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SURVEY OF THE LEGAL LANDSCAPE
APPLICABLE TO MASTER NETTING AGREEMENTS



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SURVEY OF THE LEGAL LANDSCAPE APPLICABLE TO MASTER NETTING AGREEMENTS

INTRODUCTION

The principal benefit of netting of payment obligations between two parties is risk reduction. This benefit has value to the individual participants, but risk reduction through netting also benefits the financial and derivative markets as a whole. The ability to terminate, setoff and net exposures under certain types of market-sensitive agreements reduces systemic risk. Setoff has a basis in common law, but the statutory measures that have been adopted to implement this policy objective significantly expand the circumstances in which setoff and netting is permitted by addressing the ability to setoff if a counterparty is bankrupt or in receivership.

The progenitor of such statutory measures is found in the U.S. Bankruptcy Code (the “Code”). The safe harbors under the Code permit a party to close out and setoff payments due under certain types of market-sensitive contracts in accordance with their terms in the event of a counterparty’s bankruptcy, notwithstanding the automatic stay that would otherwise be applicable. Absent such safe harbors, a party would not be able to unilaterally close out its market-sensitive contracts with a bankrupt counterparty, with the risk of unrecoverable losses and the potential for a domino chain of bankruptcies and receiverships affecting other commercial and financial institutions participating in the market. Subsequent statutory measures expanded the reach of these concepts from bankruptcy-eligible entities to insured depository institutions and also addressed netting between financial institutions generally. Currently proposed amendments to these provisions would further enhance netting of exposures arising under market-sensitive contracts. By enhancing the ability of market participants to reduce their risk to each other, netting reduces the systemic risk that the failure of one market participant will trigger other failures resulting in a domino effect on other institutions and disruption of the financial and derivative markets.

This memorandum focuses on the issues that affect the enforceability of master netting agreements. If there is legal certainty that a master netting agreement is enforceable, there are ongoing benefits (which may include net collateral posting requirements and, in the case of regulated entities, reduced capital charge requirements) which are premised on the conclusion that, in the event of a counterparty default or the bankruptcy or receivership of a counterparty, a party will be able to exercise the contractual remedies provided in the master netting agreement. As discussed herein, this may or may not be the case, depending on the type of entity that is the counterparty, the financial products that are subject to the master netting agreement, and the contractual remedies provided in the master netting agreement.

This memorandum and, in particular, Part I hereof which addresses selected issues that arise under the EEI Master Netting, Setoff, Security, and Collateral Agreement (the “EEI Master Netting Agreement”), should be read in conjunction with the User’s Guide to the EEI Master Netting Agreement (the “User’s Guide”). While this memorandum identifies and discusses certain legal issues that arise under master netting agreements generally and the EEI Master Netting Agreement specifically, the EEI Master Netting Agreement and the User’s Guide should

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be consulted to determine what approach the EEI Master Netting Agreement takes with respect to these issues.

This memorandum is comprised of four parts. Part I discusses selected issues that arise under the EEI Master Netting Agreement, including the security interest option, use of the Collateral Annex, and preservation of rights of setoff under underlying master agreements. Part II describes a basic master netting agreement and discusses netting at common law. Part III provides an overview of the safe harbors under the Code, the safe harbors under the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (“FIRREA”), netting between financial institutions under the FDIC Improvement Act of 1991 (“FDICIA”), and the proposed amendments to these provisions contained in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2002. Part IV describes more complex netting agreements and the issues they present, including cross-affiliate netting and cross-product netting involving non-safe harbored contracts.

This memorandum is intended to provide non-lawyers and lawyers who are not specialists in this area with a survey of relevant legal issues that will be useful when consulting one’s own counsel, but it does not constitute legal advice or a legal opinion. It is not intended to create, and receipt does not constitute, an attorney-client relationship. This memorandum provides general information and is intended to be used for informational purposes only. It is not intended as a comprehensive treatment of the issues mentioned, nor is it a substitute for legal advice. Parties contemplating entering into a master netting agreement are strongly urged to consult with their own counsel.

This memorandum also does not purport and should not be considered to provide an explanation of all relevant issues or considerations in a particular transaction or groups of transactions, or contractual relationship. Parties should consult with their own legal advisors and any other advisor they deem appropriate with respect to the EEI Master Netting Agreement. Neither Edison Electric Institute (“EEI”) nor any person involved in the preparation of this memorandum assumes any responsibility for any use of this memorandum, the EEI Master Netting Agreement, any related documentation, or the User’s Guide.

This memorandum was prepared in connection with the EEI Master Netting Agreement. Neither EEI nor NEM nor any member company nor any of their respective agents, representatives or attorneys shall be responsible for its use, or any damages resulting therefrom.

PART I: SELECTED EEI MASTER NETTING AGREEMENT ISSUES

This part of the memorandum discusses selected issues that are relevant to the EEI Master Netting Agreement. Market participants should also consult the User’s Guide with respect to the provisions of the EEI Master Netting Agreement under which these issues arise. In addition, as mentioned above, each market participant should consult with its own legal counsel to determine how such issues affect a market participant’s use of the EEI Master Netting Agreement. Throughout this memorandum, a master netting agreement is referred to as an “MNA” and the underlying master agreements subject to an MNA are referred to as “UMAs.”

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A. *Necessity to Review UMAs*

One general approach to MNAs is to disturb the UMAs as little as possible while linking the UMAs into one single agreement. At the other end of the spectrum, another approach is to update and conform where applicable all UMAs to a “state of the art” list of representations, events of default, and other provisions. It may seem that the former approach requires less review of the UMAs, but one consequence of the “single agreement” provisions typical to any master agreement, including an MNA, is the need to assure that the entire agreement does not have internal inconsistencies that undermine its purpose. For example, declarations of default, timing of calculations and payments of damages are among the provisions that should be considered in connection with the MNA Default Options, Remedies Options, Settlement Amount Options and other options under the EEI Master Netting Agreement. For this reason, all underlying UMAs should be reviewed carefully when an MNA is negotiated so that any inconsistencies can be detected and addressed as necessary or appropriate. Whether one uses the negotiation of an MNA to address broader changes in documentation of the contractual relationship between the parties is a matter for the parties to determine, but, in any event, a thorough review of the existing UMAs should be undertaken in connection with the negotiation of an MNA.

B. *Single Agreement*

The purpose of the “single agreement” language in an agreement such as the EEI Master Agreement is to integrate the contractual relationship in a way that protects the underlying transactions from being individually assumed or rejected by a bankruptcy trustee, receiver or conservator. Such “single agreement” language is generally relied upon to prevent the occurrence of such “cherry-picking.” Such provisions can also be useful under current law to bring collateral arrangements into the same agreement as the operative transactional documentation.¹

C. *Security Interest Option*

A grant of a security interest in a party’s receivables under the UMAs and the MNA (collectively, the “UMA/MNA Receivables”) is included in Section 5(i) of the EEI Master Netting Agreement. The security interest applies unless the parties exercise the Security Interest Deletion Option. Parties may, by including this security interest language in their MNA, enhance their level of comfort that cross-product netting thereunder is enforceable in the event that their counterparty declares bankruptcy.² In addition, some practitioners believe that such security interest language protects against the possibility that a third-party creditor with a

¹ See *infra* I.E.

² Some practitioners believe that such a security interest enhances the enforceability of cross-product netting in the bankruptcy context because the net receivable in respect of an agreement that is within one of the Code safe harbors is pledged as collateral for amounts due under a different agreement that is within a different Code safe harbor. While this approach may enhance the enforceability of cross-product netting in the bankruptcy context, a number of practitioners take the view that it is not a requirement in order to make cross-product netting enforceable in the bankruptcy context. For a discussion of cross-product netting, see *infra* III.B.5.

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security interest in such UMA/MNA Receivables could trump the intended setoff rights of the parties under the MNA.

Parties who do not intend to opt out of the security interest language should conduct appropriate due diligence to confirm that the grant and existence of such security interest does not conflict with any applicable audit or financing agreements, and particularly verify that there is no conflict with any prior pledges or negative pledge covenants. If the security interest is applicable, parties may also wish to file UCC financing statements and conduct a UCC search to determine if there are other financing statements on file indicating that a third party creditor claims a security interest in the UMA/MNA Receivables. Parties should also be aware of the representation and warranty set forth in Section 10(b) of the EEI Master Netting Agreement which confirms that a party has not granted any other security interest in its UMA/MNA Receivables. As with the Security Interest Deletion Option, the parties must “opt out” of this representation in order for it not to apply.

Some participants may be concerned that such a security interest is incompatible with an existing security interest arrangement with respect to receivables under some or all of the UMAs. To the extent a party’s receivables under the UMAs that are governed by the EEI Master Netting Agreement are subject to a security interest in favor of a third party which is not expressly subject and subordinate to the rights of netting and setoff set forth in the EEI Master Netting Agreement, there is arguably a conflict between the express terms of the EEI Master Netting Agreement and any such existing security interest arrangement. Section 18(b) of the EEI Master Netting Agreement provides that the relevant agreements and the rights to amounts payable thereunder may not be assigned or transferred by a party without the prior written consent of its counterparty, subject to certain exceptions. One such exception is an assignment as collateral security so long as such assignment is expressly subject and subordinate to the EEI Master Netting Agreement and rights of netting and setoff set forth therein. Thus, if the security interest granted is not within an exception, it would arguably violate the EEI Master Netting Agreement. Such a violation could be considered a breach of a representation under the EEI Master Netting Agreement and therefore constitute an event of default under the EEI Master Netting Agreement.

However, some practitioners faced with existing security arrangements with respect to a party’s receivables under UMAs take the view that the anti-assignment provision of Section 18(b) of the EEI Master Netting Agreement may not be enforceable to the extent it purports to restrict certain transfers of such receivables, including assignment of such receivables as collateral security. Under this view, an existing security interest in such receivables in favor of a third party creditor would continue unimpaired, but the value that such a creditor would be able to realize would be subject to the netting and setoff provisions of the EEI Master Netting Agreement.³

In addition, some practitioners may make the argument that Section 18(b) applies to prospective assignments of UMA/MNA Receivables but does not affect a security interest in receivables under one or more UMAs granted prior to the execution and delivery of the EEI Master Netting

³ Under this analysis, the EEI Master Netting Agreement would be viewed as a modification of an assigned contract under UCC 9-405, which subjects the third party creditor to modifications to the contract between the party and the counterparty out of which the receivables arise. *See also Commerce Bank, N.A. v. Chrysler Realty Corporation*, 76 F. Supp. 2d 1113 (D. Kansas 1999), *reversed*, 244 F.3d 777 (10th Cir. 2001).

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Agreement. If so, there would be a further question as to the value of the third party security interest and whether such security interest was diminished by any potential setoff.

Parties who opt out of the security interest language, either because of an existing security interest arrangement or a negative pledge covenant with respect to one or more UMAs, should also take note of the Negative Encumbrance Option in Section 11(b) of the EEI Master Netting Agreement. Section 11(b) acts as a “negative pledge” clause with respect to a party’s UMA/MNA Receivables. If this option is selected by the parties, then each party covenants that it will not grant a security interest in its UMA/MNA Receivables. Users may wish to couple such a covenant with a representation that no such security interest exists as of the date of the EEI Master Netting Agreement and a UCC search. The representation contained in Section 10(b) could be used for this purpose, but the parties may wish the representation to be more comprehensive in this circumstance, and therefore may wish to delete from such representation the security interest in UMA/MNA Receivables permitted by Section 18(b).

Because of the complexity of these issues, parties to the EEI Master Netting Agreement may wish to determine what position their counterparty takes with respect to the existence and intended priority of any security interests relating to the UMA/MNA Receivables and conduct a UCC search as part of their due diligence process.

D. FDICIA Representations

The FDICIA Representation Option in Section 10(a) of the EEI Master Netting Agreement is relevant for a party that is a “financial institution” as defined in FDICIA, and desires to rely on the netting provisions of FDICIA. As discussed below, such netting is only available if both parties are “financial institutions”. Because FDICIA provides that “financial institutions” can net payment obligations but does not impose the requirement that such payment obligations arise out of the same type of transaction, cross-product netting issues generally do not arise under FDICIA (subject, however, to the caveat that there are certain related issues that do arise under FDICIA).⁴

E. Use of Collateral Annex

Whether to use the Collateral Annex depends on whether, as a credit matter, the parties intend to post collateral and treat their credit exposure on an aggregate “net exposure” basis across all UMAs that are covered by the EEI Master Netting Agreement and therefore modify collateral arrangements established pursuant to multiple UMAs. Parties that intend to establish a credit relationship on an aggregate “net exposure” basis should consider the Collateral Annex. The benefits of collateralizing on an aggregate “net exposure” basis include increased liquidity and, in general, the potential for a more active trading relationship. Parties wishing to use the Collateral Annex should consider the level of comfort they have with respect to the legal risks of aggregate collateralization, *i.e.* the enforceability of posting collateral or margin on a net basis. In this regard, parties should also consider the effects of Section 23(c) of the EEI Master Netting Agreement which would reinstate thresholds and collateral requirements as set forth in the UMAs if netting of collateral under the Collateral Annex is invalid.

⁴ For a discussion of FDICIA, *see infra* III.D.

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Prior to entering into a Collateral Annex, a practical point to consider is whether the systems, back office and operational capabilities of each party are sufficiently integrated to insure the smooth functioning of the Collateral Annex. In some cases, parties may find that different product areas use different systems. Consequently, parties may discover that determining the net, aggregate exposure between them may require that manual systems be put in place. Another practical point to consider is a review of the existing credit and collateral documents to determine if, for example, a parent guarantee should be amended to take note of the EEI Master Netting Agreement.

The EEI Master Netting Agreement may also be used on a more limited basis without the Collateral Annex. A benefit intended to be achieved under an MNA is the ability to cross default all UMAs that are covered by the MNA and to enhance setoff of termination payments in case of an early termination. By having these rights in an MNA, a non-defaulting party can avoid having to make a payment to a bankrupt defaulting counterparty at a time when a payment is due from a bankrupt defaulting counterparty⁵ even if the parties do not intend to post collateral on a net basis.

To the extent parties desire to enter into the EEI Master Netting Agreement without the Collateral Annex, the parties should consider whether the collateral agreements entered into with respect to the UMAs should be modified. Each party should consider whether each UMA with respect to which a net receivable could be said to arise (following setoff under the MNA) has an appropriate collateral posting requirement. In addition, parties may wish to consider taking a security interest in receivables under UMAs to enhance cross-product netting.⁶

F. Preservation of Rights of Setoff Under UMAs

The EEI Master Netting Agreement contemplates the preservation of such setoff rights as may exist under the UMAs.⁷ Such setoff rights may include not only payment netting and termination netting with respect to the transactions subject to such UMA, but may also include a broad right to setoff with respect to other agreements between the parties or their affiliates.

In general, one would expect a party to an MNA to make some or all of its safe-harbored contracts with a counterparty subject to the MNA. To the extent an MNA contemplates rights of setoff with respect to other agreements that are not specifically identified as UMAs, it raises issues under the MNA. Such preserved rights of setoff also raise issues to the extent they involve affiliates of the parties.

To the extent these preserved rights of setoff also include non-safe-harbored contracts under an MNA, it raises the question of how the MNA treats these two categories of agreements in the event of a counterparty bankruptcy or receivership, since a party's rights with respect to such contracts would be drastically different depending on whether or not the contracts are safe-harbored.

⁵ See *infra* II.A.

⁶ For a discussion of cross-product netting, see *infra* III.B.5.

⁷ See Section 6(b) of the EEI Master Netting Agreement.

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At least one industry group has restricted its form MNA exclusively to safe-harbored contracts, and has provided that if there is a net payment due following application of the termination, liquidation and setoff provisions thereof, such payment shall be made without regard to whether or not there are non-safe-harbored agreements between the parties where amounts may be due and owing.

Some practitioners have criticized this result and have suggested that, while only safe-harbored contracts may be terminated, liquidated and setoff, following a setoff of all amounts owing under safe-harbored contracts, if there remains a payment due to a counterparty/debtor and there is a non-safe-harbored contract between the parties pursuant to which there is a debt owed by the counterparty/debtor, then the party should not immediately remit a payment to the counterparty/debtor but should retain such right of setoff, albeit subject to stay and other potential impairment arising under the Code or other applicable law. If a party has such a right of setoff with respect to non-safe-harbored contracts, the party would be treated essentially as a secured creditor with respect to the amount it is withholding subject to setoff.

To the extent that an MNA contemplates rights of setoff with respect to other agreements that are not expressly identified as subject to the MNA, it raises additional questions with respect to ongoing valuation determinations under the MNA. For example, one may question whether the aggregate exposure of the parties does or does not taking into account such other agreements. More significantly, it also raises question about the sequence and mechanics of arriving at a settlement amount.

G. Remedies

Some practitioners question the enforceability of provisions that permit cherry-picking in the context of an integrated agreement that is treated as a single exposure. Parties should determine whether any of the UMAs they intend to make subject to the EEI Master Netting Agreement contain provisions that permit cherry-picking. Such provisions, which permit the non-defaulting party the option to close-out of some but not all underlying transactions, have been encountered in older agreements. To the extent such provisions exist under a UMA, parties may wish to consider whether they intend to preserve such rights.

Parties should consult the User's Guide for a discussion of the selection of Remedies Options.

H. Suspension

The EEI Master Netting Agreement permits a party to suspend performance based upon a counterparty's default or nonperformance. Users should consult with counsel regarding whether this remedy is consistent with the scope of the Code safe harbors. Some practitioners may take the view that, because the safe harbors limit the remedy that is exempt from the automatic stay to the termination, collateral liquidation, and setoff of amounts under safe-harbored contracts, suspension is a remedy that is not covered by the safe harbors, and therefore is a potential violation of the automatic stay.

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PART II: BASIC MASTER NETTING AGREEMENTS, TERMINOLOGY, AND COMMON LAW

A. Basic Master Netting Agreements and Terminology

An MNA is an agreement to net exposures under two or more agreements between the same two parties. In other words, a party to an MNA puts in place an agreement so that it will not be required to pay the counterparty more than the excess, if any, of (x) the party's obligations to the counterparty under the specified documents over (y) the counterparty's obligations to the party under the specified documents. Such netting may be effected with respect to periodic payments ("Payment Netting") or settlement payments following the occurrence of an event of default ("Close-Out Netting").

Perhaps the most common example of Payment Netting is the netting by the parties to an ISDA or other form of master agreement of the gross payments due in respect of the notional amount of a particular transaction. This is so routine and well understood that at first it may not seem like netting at all, but once considered it clearly is a form of netting and has obvious benefits of risk reduction and administrative convenience. Payment Netting also includes netting of payments due on the same day in the same currency but arising out of different transactions under the same master agreement. Close-Out Netting, also a mainstay of ISDA and other master agreements, is an ability to net the settlement payments of all terminated transactions documented under a single master agreement to arrive at a single payment to be either received or paid. Also relevant in certain markets is netting by novation, in which parties enter into subsequent transactions which have the effect of a termination or partial termination of an existing transaction ("Transaction Netting"). Netting also arises where two parties agree to consider their credit exposure on an aggregate basis across more than one agreement or product lines and agree to post margin on a net basis ("Margin Netting").

The underlying agreements that are subject to a master netting agreement are generally themselves master agreements that provide for netting of exposures among multiple transactions which are explicitly subject to the terms of a specified underlying master agreement. Each UMA will govern the relationship of the parties in respect of a specific category of transaction, such as, for example, commodity price swaps documented under an ISDA form of master agreement or contracts for the physical delivery of power documented under an EEI Master Power Purchase & Sale Agreement. These UMAs, in the most basic netting arrangement, are limited to transactions that are within the safe-harbored contracts discussed below. The issues that arise where master netting agreements address both safe-harbored and non-safe-harbored contracts are discussed in Part IV below.

B. Netting and Setoff at Common Law

Netting is contemplated by contract in the UMAs, but it has a basis in the common law right of setoff. In general, common law setoff requires that the debts proposed to be setoff exist between the same two parties, each of whom is acting in the same capacity in both transactions out of which such debts arose. The debts may arise out of the same transaction or different transactions as long as there is mutuality of parties. Mutuality is present when the obligations to be setoff

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against each other are (i) between the same parties,⁸ (ii) who are standing in the same right, and (iii) in the same capacity. Thus “mutuality” is lacking if, for example, a party is acting as principal in one transaction and as agent in another. If a party assigns a claim prior to setoff, there are questions as to whether the non-assigning party’s rights to setoff should be limited as a result of such assignment or whether the non-assigning party will be obligated to pay the assignee without setoff. In general, the debts must be currently due and owing.

The terms “netting” and “setoff” are generally synonymous concepts and are used interchangeably in this memorandum. Recoupment is a related but different concept. Although both recoupment and setoff involve the netting of mutual obligations, in recoupment the mutual debts and claims must arise out of the same transaction. There are two tests for whether the same transaction requirement is met. Some courts apply a “logical relationship” test (whether the two obligations have a logical relationship to each other), but other courts apply a more restrictive “integrated transaction” test. Under the integrated transaction test, even obligations arising under a single contract may not qualify if the court concludes that they arise from multiple transactions under the contract. Recoupment would arise, for example, if a debtor were seeking payment from a party, and that same party had previously overpaid the debtor in the same transaction. In such a circumstance, the party could interpose recoupment as a defense. Setoff is subject to the automatic stay in bankruptcy, but recoupment is not. However, exceptions to the automatic stay generally are narrowly construed.

PART III: STATUTORY SAFE HARBORS AND SUPPORT FOR NETTING

A. Netting and Bankruptcy

The enforceability of netting outside of proceedings involving the bankruptcy or receivership of the counterparty is certainly relevant, but the litmus test for whether or not a party will be able to exercise the contractual remedies provided in a UMA or, in turn, under an MNA, is whether the party will be able to do so in the event a counterparty becomes subject to bankruptcy or receivership proceedings. If a counterparty has insufficient funds to pay its debts, not all creditors will receive full payment. In such a situation, netting can enable a party to recover full payment of amounts due to it to the extent of payments owed by the counterparty to the party.

Although bankruptcy and receivership regimes vary significantly in their particulars, they generally share the following relevant impairments of creditors’ rights: (i) a stay (whether automatic or obtained by injunction) which suspends a creditor’s ability to exercise remedies; (ii) an ability to assume or reject executory contracts, which may enable a debtor or its successor-in-interest to “cherry-pick” and assume favorable contracts while rejecting unfavorable ones; (iii) a rescission of transfers deemed to be a preference because they meet certain technical requirements or, more generally, because they are viewed as inequitably preferring one creditor at the expense of others (and setoff and netting can be particularly vulnerable to such a charge⁹); (iv) a rescission of transfers deemed to be a fraudulent

⁸ Because of this mutuality requirement, netting involving affiliates (whether on one side as in triangular netting or on both sides as in square netting) raises additional issues. *See infra* IV.B.

⁹ Setoff, by its very nature, permits a creditor to receive full value for its claims against a debtor (albeit only to the extent the creditor owes payments to the debtor) at a point in time when other creditors may receive less than full value. For this reason, courts have expressed the view that setoff is a “preference.”

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conveyance, which generally means either transfers made with a fraudulent intent or transfers made while the debtor was insolvent for which it did not receive reasonably equivalent value; and (v) a nullification of an event of default or termination premised solely on the bankruptcy, receivership or conservatorship of the counterparty (generally referred to as “*ipso facto*” clauses).

These impairments may adversely affect the fundamental economic benefit of netting itself (for example through cherry-picking of favorable contracts or rescission of preferential transfers), or may adversely affect timing of netting due to a stay. Bankruptcy and receivership proceedings that offer protection from these impairments make it possible to conclude in the appropriate circumstances that a party would be entitled to exercise the contractual remedies provided in UMAs and an MNA, notwithstanding the bankruptcy or receivership of the counterparty.

The bankruptcy and receivership proceedings that would or could apply to a counterparty can require a technical and detailed analysis. Generally, the potentially applicable regimes can be identified based on what type of legal entity the counterparty is, whether it is domestic or foreign, and where its assets are located.

The U.S. Bankruptcy Code (the “Code”) applies to most types of U.S. entities, other than insurance companies, banks and thrifts, credit unions, certain municipalities, and pension plans. There are also significant nuances with respect to applicability of the Code to stockbrokers, commodity brokers, mutual funds, and business trusts, as well as to U.S. assets of an entity that is the subject of a foreign bankruptcy or receivership proceeding. Insurance companies are either rehabilitated or liquidated in accordance with state law proceedings. Pursuant to the Federal Deposit Insurance Act, the FDIC administers the receivership or conservatorship of FDIC-insured national and state-chartered banks and thrifts.

To the extent that a counterparty is eligible to be a debtor under the Code or is an FDIC-insured depository institution, there are similar safe harbors for the termination and setoff of obligations under certain market-sensitive contracts. The other significant statutory provision in this area is FDICIA which provides that, subject to certain limitations, netting agreements among financial institutions and clearing organizations will be enforceable notwithstanding bankruptcy or receivership.

This memorandum will not address bankruptcy or receivership proceedings other than the Code and the provisions of the FDIA relating to conservatorships and receiverships of insured depository institutions.

See, e.g., Baker v. Gold Seal Liquors, Inc., 417 U.S. 467 (1974) (overturning setoff authorized by district court under railroad reorganization when no statutory authority therefore existed). Although a creditor’s right to setoff under state law has been preserved under Section 553 of the Bankruptcy Code, and is treated in some respects like the rights of a secured creditor (*see* Section 506(a) of the Bankruptcy Code), it is subject to the automatic stay (*see* Section 362(a)(7) of the Bankruptcy Code). Granting relief from the automatic stay to permit setoff is considered an equitable matter in the court’s discretion. Once a creditor is subject to the equitable discretion of the court, the court may determine that a petitioning creditor should be denied the right of setoff. *See, e.g., In re Nielson*, 90 Bankr. 172, 175 (Bankr. W.D.N.C. 1988), *Blanton v. Prudential-Bache Securities, Inc. (In re Blanton)*, 105 Bankr. 321, 337-38 (Bankr. E.D. Va. 1989).

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B. U.S. Bankruptcy Code Safe Harbors

Under the Code there are safe harbors for the following contracts: swap agreements, securities contracts, commodities contracts, forward contracts, and repurchase agreements. However, the Code imposes certain requirements in order to qualify for these safe harbors, including limitations on the parties who may take advantage of the securities contract safe harbor (stockbroker, financial institution or securities clearing agency), and the commodity contract and forward contract safe harbor (commodity broker or forward contract merchant) in the event of a counterparty bankruptcy. There are similar limitations in the swap and repurchase agreement safe harbors, but these limitations are likely to be less constraining than in other safe harbors.

It is also noteworthy that the safe harbors literally provide an exception to the automatic stay and the other impairments of creditors rights discussed above (including preference and fraudulent conveyance). Thus, creditors will not be prevented from exercising whatever contractual rights they may have, but the Code does not confer any new rights on creditors. Some, but not all, of the safe harbors state that a creditor's "contractual rights" include rights arising outside the contract, such as normal business practices in the industry. However, the safe harbors do not validate provisions that are otherwise unenforceable.

Generally the structure of the safe harbors is that, in addition to the definitional requirements to qualify for a safe harbor, there are operative provisions which counteract the nullification of "*ipso facto*" contractual rights to terminate based on counterparty bankruptcy, permit exercise of such contractual rights notwithstanding the automatic stay, and provide that setoff of amounts under safe harbored contracts is not subject to the automatic stay and is not avoidable as a preference or constructive fraudulent conveyance. In this way, each step of the netting process is addressed and immunized from the generally applicable provisions of the Code that would otherwise impair a creditor's right to net such exposures. The precise application of these provisions to each step of the netting process forms the basis for legal arguments regarding the extent to which cross-product and cross-affiliate netting may be enforceable and in what circumstances.

Set forth below for each of the safe harbors is: (i) the definition of the type of agreement to which it applies; (ii) the operative provision that exempts the liquidation and termination of such agreements from stay based on counterparty bankruptcy; (iii) other relevant definitional provisions, including the types of parties entitled to take advantage of the safe harbor and the source of "contractual rights" to terminate safe-harbored contracts; (iv) the operative provisions that protect setoff of termination payments and certain collateral; and (v) the provisions that protect setoffs that comply with the foregoing from avoidance as a preference or constructive fraudulent conveyance.

There is a provision of the Code, Section 553, which preserves the right of setoff in bankruptcy. This provision does not permit a party to exercise setoff against a debtor, as it merely preserves the property right that a creditor has by virtue of setoff. Section 553 provides that a creditor does not lose this property right, but the ability to exercise this right against a debtor is specifically stayed by the automatic stay under Section 362 of the Code.

The safe harbors permit a creditor to exercise its contractual rights to terminate the contract notwithstanding bankruptcy and setoff the amount due upon termination against the liquidation

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proceeds of collateral. To the extent that a creditor has a right to terminate a contract under the safe harbors but chooses not to exercise that right, the creditor should be aware that the debtor generally will not be able to make any post-petition settlement payments or deliveries of collateral without the approval of the bankruptcy court. In addition, if a creditor chooses not to exercise its right to terminate a safe harbored contract for some period of time, a court could find that the creditor no longer is within the safe harbors since they were intended to protect parties to market-sensitive contracts, and thereby to prevent dislocation in the markets.

1. Swap Agreements

a. Definition

Section 101(53B) of the Code defines a “swap agreement” as:

(A) an agreement (including terms and conditions incorporated by reference therein) which is a rate swap agreement, basis swap, forward rate agreement, commodity swap, interest rate option, forward foreign exchange agreement, spot foreign exchange agreement, rate cap agreement, rate floor agreement, rate collar agreement, currency swap agreement, cross-currency rate swap agreement, currency option, any other similar agreement (including any option to enter into any of the foregoing); (B) any combination of the foregoing; or (C) a master agreement for any of the foregoing together with all supplements.

b. Liquidation and Termination

Under Section 560 of the Code, a swap participant’s contractual right to terminate a swap agreement upon the bankruptcy, insolvency or financial condition of the counterparty, or to setoff any termination values or payment amounts arising under or in connection with any swap agreement will not be stayed, avoided or otherwise limited by any provisions of the Code.¹⁰

A “swap participant” is broadly defined in Section 101(53C) to mean an entity¹¹ that, at any time before the filing of the petition, has an outstanding swap agreement with the debtor. It is not clear that a guarantor or the beneficiary of a guarantee would be viewed as a “swap participant” under this definition.

For purposes of the swap safe harbor, a “contractual right” includes a right, whether or not evidenced in writing, arising under common law, under law merchant, or by reason of normal business practice. The swap agreement safe harbor does not permit the inference of a contractual right to terminate a swap agreement from a rule of a bylaw or governing body having jurisdiction over swap agreements. The standard forms of ISDA master agreements provide that the bankruptcy of a counterparty is an event of default that gives rise to either an automatic early termination or the right of the non-defaulting party to effect an early termination, depending on how the parties have tailored their agreements.

¹⁰ Unlike the other Code safe-harbors, the setoff rights of swap participants are addressed in this termination provision as well as in Section 362.

¹¹ Section 101(15) of the Code defines “entity” to include a person, estate, trust, governmental unit and United States trustee.

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c. *Setoff and Collateral Liquidation*

Under Section 362(b)(17) of the Code, the automatic stay does not apply to the setoff by a swap participant of any mutual debt and claim under or in connection with any swap agreement. However, such setoff is limited to the setoff of (x) a claim against the debtor for any payment due from the debtor under or in connection with any swap agreement, against (y) any payment due to the debtor from the swap participant under or in connection with any swap agreement or against cash, securities or other property of the debtor held by or due from such swap participant to guarantee, secure or settle any swap agreement. Although the scope of this provision is broadened by the use of the phrases “in connection with” and “any payment” (whereas other safe harbors use the terms “margin payment” and “settlement payment”), there is no express statutory authority for the netting of swap payments on the one hand and payments under other safe-harbored contracts on the other hand.

However, such “cross-product netting” between and among safe harbored contracts can be supported by reasoned arguments, in particular, where the debtor/counterparty’s rights to payments due under each safe harbored contract secure the obligation of the debtor/counterparty to make payments due under all other safe harbored contracts. Where the safe-harbored receivables are pledged to support each other, legal counsel may conclude that such receivables are within the scope of the collateral protected by the safe harbors, and therefore the liquidation and application thereof would be protected as well.¹²

d. *Preference and Fraudulent Conveyance*

Section 546(g) of the Code protects transfers under a swap agreement by or to a swap participant in connection with a swap agreement from avoidance as a preference or fraudulent conveyance (unless the transaction is tainted by fraudulent intent). Some practitioners are of the view that collateral arrangements with respect to swap agreements should be drafted so that they form a part of the swap agreement so that there is no doubt that collateral transfers are “under” the swap agreement.¹³

Section 548 of the Code provides for the avoidance of any transfer that constitutes either of two types of fraudulent conveyance: (i) a transfer made with actual intent to hinder, delay or defraud creditors or (ii) certain specific definitional criteria that include the receipt by the debtor of less than reasonably equivalent value in exchange for what the debtor transfers. Section 548(d)(2)(D) of the Code provides that a swap participant that receives a transfer in connection with a swap agreement takes for value to the extent of such transfer. By defining “value” in this way, safe-harbored swap agreements are immune from attack as a fraudulent conveyance unless the transaction is tainted by fraudulent intent.

¹² See *infra* III.A.5. and IV.A.

¹³ It has been held that attachment of a counterparty’s assets is not a transfer “under” a swap agreement. See *Interbulk, Ltd. v. Louis Dreyfus Corp.*, 240 B.R. 195 (Bankr. S.D.N.Y. 1999)

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e. Summary

The effect of these provisions is that a party who is a swap participant may (i) exercise a right set forth in a swap agreement to terminate swaps entered into under such agreement based on the counterparty/debtor's bankruptcy; (ii) setoff the resulting termination values; and (iii) setoff collateral received under such agreement against amounts owed by the counterparty/debtor to such swap participant.

2. Securities Contract

a. Definition

Section 741(7) of the Code defines a "securities contract" as follows:

"securities contract" means contract for the purchase, sale, or loan of a security including an option for the purchase or sale of a security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any option entered into on a national securities exchange relating to foreign currencies or the guarantee of any settlement of cash or securities by or to a securities clearing agency.

b. Liquidation and Termination

Under Section 555 of the Code, the contractual right of a stockbroker,¹⁴ financial institution,¹⁵ or securities clearing agency¹⁶ to liquidate a securities contract will not be stayed, avoided or otherwise limited by any provision of the Code, unless, where the debtor is a stockbroker or securities clearing agency, such order is authorized under the SIPA or any statute administered by the SEC.

For purposes of the securities contract safe harbor, a "contractual right" includes a right set forth in a rule or bylaw of a national securities exchange, a national securities association, or a securities clearing agency.

c. Setoff and Collateral Liquidation

Under Section 362(b)(6) of the Code, the automatic stay does not apply to the setoff by a commodity broker, forward contract merchant, stockbroker, financial institution, or securities clearing agency of any mutual debt and claim under or in connection with commodity contracts, forward contracts or securities contracts that constitute the setoff of a claim against the debtor for

¹⁴ Under Section 101(53A) of the Code, a stockbroker is a person (A) with respect to which there is a customer, and (B) that is engaged in the business of effecting transactions in securities (i) for the account of others, or (ii) with members of the general public, from or for such person's account. "Customer" is defined in Section 741(2) of the Code.

¹⁵ Under Section 101(22) of the Code, a financial institution means a bank (including a receiver or conservator therefor) or an investment company.

¹⁶ Under Section 101(48) of the Code, a securities clearing agency means a person registered as such under the Securities Exchange Act (the "1934 Act") or whose business is confined to clearing exempted securities as defined in Section 3(a)(12) of the 1934 Act.

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a margin payment¹⁷ or a settlement payment¹⁸ arising out of commodity contracts, forward contracts, or securities contracts against cash, securities or other property held by or due from such commodity broker, forward contract merchant, stockbroker, financial institution or securities clearing agency to margin, secure, or settle commodity contracts, forward contracts or securities contracts.

The inclusion of commodity contracts, forward contracts and securities contracts in this provision has been viewed as express authority to net and setoff settlement payments and liquidated collateral within and among these three safe-harbored categories.

d. Preference and Fraudulent Conveyance

Section 546(e) of the Code protects transfers of margin or settlement payments made by or to a commodity broker, forward contract merchant, stockbroker, financial institution or securities clearing agency (unless the transaction is tainted by fraudulent intent).

Section 548(d)(2)(B) of the Code provides that a commodity broker, forward contract merchant, financial institution, or securities clearing agency that receives a margin payment or a settlement payment takes for value to the extent of such payment. Accordingly, as discussed above, margin payments and settlement payments under safe harbored securities contracts should not be subject to attack as a fraudulent conveyance unless the transaction is tainted by fraudulent intent.

e. Other Points, Summary

At least one court has held that a repurchase agreement with respect to a security which fails to qualify for treatment as a repurchase agreement under Section 559 of the Code may qualify as a securities contract under Section 555.¹⁹ However, the exercise of a contractual right to cause the liquidation of a repurchase agreement that involves commodities is a “forward contract” for purposes of the safe harbors.

The effect of these provisions is that a party who fits the requirements to take advantage of this safe harbor may (i) exercise a contractual right to terminate securities contracts entered into with a counterparty/debtor based on the counterparty/debtor’s bankruptcy and (ii) setoff any mutual debt and claim under securities contracts, commodity contracts and forward contracts against the

¹⁷ “Margin payment” means payment or deposit of cash, a security or other property that is commonly known in the securities, forward contract or commodities trade, as applicable, as original margin, initial margin, maintenance margin, or variation margin, including mark-to-market payments. With respect to securities contracts it includes property that secures an obligation to a participant in a securities clearing agency. *See* 11 U.S.C. 741(5) With respect to forward contracts it includes variation payments. *See* 11 U.S.C. 101(38) With respect to commodities contracts it includes settlement payments, variation payments, daily settlement payments and final settlement payments made as adjustments to settlement prices. *See* 11 U.S.C. 761(15).

¹⁸ “Settlement payment” means a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, a net settlement payment or, with respect to forward contracts it includes any other similar payment commonly used in the forward contract trade. *See* 11 U.S.C. 101(51A). With respect to securities contracts it includes any other similar payment commonly used in the securities trade. *See* 11 U.S.C. 741(8).

¹⁹ *See In re Residential Resources*, 88 B.R.2 (Bankr. D. Az. 1989).

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counterparty/debtor for a margin payment or settlement payment arising out of such contracts against cash, securities or other property held by or due from such party to margin, secure or settle such contracts.

3. *Commodities Contract and Forward Contract*

a. *Definition*

Section 101(25) of the Code defines a “forward contract” as:

a contract (other than a commodity contract) for the purchase, sale, or transfer of a commodity, as defined in the Commodity Exchange Act,²⁰ or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade, or product or byproduct thereof, with a maturity date more than two days after the date the contract is entered into, but not limited to, a repurchase transaction, reverse repurchase transaction, consignment, lease, swap, hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction, or any combination thereof or option thereon.

Section 761(4) defines “commodities contract” to mean:

- (A) with respect to a futures commission merchant, contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade;
- (B) with respect to a foreign futures commission merchant, foreign future;
- (C) with respect to a leverage transaction merchant, leverage transaction;
- (D) with respect to a clearing organization, contract for the purchase or sale of a commodity for future delivery on or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization, or commodity option traded on, or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization; or
- (E) with respect to a commodity options dealer, commodity option.

b. *Liquidation and Termination*

Under Section 556 of the Code, the contractual right of a commodity broker²¹ or forward contract merchant²² to liquidate a commodity contract or a forward contract upon the bankruptcy,

²⁰ See 11 U.S.C. 101(25) and 11 U.S.C. 762(8).

²¹ Under Section 101(6) of the Code, a “commodity broker” means a futures commission merchant, foreign futures commission merchant, clearing organization, leverage transaction merchant, or commodity options dealer, as defined in Section 761, with respect to which there is a customer, as defined in Section 761.

²² Under Section 101(26) of the Code, a “forward contract merchant” means a person whose business consists in whole or in part of entering into forward contracts as or with merchants in a commodity, as

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insolvency or financial condition of the counterparty, and the right to a variation or maintenance margin payment received from a trustee with respect to open commodity contracts or forward contracts, will not be stayed, avoided or otherwise limited by the Code.²³

For purposes of the commodities contract and forward contract safe harbors, a “contractual right” includes a right set forth in a rule or bylaw of a clearing organization or contract market or in a resolution of the governing board thereof and a right, whether or not evidenced in writing, arising under common law, under law merchant or by reason of normal business practice.

c. Setoff and Collateral Liquidation

Under the provision of Section 362(b)(6) referred to above,²⁴ setoff with respect to commodity contracts and forward contracts, including collateral, is protected. In addition, setoff between and among securities contracts, commodities contracts and forward contracts is permitted so long as all the definitional criteria are met.

d. Preference and Fraudulent Conveyance

Section 546(e) of the Code protects transfers of margin or settlement payments made by or to a commodities broker, forward contract merchant, stockbroker, financial institution or securities clearing agency (unless the transaction is tainted by fraudulent intent).

Section 548(d)(2)(B) of the Code provides that a commodity broker, forward contract merchant, stockbroker, financial institution, or securities clearing agency that receives a margin payment or settlement payment takes for value to the extent of such payment. Accordingly, as discussed above, margin payments and settlement payments under safe harbored commodities contracts and forward contracts should not be subject to attack as a fraudulent conveyance unless the transaction is tainted by fraudulent intent.

e. Summary

The effect of these provisions is that a party who fits the requirements to take advantage of this safe harbor may (i) exercise a contractual right to terminate commodities contracts and forward contracts based on the counterparty/debtor’s bankruptcy and (ii) setoff any mutual debts and claims under securities contracts, commodities contracts and forward contracts against the counterparty/debtor for a margin payment or settlement payment arising out of such contracts against cash, securities or other property held by or due from such party to margin, secure or settle such contracts.

defined in the Commodity Exchange Act (the “CEA”), or any similar good, article, service, right, or interest which presently or in the future becomes the subject of dealing in the forward contract trade.

²³ The right to liquidate a commodity contract is the right to close out an open position, but may not include the right to transfer collateral with respect thereto. *But see* Section 362(b)(6).

²⁴ *See supra* III.B.2.c.

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4. Repurchase Agreements

a. Definition

Section 101(47) of the Code defines “repurchase agreement” (which definition also applies to a reverse repurchase agreement) as:

an agreement, including related terms, which provides for the transfer of certificates of deposit, eligible bankers’ acceptances, or securities that are direct obligations of, or that are fully guaranteed as to principal and interest by, the U.S. or any agency of the U.S. against the transfer of funds by the transferee of such certificates of deposit, eligible bankers’ acceptances, or securities with a simultaneous agreement by such transferee to a transfer to the transferor thereof certificates of deposit, eligible bankers’ acceptances, or securities, as described above, at a date certain not later than one year after such transfers or on demand, against the transfer of funds.

b. Liquidation and Termination

Under Section 559 of the Code a repo participant’s contractual right to liquidate a repurchase agreement upon the bankruptcy, insolvency or financial condition of the counterparty will not be stayed, avoided or otherwise limited by the Code, unless, where the debtor is a stockbroker or a securities clearing agency, such order is authorized under SIPA or any statute administered by the SEC. Section 559 of the Code further provides that, in the event that a repo participant liquidates one or more repurchase agreements with a debtor and under the terms of one or more such agreements has agreed to deliver assets subject to repurchase agreements to the debtor, any excess of the market prices received on liquidation of such assets (or if any such assets are not disposed of on the date of liquidation of such repurchase agreements, at the prices available at the time of liquidation of such repurchase agreements from a generally recognized source or the most recent closing bid quotation from such a source) over the sum of the stated prices and all expenses in connection with the liquidation of such repurchase agreements shall be deemed property of the estate, subject to the available rights of setoff.

A “repo participant” is broadly defined in Section 101(46) to mean an entity²⁵ that, on any day during the period beginning 90 days before the date of the filing of the petition, has an outstanding repurchase agreement with the debtor.

For purposes of the repurchase agreement safe harbor, “contractual right” includes a right set forth in a rule or bylaw, applicable to each party to the repurchase agreement, of a national securities exchange, a national securities association, or a securities clearing agency, and a right, whether or not evidenced in writing arising under common law, under law merchant or by reason of normal business practice.

²⁵ See *supra* n. 11.

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c. Setoff and Collateral Liquidation

Under Section 362(b)(7) of the Code, the automatic stay does not apply to the setoff by a repo participant of any mutual debt and claim under or in connection with repurchase agreements that constitutes the setoff of a claim against the debtor for a margin payment or a settlement payment arising out of repurchase agreements against cash, securities or other property held by or due from such repo participant to margin, secure, or settle repurchase agreements.

d. Preference and Fraudulent Conveyance

Section 546(f) of the Code protects transfers of margin or settlement payments made by or to a repo participant, in connection with a repurchase agreement (unless the transaction is tainted by fraudulent intent).

Section 548(d)(2)(C) provides that a repo participant that receives a margin payment or settlement payment in connection with a repurchase agreement takes for value to the extent of such payment. Accordingly, as discussed above, margin payments and settlement payments under safe harbored repurchase agreements should not be subject to attack as a fraudulent conveyance unless the transaction is tainted by fraudulent intent.

e. Summary

The effect of these provisions is that a party who is a repo participant may (i) exercise a contractual right to terminate repurchase agreements entered into with a counterparty/debtor based on the counterparty/debtor's bankruptcy and (ii) setoff any mutual debt and claim under or in connection with repurchase agreements for margin payment or a settlement payment arising out of repurchase agreements against cash, securities or other property held by or due from such repo participant to margin, secure or settle repurchase agreements.

5. Cross-Product Netting within Safe Harbors and Cross-Collateralization

As discussed above, there is express authority to net between and among the securities contract, commodities contract and forward contract safe harbors, to the extent all other requirements are satisfied. The plain language of Section 362(b)(6) supports this conclusion.²⁶ Under Section 362(b)(6), a party is permitted to setoff claims against the counterparty/debtor for margin payments and settlement payments in respect of securities contracts, forward contracts and commodity contracts. However, some practitioners have noted that there is no express authority to net safe-harbored contracts beyond these three categories. Notwithstanding the express statutory authority to net between and among securities contracts, commodities contracts and forward contracts, in order to take advantage of the netting expressly provided for, a party would have to conduct these businesses in the same legal entity (*e.g.*, an FCM that was also licensed as a broker-dealer). If a party conducts its securities, commodities and forward contract businesses in the same legal entity and the other safe harbor criteria are met, a party could apply the express

²⁶ The legislative history also supports this view of Section 362(b)(6). The enactment of Section 362(b)(6) was "intended to minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries", and "to protect against such a ripple effect." H.R. Rep. No. 97-420, *reprinted in* 1982 U.S. Code Cong. & Admin. News 583.

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statutory authority summarized above and net the exposures under all three products down to one exposure.

Some practitioners also have suggested that if a counterparty pledges its rights to receive payment under all safe-harbored agreements as collateral for its obligations to make payments thereunder, then the net receivable payable to the counterparty under any such agreement would be collateral for payments due under other such agreements. Such an agreement would provide for the grant to a party of an interest in each and every asset held by it, including the proceeds of the liquidation of any safe-harbored contract, to margin, guaranty, secure or settle each and every underlying safe-harbored contract.

Each of the provisions of Section 362(b) relating to the setoff of obligations in respect of the safe-harbored contracts provides that setoff is permitted (i) by a party that meets certain criteria, (ii) with respect to a mutual debt owed in respect of a safe-harbored contract that constitutes the setoff of a margin payment or a settlement payment (or, in the case of a swap agreement, the setoff of any payment), (iii) arising out of a safe-harbored contract, (iv) against cash, securities or other property held by or due from such eligible entity, (v) to guarantee, secure, settle or (except in the case of a swap agreement) margin such safe-harbored contract.

“Cash, securities or other property” held by or due from such party could include, by agreement of the parties, the rights of such eligible non-debtor entity under each other eligible financial contract to which the eligible non-debtor entity and the debtor are parties, together with the proceeds of such other financial contracts. This property would be held “to guarantee, secure, settle, or [where applicable] margin” the other financial contracts. Under a cross product netting agreement, each set of financial contracts would thus be “secured” by each other set of financial contracts to which the eligible non-debtor entity and the debtor were parties.

Although this approach may increase a party’s level of comfort with cross-product netting, it is still subject to the practical limitation that the safe harbor exceptions to the broadly applicable automatic stay under Section 362 of the Code are limited to mutual debts and claims. As discussed above,²⁷ mutuality requires that the obligations to be setoff against each other be (i) between the same parties, (ii) who are standing in the same right, and (iii) in the same capacity. Given that most market participants do not conduct their businesses with respect to all safe-harbored contracts in the same legal entity due to other regulatory constraints (*e.g.* capital charges that would be applicable to swap transactions entered into by a broker-dealer), there may be significant practical limitations to the benefits of this approach (absent an ability to achieve cross-affiliate netting).²⁸

C. *FIRREA*

As noted above, the FDIC administers the receivership or conservatorship of FDIC-insured national and state-chartered banks and thrifts. Such proceedings differ markedly from proceedings under the Code, but in general there are comparable impairments of creditors

²⁷ See *supra* II.B.

²⁸ See *infra* IV.

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rights²⁹ and similar safe-harbors for market-sensitive contracts. Although a Code-like automatic stay does not take effect upon the appointment of the FDIC as receiver or conservator of an insured depository institution, the FDIC has the authority to enforce contracts notwithstanding any contractual provisions for termination, default, acceleration or exercise of rights upon, or solely by reason of, insolvency or appointment of a conservator or receiver,³⁰ subject to limited exceptions for safe-harbored contracts.³¹ A party is not permitted to terminate a safe-harbored contract based solely on the appointment of the FDIC as conservator. If the FDIC has been appointed as the receiver of the counterparty, a party must wait until the close of business on the business day following such appointment prior to terminating such contract. If the safe-harbored contracts of the party and its affiliates have not been transferred to another insured depository institution at such time, then the party may terminate its safe-harbored contracts based solely on the appointment of the FDIC as receiver.³² As is the case under the Code, the FIRREA safe harbor provisions permit a party to exercise its contractual rights, but do not confer any rights. The FDIC does not have the authority to avoid as a “preferential” or “fraudulent” any transfer of money or property in connection with a safe-harbored contract unless the transferee had actual intent to hinder, delay or defraud the insured depository institutions, its creditors or the FDIC.³³

1. Definitions of Safe-Harbored Contracts

Safe-harbored contracts are collectively called “Qualified Financial Contracts” or “QFCs” under FIRREA, and are generally defined by cross-referencing or restating the Code definitions and are therefore virtually identical to the Code definitions,³⁴ except as noted below:

- (a) The definitions of “securities contracts” and “repurchase agreements” expressly include mortgage-related securities, mortgage loans and any interest in any mortgage loan (exclusive of commercial loan participations) among the list of items eligible for securities contract and repurchase agreement treatment.

²⁹ The FDIC as conservator or receiver has the authority to enforce contracts, notwithstanding any contractual provisions for termination, default, acceleration or exercise of rights upon, or solely by reason of, insolvency or appointment of a conservator or receiver. *See* 12 U.S.C. § 1821(e)(12). The FDIC as conservator or receiver has the authority to disaffirm or repudiate burdensome contracts. *See* 12 U.S.C. § 1821(e)(1). The FDIC may obtain a stay of any judicial action of up to 45 days when it is acting as conservator and up to 90 days when it is acting as receiver. *See* 12 U.S.C. § 1821(d)(12). The FDIC has broad authority to transfer assets and liabilities of an insured depository institution. *See* 12 U.S.C. § 1821(d)(2)(G). The FDIC also may have the ability to avoid “preferential” or “fraudulent” transfers. *See* 12 U.S.C. §§ 1821(c)(2)(B), (c)(3)(B) and (c)(9)(A).

³⁰ *See* 12 U.S.C. § 1821(e)(12).

³¹ *See* 12 U.S.C. § 1821(e)(8).

³² The FDIC is required to transfer all safe-harbored contracts with a party and its affiliates or none of them. However, practitioners have taken the view that if a party provides for cross-collateralization, setoff and netting between and among safe-harbored contracts, the party would retain these benefits notwithstanding an attempt to transfer less than all safe-harbored contracts. Other practitioners have pointed out that a concern as to selective repudiation of safe-harbored contracts can be addressed by the inclusion of a default based on the repudiation of one safe-harbored contract. *See also* 59 Fed. Reg. 37730, n. 15 (July 25, 1994) (FDIC determination not to exercise powers to selectively enforce or repudiate safe harbored contracts with the same party that are subject to a bilateral netting contract).

³³ *See* U.S.C. § 1821(e)(8)(C).

³⁴ *See* 12 U.S.C. 1821(e)(8)(D).

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- (b) Practitioners have questioned whether the cross-references to the Code safe harbor definitions are intended to include amendments to such Code definitions subsequent to the date FIRREA was adopted.
- (c) QFCs also include any similar agreement that the FDIC determines by regulation to be a QFC. Pursuant to this authority, the FDIC expanded the definition of QFCs to include spot and other short-term foreign exchange agreements and repurchase agreements on securities issued or guaranteed by the central governments belonging to the Organization for Economic Cooperation and Development (OECD), or that have concluded special lending arrangements with the International Monetary Fund (IMF).³⁵
- (d) The parties eligible to take advantage of the safe harbors are not limited as they are under the Code.

2. *Cross-Product Netting*

Unlike the Code, FIRREA does not limit the parties who are eligible to take advantage of the safe harbors. Therefore, cross-product netting within the safe harbors is permitted, if mutuality exists. However, the FDIC has certain requirements with respect to the agreements that will be enforceable against it. These “agreements in writing” requirements are substantial under the statute³⁶ and have been the subject of regulatory and interpretative guidance.

3. *Agreements in Writing*

To be enforceable against the FDIC as conservator or receiver of an insured depository institution, a contract, including a QFC, must satisfy the so-called “agreements in writing” or “D’Oench Duhme” requirements, *i.e.*, the agreement must be (1) in writing; (2) executed contemporaneously with the insured institution’s acquisition of the asset; (3) approved by the board of directors or loan committee of such institution, as reflected in the minutes of the board of committee; and (4) maintained as a continuous official record of the insured institution.³⁷

These stringent requirements have been the subject of FDIC policy statements that address concerns that have arisen as to the appropriate interpretation of these requirements.³⁸

In the FDIC’s Statement of Policy Regarding Qualified Financial Contracts (December 12, 1989) (the “1989 Policy Statement”), the FDIC set forth the following criteria for QFCs between

³⁵ Codified at 12 C.F.R. 360.5. *See also* 60 Federal Register 66863 (December 27, 1995) (adopting release for final rule).

³⁶ *See* 12 U.S.C. § 1823(e).

³⁷ *See* 12 U.S.C. § 1823(e).

³⁸ For example, practitioners expressed concern as to whether unsigned confirmations satisfied these agreement in writing requirements. Practitioners were also concerned that, on their face, these provisions would seem to require that a pledge be executed “contemporaneously with the acquisition” of the collateral being pledged. There was also concern as to how a party could be certain that the insured depository institution obtained the appropriate approvals and maintained the documentation relating to the relevant QFC in its books and records.

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depository institutions and non-affiliated counterparties with respect to the “agreement in writing” requirements:

(i) The QFC is evidenced by a writing (including a confirmation) sent by either party reasonably contemporaneously with the agreement to enter into a specific transaction. The writing need not be signed unless otherwise required by applicable non-insolvency law.

(ii) The depository institution, by corporate action, was authorized under applicable non-insolvency law to enter into the QFC. Such corporate action will be deemed to have been taken if the counterparty relies on either a certified board resolution (or extract thereof) or a written representation from an officer of the level of vice president or higher as to the institution’s authority.

(iii) The writing (or a copy) evidencing the QFC and authorization must be maintained by the depository institution in its official books and records. However, the counterparty may establish the existence of the writing and authorization by appropriate evidence, including the counterparty’s records.

In its 1989 Policy Statement, the FDIC also stated that it would apply these requirements in a manner generally consistent with reasonable business trading practices in QFC markets and will look to the totality of the circumstances surrounding such transactions, including the counterparty’s good faith attempt to comply with all reasonable trading practices and requirements, any non-insolvency law requirements, and the criteria set forth in the 1989 Policy Statement.³⁹

In addition, in the FDIC’s Statement of Policy Regarding Treatment of Security Interests After Appointment of the FDIC as Conservator or Receiver (March 23, 1993) (the “1993 Policy Statement”), the FDIC stated that, if a security arrangement is undertaken in the ordinary course of business for adequate consideration in an arm’s length transaction, the FDIC as conservator or receiver would not seek to avoid an otherwise legally enforceable and perfected security interest *solely because* the collateral (i) was not acquired by the financial institution contemporaneously with the approval and execution of the security agreement granting or creating such security interest and/or (ii) may change, increase, or be subject to substitution from time to time during the period that the security interest is enforceable and perfected. The 1993 Policy Statement is consistent with certain advisory opinions issued by the FDIC.

D. *FDIC Improvement Act of 1991 (“FDICIA”)*

FDICIA⁴⁰ provides that a bilateral “netting contract” between two “financial institutions” is enforceable in accordance with such netting contract notwithstanding the financial failure of one of the financial institutions.⁴¹ FDICIA also makes similar provision for netting and setoff among

³⁹ See 1989 Policy Statement at pp. 4-5.

⁴⁰ Codified at 12 U.S.C. Section § 4401 et seq.

⁴¹ See 12 U.S.C. § 4403.

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members of a clearing organization.⁴² Netting permitted in accordance with the foregoing provisions of FDICIA is not subject to stay, avoidance, or similar proceeding.⁴³

While both the Code and FIRREA address the issue of the enforceability of netting and setoff by imposing certain requirements as to the types of contract out of which the relevant payments arose, FDICIA shifts the emphasis away from the type of contract and focuses almost exclusively on the type of counterparty. However, as is the case under the Code and FIRREA, FDICIA does not create or grant any rights that do not otherwise exist under the netting contract.

FDICIA provides that any “financial institution” can net any obligation it has to make payment to another financial institution against its entitlement to receive payment from the other financial institution, notwithstanding that one of the financial institutions is a “failed financial institution,”⁴⁴ provided that the netting is in accordance with the terms of the applicable netting contract.⁴⁵

“Financial institution” is defined as a broker or dealer,⁴⁶ a depository institution,⁴⁷ a futures commission merchant,⁴⁸ or any other institution as determined by the Board of Governors of the Federal Reserve System.⁴⁹ The Federal Reserve Board exercised its authority to expand the list of entities that qualify as “financial institutions” to include a person that represents that it will engage in financial contracts as a counterparty on both sides of one or more financial markets and either (i) had one or more financial contracts of a total gross dollar value of at least \$1 billion in notional principal amount outstanding on any day during the previous 15-month period with

⁴² See 12 U.S.C. § 4404. “Clearing organization” is defined as a clearinghouse, clearing association, clearing corporation or similar organization that either (a) provides clearing, netting or settlement services for its members and (i) in which all members are financial institutions or other clearing organizations, or (ii) which is registered as a clearing agency under the 1934 Act; or (b) performs clearing functions for a contract market designed pursuant to the Commodity Exchange Act.

⁴³ See 12 U.S.C. § 4405.

⁴⁴ A “failed financial institution” is defined as a financial institution that (i) fails to satisfy its payment obligation pursuant to a netting contract; (ii) has commenced or had commenced against it insolvency, liquidation, reorganization, receivership, conservatorship, or similar proceedings; or (iii) has generally ceased to meet its obligations when due. See 12 U.S.C. § 4402(7).

⁴⁵ See 12 U.S.C. § 4403.

⁴⁶ A “broker or dealer” means (a) any company that is registered or licensed under federal or state law to engage in the business of brokering, underwriting, or dealing in securities in the United States and (b) to the extent consistent with title 12 of the United States Code, as determined by the Federal Reserve Board, any company that is an affiliate of a company described in subparagraph (a) and that is engaged in the business of entering into netting contracts. See 12 U.S.C. § 4402(1).

⁴⁷ “Depository institution” means (a) any insured bank or bank eligible to become insured, mutual savings bank, savings bank or insured credit union; (b) a U.S. branch or agency of a foreign bank; (c) a corporation chartered to do foreign banking business; or (d) a corporation having an agreement or undertaking with the Federal Reserve Board to engage in foreign banking activities and/or business. See 12 U.S.C. § 4402(6).

⁴⁸ “Futures commission merchant” means a company that is registered or licensed under federal law to engage in the business of selling futures and options in commodities. See 12 U.S.C. § 4402(10).

⁴⁹ See 12 U.S.C. § 4402(9).

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counterparties that are not its affiliates; or (ii) had total gross mark-to-market positions⁵⁰ (aggregated across counterparties) in one or more financial contracts of \$100 million on any day during the previous 15-month period with counterparties that are not its affiliates.⁵¹

“Netting contract” means any contract or agreement between two or more financial institutions or members that (a) is governed by the laws of the United States, any State or any political subdivision of any State; and (b) provides for netting present or future payment obligations or payment entitlements (including liquidation or close-out values) among the parties to the agreement.⁵²

After the “financial institution” and “netting contract” elements are satisfied, all payment obligations owing to the counterparty under the netting contract can be netted in accordance with the netting contract.⁵³ There is no requirement that netting be against the same or similar contracts. Thus, foreign exchange payments can be netted against swaps or other payments. Accordingly, cross-product netting does not present an issue under FDICIA.

A payment obligation due from a financial institution cannot be netted against a payment obligation to its subsidiary or affiliate. It is not clear, however, whether a netting contract provision that specifically provides that the obligations of affiliates or subsidiaries, which are themselves “financial institutions,” would be enforceable.⁵⁴

Practitioners have pointed out that the scope of FDICIA is unclear. On its face, FDICIA broadly states that netting contracts are enforceable “notwithstanding any other provision of law.”⁵⁵ However, as applied to the FDIC’s authority as conservator or receiver of an insured depository institution, this provision could conceivably negate the FDIC’s ability to render “*ipso facto*” clauses unenforceable in a conservatorship and impair the one business day stay that applies in a receivership.⁵⁶ Another example is whether FDICIA is intended to pre-empt the discretionary power of the Securities Investor Protection Corporation to enjoin a secured party that is otherwise exempt from the automatic stay provisions of section 362 of the Code from foreclosing on its collateral.

On the one hand, it could be argued that FDICIA expressly overrides FIRREA and liquidation or close-out under a netting contract is consistent with reducing systemic risk as Congress intended in enacting FDICIA. On the other hand, uncertainty as to the meaning of the term “otherwise enforceable netting contracts,” the lack of detailed legislative history explaining the intended relationship among FDICIA, FIRREA and the Code, and policy considerations raised by a

⁵⁰ “Gross mark-to-market positions” is defined as the “sum of the absolute values of positions in . . . contracts, adjusted to reflect the market values of those positions in accordance with the methods used by the parties to each contract to value the contract . . .” 12 C.F.R. § 231.3(e).

⁵¹ See 12 C.F.R. § 231.1.

⁵² See 12 U.S.C. § 4402(14). The term “netting contract” includes the rules of a clearing organization.

⁵³ In contrast to the Code and FIRREA, which explicitly delineate the type of payments that can be netted, FDICIA does not impose a limitation upon the type of payment obligations that can be netted.

⁵⁴ See *infra* IV.B.

⁵⁵ See 12 U.S.C. §§ 4403(a); 4404(a).

⁵⁶ See *supra* III.C.

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blanket pre-emption of existing law, suggest that any such interpretation of FDICIA be approached with caution.

The FDIC has stated that FDICIA does not protect close-out rights and therefore does not supersede the FDIC's ability to transfer QFCs.⁵⁷ FDICIA does, however, reinforce and arguably expand the prohibition on cherry-picking of transactions.

E. Proposed Legislation

Legislation has been proposed to amend the Code and the Federal Deposit Insurance Act provisions that codify FIRREA and FDICIA (the "Proposed Legislation").⁵⁸ If adopted, it would generally (i) expand and conform the scope of safe-harbored contracts as between the two statutes; (ii) establish exceptions to FDICIA with respect to the authority of the FDIC to render "*ipso facto*" clauses unenforceable in a conservatorship or receivership and to utilize a one business day stay prior to the transfer, assumption or repudiation of a depository institution's QFCs; and (iii) provide for cross-product netting among safe-harbored contracts pursuant to master netting agreements. The Proposed Legislation would also address certain related issues, and codify FDIC positions previously adopted by regulation or policy statement.

By providing express statutory recognition of master netting agreements, the Proposed Legislation is viewed by practitioners and market participants as eliminating any ambiguity or doubt as to the enforceability of master netting agreements. However, although the Proposed Legislation explicitly addresses cross-product netting, netting and setoff remain framed in terms of mutual debts and claims and there is no express authority for cross-affiliate setoff beyond whatever is available under current law. As noted, absent cross-affiliate setoff, the practical benefits of full cross-product netting may not be realized since many market participants continue to conduct safe-harbored businesses in separate legal entities. Accordingly, some practitioners take the view that the master netting legislation should be interpreted to support cross-affiliate setoff, because failure to do so would frustrate the underlying purpose of the legislation.

1. Definitions of Safe-Harbored Contracts

Under the Proposed Legislation, the definitions of safe-harbored contracts under the Code and the FDIA would be expanded and would be virtually identical under the Code and the FDIA. Although each definition has specific expansions, they would also include transactions similar to those specifically enumerated. In addition, each safe harbor definition would include any security agreement or arrangement or other credit enhancement related to any agreement or transaction within such safe harbor.

⁵⁷ See 59 Fed. Reg. 37730 (July 25, 1994).

⁵⁸ Citations are to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2002 (H.R. 333). The Proposed Legislation has been under consideration in substantially the same form for a number of years. Although the likelihood that it will be adopted this year diminishes as the year progresses, if netting legislation is ultimately adopted, it appears likely that such legislation would be based on the Proposed Legislation.

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The definition of “swap agreement” would be expanded to conform to the Commodity Futures Modernization Act of 2000 (the “CFMA”), both by inclusion of a long list of specific categories of swaps that are not specifically enumerated under the existing definition (including total return swaps, credit derivatives and weather derivatives) and also by expanding the phrase “or any similar agreement” to include any agreement similar to those enumerated that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap market and that 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.”⁵⁹

This broad definition of “swap agreement” would be applicable solely for purposes of the Code and FDIA provisions relating to safe-harbored contracts. In this regard, the legislation would expressly provide that this definition not be construed or applied to challenge or affect the characterization, definition, or treatment of swaps under other enumerated securities, commodities and banking laws.

The definition of “securities contract” would include margin loans and would also include repurchase and reverse repurchase agreements with respect to any security.

The definition of “repurchase agreement” would be expanded to include such agreements with respect to mortgage-related securities, mortgage loans, qualified foreign government securities (which are included under current law for QFCs only), and principal and interest-only U.S. government and agency securities.

The Code provisions regarding the definitions of a “contractual right” to liquidate a safe-harbored contract would be conformed and modified to reflect the enactment of the CFMA.

The Code provisions regarding the parties permitted to take advantage of the safe harbors would be amended and broadened. A party seeking to take advantage of a safe harbor would either have to satisfy the particular definition of the type of entity that may take advantage of that specific safe harbor (and these categories would be somewhat broader under the Proposed Legislation), or a new category of entity that is permitted to take advantage of all of the safe harbors. This new category of “financial participant” requires that a party have, at the time it enters into a safe-harbored contract with the counterparty or at the time of filing of the petition, one or more safe-harbored contracts with the counterparty/debtor and other non-affiliates of a total gross dollar value of not less than \$1 billion in notional or actual principal amount outstanding on any day during the previous 15 months, or gross mark-to-market positions of not less than \$100 million (aggregated across counterparties) in one or more such agreements or transactions with the counterparty/debtor or any other non-affiliate on any day during the previous 15 months.

The Proposed Legislation would add to the Code a provision regarding the determination of damages for rejection or liquidation, termination or acceleration of a safe-harbored contract.

⁵⁹ See Sections 901(f) (amending FDIA) and 907(a) (amending Code).

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Such damages would be determined as of the earlier of the date of rejection or the date or dates of such liquidation, termination or acceleration, or, if there are not any commercially reasonable determinants of value as of any such date, as of the earliest subsequent date as of which there are commercially reasonable determinants of value.

The Proposed Legislation would codify that agreements to provide collateral with respect to QFCs are not to be deemed to be invalid pursuant to the “agreements in writing” requirements solely because such agreement was not executed contemporaneously with the acquisition of the collateral or because of “pledges, delivery, or substitution of the collateral made in accordance with such agreement.”⁶⁰

2. FDICIA

The Proposed Legislation would prevent FDICIA and any other provision of law from being construed to limit the FDIC’s authority to transfer all or none of a depository institution’s QFCs with a party and such party’s affiliates.⁶¹ The Proposed Legislation includes a one-day stay of termination when the FDIC is acting as conservator or receiver, and provides for the enforcement of QFCs notwithstanding an “*ipso facto*” clause when the FDIC is acting as conservator or receiver.⁶² The FDIC would continue to have broad authority to disaffirm or repudiate contracts, subject to the provisions that limit cherry-picking with respect to QFCs.

FDICIA would also be amended to (i) expand the scope of the institutions that benefit from the netting provisions of FDICIA to include uninsured banks and foreign banks; (ii) eliminate the requirement that the netting agreement be governed by U.S. law; and (iii) define “payment” broadly to mean payments in currency and noncash delivery obligations, including a payment or delivery to liquidate an unmatured obligation.⁶³

3. Master Netting Agreements and Cross-Product Netting

The Proposed Legislation would provide that a master agreement under the Code or the FDIA with respect to safe-harbored contracts may include any one or more of the enumerated safe-harbor contracts. This provision would expand the master agreement concept from a single product agreement to a multiple product agreement, but would only be a “master agreement” within the meaning of the safe harbors with respect to those transactions that are themselves

⁶⁰ See Section 909.

⁶¹ See Section 902. In addition, the entities to whom such assets may be transferred would be expanded to include financial institutions (broker, dealer, depository institution, futures commission merchant, or any other institution as determined by the FDIC). However, the FDIC would only be permitted to transfer such assets to a foreign entity if the contractual rights of the parties to such QFCs, any related netting agreements, and any related credit enhancement agreements would be enforceable substantially to the same extent as prior to such transfer. To the extent the FDIC transfers property subject to the rules of a clearing organization, the clearing organization would not be required to accept the transferee as a member by virtue of the transfer.

⁶² Such provisions would broadly provide that a party may not terminate a QFC solely by reason of the appointment of conservator or receiver or the financial condition of the depository institution.

⁶³ See Section 906.

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safe-harbored contracts. The language suggests that the inclusion of non-safe-harbored contracts would not necessarily jeopardize safe-harbored treatment of safe-harbored contracts.⁶⁴

The Proposed Legislation would provide a definition of “master agreement participant” under the Code as any entity that is a party to an outstanding master netting agreement with the counterparty/debtor prior to the filing of a bankruptcy petition.

The Proposed Legislation would add a new Section 561 to the Code to provide that the provisions that would ordinarily render an “*ipso facto*” clause unenforceable would not apply to contractual rights to cause the termination, liquidation, or acceleration of, or to offset or net termination values, payment amounts, or other transfer obligations arising under or in connection with one or more (or the termination, liquidation, or acceleration of one or more) safe harbored contracts or master netting agreements. However, a party may only exercise such contractual rights to the extent that such party could exercise that right under the relevant provisions⁶⁵ for each individual contract covered by the master netting agreement. As with the “master agreement” definition discussed above, the “to the extent” language suggests that non-safe-harbored contracts would not necessarily jeopardize safe-harbored treatment of safe-harbored contracts.

New Section 561 would also provide that a party may not net or offset an obligation to a counterparty/debtor arising under, or in connection with, a commodity contract traded on or subject to the rules of a contract market designated under the CEA or a derivatives transaction execution facility registered under the CEA against any claim arising under, or in connection with, other safe-harbored contracts, except to the extent the party has positive net equity in the commodity accounts at the counterparty/debtor. In addition a commodity broker may not net or offset an obligation to the counterparty/debtor under such a contract if such contract is held by or on behalf of a customer of the counterparty/debtor.

***PART IV: CROSS-PRODUCT NETTING, CROSS-AFFILIATE NETTING AND
CROSS-PRODUCT NETTING BEYOND SAFE-HARBORED CONTRACTS***

A. Cross-Product Netting within Safe-Harbored Contracts

Although cross-product netting within safe-harbored contracts is not expressly provided for under the Code, to the extent that the payments due to be received under safe harbored contracts are pledged as collateral for payment obligations under such contracts, reasoned arguments exist to permit the net amounts due under safe-harbored contracts to be further netted and setoff pursuant to the provisions pertaining to collateral for safe harbored contracts. This would enable parties who otherwise satisfy the mutuality requirements for setoff to achieve what is essentially cross-product netting.

If the Proposed Legislation is adopted, cross-product netting among safe-harbored contracts under the Code would be expressly permitted to the extent provided in a master netting

⁶⁴ See Sections 905, 907(c).

⁶⁵ The specific provisions are those discussed in III.B. *supra*: Sections 555 for securities contracts, Section 556 for commodities contracts and forward contracts, Section 559 for repurchase agreements, and Section 560 for swap agreements, in each case as amended by the Proposed Legislation.

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agreement between the relevant parties. However, to take advantage of the safe harbors under the Code, a party would still be required to be the type of party entitled to take advantage of such safe harbors, or the type of party that can take advantage of all of the safe harbors. In practice, a party that fits the requirements to take advantage of all of the safe harbors would likely also meet the requirements to be eligible to use the netting provisions of FDICIA under current law.

The netting provisions of FDICIA provide a mechanism for market participants that meet the eligibility criteria to essentially achieve cross-product netting. Since FDICIA provides for the netting of payment obligations between such institutions, to the extent that parties were able to reduce their obligations to payment amounts under other applicable law, such as the Code safe-harbored contract provisions, the resulting payment amounts could be netted and setoff under FDICIA.

Under the provisions of the FDIA relating to the conservatorship and receivership of depository institutions, cross-product netting is more readily available than under the Code. Unlike the Code, such provisions do not limit the availability of the safe harbors to entities meeting certain requirements. Under the Proposed Legislation, there would also be an express recognition of master netting agreements under the FDIA.

B. Cross-Affiliate Netting

Setoff with multiple parties can be described as either triangular (one party on one side and multiple parties on the other) or square (multiple parties on each side). In triangular and square setoffs, mutuality by definition does not exist. There is, however, an exception to the mutuality requirement that is recognized in bankruptcy where there is a formal agreement among the parties specifically providing for setoff.⁶⁶ Although a number of cases have referred to this specific exception,⁶⁷ few cases have actually found there to be such an agreement and enforced it.⁶⁸ Those that have enforced such an agreement are Depression-era bank cases or arise in other contexts that are not closely related to the netting agreements contemplated by market

⁶⁶ See e.g. *Wooten v. Vicksburg Refining, Inc. (In re Hill Petroleum Co.)*, 95 B.R. 404, 411 (Bankr. W.D. La. 1988) (“narrow exception to the rule against three party, ‘triangular’ setoffs, occurs where there is a formal agreement by the debtor that two entities may aggregate debts owed to and from the debtor”); *Walter E. Heller & Co. v. Food Marketing Assocs., Ltd. (Matter of Fassano/Harris Pie Co.)*, 43 B.R. 864, 870-71 (Bankr. W.D. Mich. 1984) (“Courts have carved out an exception to this general rule in the ‘triangular tradeoff’ situation. The courts have found mutuality between three parties, as a matter of contract law, where there was an express agreement clearly evidencing the intent of the parties to treat the related corporations as a single entity.”), *aff’d on other grounds*, 70 Bankr. 285 (W.D. Mich. 1987), *aff’d without opinion*, 848 F.2d 190 (6th Cir. 1988); 5 *Collier* § 553.03[3][b][ii] (“If the parties all agree in a pre-petition contract that a setoff may be taken between A, B and C, then the agreement may be enforced in bankruptcy to the extent that it is enforceable under applicable non-bankruptcy law”).

⁶⁷ See e.g. *Inland Steel Co. v. Berger Steel Co., Inc. (In re Berger Steel Co., Inc.)*, 327 F.2d 401, 404-6 (7th Cir. 1964), *Eckles v. Petco Inc. (In re Balducci Oil Co., Inc.)*, 33 Bankr. 847, 853 (Bankr. D. Colo. 1983); *Virginia Block Co. v. Bushong (In re Virginia Block Co.)*, 16 Bankr. 560, 562 (Bankr. W.D. Va. 1981).

⁶⁸ See *Franklin Savings Corp. v. Resolution Trust Corp. (In re Franklin Savings Corp.)*, 182 B.R. 859, 863-64 (D. Kan. 1995) (tax sharing agreement between parent and subsidiary allowed parent to setoff subsidiary’s tax refund); *Piedmont Print Works v. Receivers*, 68 F.2d 110, 111 (4th Cir. 1934) (bank insolvency); *Bromfield v. Trinidad Nat’l Inv’t Co.*, 36 F.2d 646, 647-49 (10th Cir. 1929) (bank insolvency). See also *Bloor v. Shapiro*, 32 B.R. 993 (S.D.N.Y. 1983).

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participants. Where there is no such agreement, a number of cases have held that triangular setoff is not preserved in bankruptcy.⁶⁹

Although such an agreement is, in certain respects, similar to a situation where a parent guarantees the obligations of a number of its subsidiaries to a counterparty/debtor, it is different in that the counterparty/debtor has not agreed to the setoff of amounts it owes to the subsidiaries. Mutuality is not present because the counterparty/debtor owes its obligation to the subsidiary not to the parent guarantor. Absent such an agreement to which the counterparty/debtor is a party, there would not be a sufficient agreement among the parties to achieve setoff.⁷⁰

Where there is an agreement regarding cross-affiliate netting it may be closely scrutinized because such agreements are rarely found to exist in reported cases and rarely enforced. One area that could conceivably be scrutinized is the consideration received by each of the affiliates. Another area that may be examined is what the affiliates' obligations are to the counterparty/debtor with respect to the shortfall, and what obligations they may have to each other with respect to the amounts setoff.

Although formal agreements providing for triangular setoff have been recognized as an exception to the mutuality requirement, there has been such limited case law with respect to their enforceability that it is difficult to generalize with respect to such agreements, let alone more complex varieties of such agreements. In theory, the same conceptual framework should exist for square setoff, but it is unclear what factors might alter that analysis.

Market participants should also consult with counsel regarding issues arising under the Public Utility Holding Company Act of 1935 in connection with cross-affiliate setoff.

C. Cross-Product Netting Beyond Safe-Harbored Contracts

Cross-product netting beyond safe-harbored contracts raises additional issues. Although the netting provisions of FDICIA are available to market participants that meet the FDICIA eligibility requirements and such provisions are not limited to payments due under safe-harbored contracts, one would nevertheless need some basis on which to effect a termination and liquidation of an exposure in order to take advantage of such provisions. In general, one would need some express statutory authority to effect such a termination and liquidation with respect to a counterparty that is a debtor under the Code or in receivership or conservatorship. Moreover, practitioners have expressed concern that inclusion of non-safe-harbored contracts and safe-harbored contracts in the same netting agreement could conceivably "taint" the safe-harbored contracts and adversely affect a party's ability to exercise contractual remedies with respect to such safe-harbored contracts.

CONCLUSION

The decision to enter into a master netting agreement should be made only after careful consultation with legal counsel and a thorough review of the master netting agreement itself, the

⁶⁹ See, e.g., *In re United Sciences of Am., Inc.*, 893 F.2d 720, 723 (5th Cir. 1990). Compare *Depositors Trust Co. v. Franti Enterprises, Inc.*, 590 F.2d 377, 379 (1st Cir. 1979).

⁷⁰ See *In re Ingersoll*, 90 Bankr. 168, 171 (Bankr. W.D.N.C. 1987).

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underlying master agreements proposed to be included in the master netting agreement, other material agreements which could contain provisions that conflict with the master netting agreement, and a review of back office, systems and operational capabilities. Business, credit, legal, risk management, and operational concerns should be carefully considered and evaluated.