fraudulent transfer laws could be applied by FDIC to avoid such transfers. Section 901(i) of the 2005 Amendments makes clear that the limitations on FDIC's avoidance powers in FDIA apply notwithstanding any other Federal or state law.¹⁴ Thus, payments made in the normal course of business under the ISDA Master Agreement should not be subject to any power of the FDIC to avoid and reclaim those payments.

¹³ 12 U.S.C. § 1821(e)(8)(C)(ii).

¹⁴ 12 U.S.C. § 1821(e)(8)(C)(i).

D. Automatic Early Termination Under FDIA

The ISDA Master Agreement provides that parties can elect to automatically terminate the ISDA Master Agreement upon the bankruptcy or insolvency of a counterparty. The election is made by designating in the Schedule to the ISDA Master Agreement that Automatic Early Termination applies. In the past, parties agreed to Automatic Early Termination because they were concerned that the automatic stay or similar restrictions in the bankrupt or insolvent counterparty's jurisdiction would preclude a party from terminating the ISDA Master Agreement. The contractual provision specified that the ISDA Master Agreement would be deemed to terminate immediately prior to the institution of bankruptcy or insolvency proceedings.

Today, however, many of the concerns that motivated parties to elect Automatic Early Termination no longer exist due to the amendments made to FDIA by FIRREA. Now, there is a general presumption that parties should not elect Automatic Early Termination, at least for ISDA Master Agreements entered into with counterparties subject to FDIA. Solvent parties can now wait and choose the appropriate moment to terminate an ISDA Master Agreement with an insolvent depository institution, subject to the restrictions imposed by FIDA.

Choosing Automatic Early Termination might now actually be undesirable. Although Automatic Early Termination deems the ISDA Master Agreement to be terminated upon a bankruptcy or insolvency filing, it does not necessarily mean that the solvent counterparty will be aware of the filing. In such situations, it may be several weeks or longer before the solvent party is aware that the ISDA Master Agreement and any underlying transactions that it had with its now bankrupt or insolvent counterparty were terminated earlier. This could result in important hedges being terminated at the time of the bankruptcy or insolvency without the solvent party knowing that the hedges should be replaced. During this period of delay, the cost of replacement could increase due to change in market conditions.

Even if the solvent party knows of the bankruptcy or insolvency and acts to replace the terminated transactions that it had entered into with the bankrupt or insolvent counterparty, it may discover that a bankruptcy trustee, receiver or conservator may refuse to enforce the automatic termination provision. It may refuse to do so even if the solvent party has already entered into new hedge agreements to replace those that it believed had been automatically terminated. Thus, the solvent counterparty may end up with two outstanding transactions, the original

transaction (that the trustee or receiver refused to terminate), and the replacement transaction.

A U.S. party dealing with certain counterparties not subject to the Code or FDIA should be aware that Automatic Early Termination may still be an important option. Many foreign jurisdictions and certain U.S. insolvency regimes have not made the same amendments and changes to their insolvency and bankruptcy rules as have been made under the Code and FDIA. Automatic Early Termination may still be worth electing with those classes of counterparties.

Parties dealing with counterparties not subject to the Code or FDIA should seek legal counsel as to the effect that the relevant foreign or domestic insolvency regime would have on a party's right to terminate the ISDA Master Agreement or to exercise its close-out netting rights. Some attorneys continue to opine that electing Automatic Early Termination is important when entering into an ISDA Master Agreement with these counterparties.

E. Walkaway Clauses

The 2005 Amendments provide that “walkaway clauses,” i.e., First Method under the ISDA Master Agreement, are unenforceable under FDIA.¹⁵ The 2006 Amendments further refined the 2005 Amendments to provide for the suspension of any payment or delivery obligations under any walkaway clause from the time a receiver is appointed for a depository institution until either (i) the time such depository institution's counterparty receives notice of a transfer of the QFC by the FDIC, or (ii) 5:00 p.m. (eastern time) of the business day following the date of the appointment of the receiver.¹⁶ The 2006 Amendments also modified the definition of walkaway clauses. Such clauses now are defined as any provision in a QFC that suspends, conditions, or extinguishes a payment obligation of a party, in whole or in part, or does not create a payment obligation of a party that would otherwise exist, solely because of such party's status as a non-defaulting party in connection with the insolvency of an insured depository institution that is party to the contract or the appointment of or the exercise of rights or powers by a conservator or receiver of such depository institution, *and not as a result of a party's exercise of any right to offset, setoff, or net obligations that exist under the contract, any other contract between those parties, or applicable law* [emphasis added]. This new language added by the 2006 Amendments makes it clear that exercise of general rights of offset, setoff or netting should not be considered de facto walkaway clauses. The 2005

¹⁵ 12. U.S.C. § 1821(e)(8)(G).

¹⁶ *Id.*

Amendments also provide that walkway clauses in QFCs under FDIA are excluded from the protections for netting contracts under FDICIA.

F. Exemption from Contemporaneous Execution Requirement

FDIA renders certain inadequately documented contracts unenforceable, i.e., the so-called “D’Oench, Duhme doctrine.”¹⁷ One of the requirements to have a properly documented security interest under this doctrine is that the security document must be executed contemporaneously with the acquisition of the collateral. This has caused uncertainty with respect to the enforcement of a security arrangement under the Credit Support Annex of the ISDA Master Agreement, since these arrangements are often entered into before, or after, the collateral has been acquired. The 2005 Amendments provide by statute, what had previously been addressed by FDIC policy statement. Now, a QFC is exempt from the contemporaneous execution requirement with respect to any pledge, delivery or substitution of collateral made under such QFC.¹⁸

G. FDICIA

Although many of the concerns involving swap agreements and the insolvency or bankruptcy of a counterparty subject to the Code or FDIA were resolved, Congress was still concerned that there were situations in which a party could be prevented from exercising its close-out netting rights upon the insolvency of its counterparty. A party could be restrained from exercising such rights if neither the Code nor FDIA applied to the insolvent or bankrupt counterparty, or if the particular outstanding OTC derivative did not meet the applicable definition of a swap agreement under the Code or FDIA.

1. Definition of Financial Institution

Congress minimized these risks by enacting FDICIA, which enforces and protects the close-out netting provisions found in the ISDA Master Agreement between “financial institutions.”¹⁹ In enacting FDICIA, Congress also provided that FDICIA expressly preempts any other statute, stay or court order to the contrary (12 U.S.C. §§ 4401-4407). As described above, this broad language gave rise to interpretative questions regarding the interplay of FDIA and FDICIA that were resolved only with the 2005 Amendments.

¹⁷ 12. U.S.C. § 1823(e).

¹⁸ 12. U.S.C. § 1823(e)(2).

¹⁹ The 2006 Amendments made it clear that the rights to terminate, liquidate and accelerate under a covered contract are also protected along with the general right to “net” payments.

The definition of financial institution under FDICIA is much broader than the corresponding definition of depository institution under FDIA. The definition of a depository institution is generally limited to a financial institution that accepts federally insured deposits. In contrast, a financial institution for FDICIA purposes is defined to include “a broker or dealer, a depository financial institution, a futures commission merchant, or any other financial institution as determined by the Board of Governors of the Federal Reserve System” (12 U.S.C. § 4402(9)). Section 906(a) of the 2005 Amendments broadened this definition further to include certain non-FDIC insured banks and foreign banks, including its branches and agencies, on a combined basis.

The Federal Reserve Board has set forth in Regulation EE what other parties are to be treated as a financial institution under FDICIA (12 CFR Part 231). Under Regulation EE, a party will be considered a financial institution for purposes of FDICIA if it meets both a qualitative and a quantitative test.

The qualitative test requires that a party “engage in financial contracts as a counterparty on both sides in one or more financial markets.” The test is used to identify entities that have trading activities and characteristics more similar to a dealer than to a typical enduser that only hedges its business and market risks on one side of the market.

The quantitative test measures a party’s level of activity in the financial markets. A party meets the test if it has entered into financial contracts totaling at least \$1 billion in outstanding notional principal amount. Alternatively, it will meet the test if it can establish that it has financial contracts with gross mark-to-market positions of at least \$100 million. Financial contracts include securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements, and any similar agreement as defined in FDIA.²⁰

Parties to an ISDA Master Agreement typically require a representation from each other to determine if they meet the definition of a financial institution under FDICIA. It is important to remember that both parties must meet the definition of a financial institution under FDICIA in order for FDICIA to be applicable.

2. Elimination of U.S. Law Requirement

The 2005 Amendments makes FDICIA applicable to netting contracts governed by non-U.S. law.²¹ Before, only netting contracts governed by U.S. law were eligible for such protection.

²⁰ 12 U.S.C. § 1821 (e)(8)(D)(i).

²¹ 12 U.S.C. § 4402(14).

3. Security Agreements and Credit Enhancements Included

The 2005 Amendments expressly provide that security agreements and forms of credit enhancement relating to a netting contract are protected to the same extent as the netting contract itself.²²

²² 12. U.S.C. §§ 4403(f), 4404(h).

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