Swaps and the Bankruptcy Code

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On September 15, 2008, the Dow Jones Industrial Average suffered its largest one day market drop since September 11, 2001, closing down 504 points. That morning, the 158 year old investment bank, Lehman Brothers, filed the largest bankruptcy case in history. Mired among the multitude of adversary proceedings in Lehman's bankruptcy were several lawsuits dealing with derivatives. As the financial world crumbled on that September day, one thing emerged very clearly. Derivative financial instruments had played a significant factor in the destruction of the financial markets.

Among the categories of derivatives, swaps are by far the largest. And within the world of swaps, interest rate swaps account for the lion's share. The size of the swap markets is gargantuan. As of June 2010, swaps accounted for more than $24 trillion in gross market value based upon a notional amount of more than $582 trillion. By comparison, the combined gross domestic product of the world is $58.23 trillion. In light of the current economic crisis and the prevalence of swaps in it, an understanding of the treatment of swaps in bankruptcy is essential.

Swaps are financial instruments that are embodied in contracts. Interest rate swaps are utilized by borrowers to minimize borrowing costs and to hedge against fluctuations in interest rates. Swap agreements share many similarities with other kinds of contracts. Like other contractual arrangements, swaps can be bilateral or multilateral in nature depending upon the number of parties to the swap agreement. They can be secured and subjected to subordination agreements and guaranties. Additionally, like other kinds of contracts, when a breach occurs under a swap agreement, the non-breaching party is entitled to damages. One important distinction between swaps and standard commercial contracts is that swap agreements receive special treatment under the United States Bankruptcy Code ("Code"). Although interest rate swaps are based upon a notional amount—usually equivalent to the principal amount of the underlying loan—they are a legally independent and separate obligation from the underlying loan.

Bankruptcy provides many well known protections to a debtor. Creditors are subject to the automatic stay, which prevents them from seizing assets of the debtor. Executory contracts can be rejected or assumed. The trustee's avoidance powers are significant. While these protections are essential to the purposes of the Code, they are subject to important limitations as they apply to swaps.

Sections 362 and 560 of the Code provide that a non-debtor swap counterparty is permitted to terminate the swap and seize its collateral notwithstanding the automatic stay. While the automatic stay is lifted for that purpose, it remains in effect as to all other actions relating to the swap. Thus, a debtor cannot be compelled to make payments or provide reports to the swap counterparty.

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These provisions of the Code are practical accommodations adopted by Congress in support of the principle that smoothly functioning markets require market participants to be able to terminate swap transactions immediately in insolvency situations.

Agreements Governing Swaps

Most interest rate swap agreements are documented using the form of Master Agreement of the International Swaps and Derivatives Association Inc. ("ISDA"). ISDA agreements provide for the termination of swap transactions between two parties prior to their stated expiration upon the occurrence of "termination events" and "events of default" (each as defined in the Master Agreement).

The ISDA form agreements are periodically updated by working groups convened from among professionals who practice in the field (*i.e.*, the 1992 ISDA Master Agreement and the 2002 ISDA Master Agreement). With respect to interest rate swaps, the most commonly used version of the ISDA Master Agreement is the 1992 (Multicurrency–Cross Border) form, notwithstanding the existence of a more recent version. The ISDA form Master Agreement, and the more heavily negotiated Schedule accompanying it, establish the legal and credit relationship between the parties.

If a swap is to be collateralized, the credit support annex ("CSA") is another important component of the ISDA Master Agreement. The CSA governs the collateral terms for derivative transactions under the ISDA Master Agreement, including one-way or two-way collateral agreements. An important aspect of the CSA is that it selects New York law as the governing law and provides that collateral will be located in New York. Accordingly, New York law governs the perfection and the priority of competing security interests in the collateral.

Ipso Facto Clauses and Setoffs

Many commercial agreements contain a provision, known as an ipso facto clause, which vests a right of termination in a party upon the bankruptcy or insolvency of the counterparty to the contract. Under the Code, ipso facto clauses are generally not enforceable, and a trustee can thus assume (and enforce) a contract notwithstanding the non-defaulting party's right to terminate a contract pursuant to such a clause. However, where swap agreements are concerned, the Code recognizes a special exception by which ipso facto clauses are enforceable. Section 560 of the Code overrides § 365(e)(1), permitting swap participants to exercise the contractual right to terminate a swap agreement in the event of insolvency or bankruptcy. But that right may be subject to certain equitable constraints according to the holdings of recent cases on the issue.[1]

Section 2(a)(iii) of the ISDA Master Agreement conditions the performance by a swap party of its obligations on the absence of any events of default by its counterparty. When a party to a swap agreement files for bankruptcy protection, the ipso facto clause is triggered, relieving the non-debtor swap counterparty from performance of the terms of the contract. The counterparty is entitled to termination damages caused by the event of default.

The Code provides swap participants with the right to set off mutual obligations that arise when the counterparties net out upon a termination event or an event of default. But setoff rights are not absolute. The obligations must both be pre-petition debts; one cannot setoff a pre-petition obligation with an obligation that arises post-petition.

The litigation over swap agreements generally and their treatment in bankruptcy in particular is a rapidly developing area of the law. Nearly every case dealing materially with swap transactions is under appeal or is so recent that its precedential value is unclear.

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Calculating Damages: Commercially Reasonable Standard

Under the Code, a creditor must establish that its damage claims are "commercially reasonable." Notwithstanding a swap counterparty's rights to terminate and take possession of swap collateral, this principle still applies so that the counterparty may not retain collateral if its value is more than what is commercially reasonable.

The inquiry into commercial reasonableness is fact-driven and requires review of all of the circumstances surrounding the liquidation. Although offering some guidance, the Uniform Commercial Code ("UCC") fails to offer any bright-line rule describing what is commercially reasonable. As a result, the standard for commercial reasonableness remains somewhat ambiguous.

The ISDA Master Agreement provides several methods and alternatives for calculating termination damages. Generally, under the ISDA formulations, damages represent the replacement cost of a terminated swap agreement and are "determined by obtaining market quotations for the cost of replacing the swap at the time of termination."[2]

Calculating Damages Following Termination Events

When an early termination date occurs following a termination event, the parties are obligated to make a settlement payment reflecting the net value of the future performance obligations under the terminated swap. Under the 1992 ISDA Master Agreement, the counterparties' terminated swap positions are valued using either the "market quotation" method or the "loss" method.

Under the Market Quotation Method, the parties obtain the average of quotations from leading dealers in the swap market for the amount that would be paid to one party to the swap or that would be payable by that party in consideration for the agreement between that party and the swap dealer to enter into a new swap contract economically identical for the remaining period of the terminated agreement.

If the parties elect the Loss Method, then any payment upon termination will be equal to the non-defaulting party's total net losses and costs (or gains, in which case it is expressed as a negative number) under the 1992 ISDA Master Agreements as a result of termination.

The 2002 ISDA Master Agreement mandates a very different valuation methodology than the 1992 form called the "close-out amount." In calculating the close-out amount, the parties determine the amount of the losses and costs incurred in replacing or providing the economic equivalent of the payments and deliveries under the terminated transactions that would have been required but for the early termination. These amounts remain subject to the standards of commercial reasonableness discussed previously.

Calculating Damages Following Events of Default

The method for calculating termination damages in the context of an event of default is identical to the methodology required in connection with an early termination following a termination event. There is, however, an important difference between termination events and events of default relating to the netting procedures following a default. In certain circumstances, depending on the form agreement used and the valuation methods selected, the parties net the various swaps under the master agreement to determine whether the non-defaulting party or the defaulting party suffered a loss. If the non-defaulting party owes a net payment, it is not required to make any payment to the defaulting party in settlement of any future payment obligations irrespective of how valuable or "in the money" the defaulting party's swap positions are as of the early termination date.

This creates a scenario where the non-defaulting party may be able to reap a windfall that it would

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not be entitled to receive but for the occurrence of the event of default because the provision in effect denies the defaulting party the right to receive compensation for the market value of the swap agreements that it would have otherwise been entitled to receive had the swap agreements been terminated following a termination event. These provisions were specifically excluded from the 2002 ISDA Master Agreement.

Where the bankruptcy filing of a party is the precipitating event of default triggering termination payments under the swap, the one-way settlement provisions under the pre-2002 versions of the ISDA Master Agreement come squarely into conflict with the commercial reasonableness requirements of the Code. The most prominent case discussing termination damages and swaps in bankruptcy is an unpublished decision from the United States District Court for the Middle District of Tennessee, *In re BKB Props., LLC v. SunTrust Bank*.[3]

BKB Properties

On March 12, 2002, BKB Properties ("BKB") entered into a secured construction loan transaction with SunTrust Bank ("SunTrust"). At the same time, BKB and SunTrust entered into a "floating for fixed" interest rate swap agreement. In March 2007, BKB notified SunTrust of its intention to exercise its call right and prepay the loan and the swap agreement. SunTrust refused to accept payment, refused to cancel the swap agreement, and refused to remove its lien from the property unless BKB paid a "substantial penalty" (which SunTrust argued was the market value of the swap). After failed negotiations to resolve the dispute, BKB sued SunTrust, alleging breach of contract and libel of title.

With respect to the swap termination payments, the court sought to determine whether any swap termination payments that BKB were obligated to make constituted a prohibited penalty or premium such that SunTrust was not entitled to refuse lien removal after prepayment of the loan.

On this issue, the court noted that "though the purpose and practical effect of the swap may have been to provide BKB with the financial equivalent of fixed-rate financing, the terms of the agreement, taken as a whole, make clear that BKB had distinct obligations under the loan portion of the agreement and under the swap portion of the agreement - that is, BKB had an obligation to repay the note and a separate obligation to make payments under the swap."[4] Importantly, the court found that the amounts that BKB owed under the swap were not the result of the prepayment of the loan but were the result of obligations that had been independently incurred under the swap, and could have been owing regardless of whether the loan was prepaid. "Therefore, those amounts did not constitute a penalty or premium assessed as a result of BKB's prepayment of the [loan]."[5] Accordingly, SunTrust was not obligated to remove its lien until the swap obligations had been satisfied by BKB.

Valuation and Treatment of Swap Claims Pending Rejection or Assumption

Under the safe harbor rules, there is no requirement for the debtor to perform under swap agreements except for netting the termination value and offsets. However, if the claim is secured, creditors may have a right to adequate protection. Because swap claims are separate and independent obligations from loans, it is necessary to determine the priority, perfection, and classification of the swap obligations. The underlying loan agreement that the swap is hedging will typically determine if the swap is *pari passu* or subordinate to the loan. If it is *pari passu*, then swap obligations get added to loan obligations to determine if both the loan agreement and the swap agreement is fully secured or undersecured under § 506 of the Code based on the collateral value. This affects adequate protection requirements, plan classification, impairment, relief under § 362 of the Code, and plan treatment. This analysis is separate and independent of the termination calculations set forth above.

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Liquidated Damages Versus Penalty

Another argument used by swap counterparties seeking to enforce termination payments in bankruptcy is that the termination payment provisions in the ISDA Master Agreement are in the nature of liquidated (or pre-agreed) damages provisions and are therefore allowable claims in bankruptcy. As a general principle, courts will enforce a liquidated damages provision unless the amount is determined to be punitive in nature. If the clause is rejected as a penalty, the recovery is limited to actual damages proven. Moreover, it is well established that a liquidated damages provision is enforceable where the fixed amount bears a reasonable proportion to the probable loss and the amount of actual loss is incapable or difficult of precise estimation. Thus, if termination damages under a swap agreement are determined under New York law to be a penalty, then they would not be enforceable as a matter of state law and would thus not be allowable as a claim in bankruptcy.

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[1] *See In re Lehman Brothers Holdings Inc.*, No. 08-13555 (Bankr. S.D.N.Y. filed Sept. 15, 2008).

[2] *Thrifty Oil Co. v. Bank of America Nat'l Trust and Sav. Ass'n*, 322 F.3d 1039, 1043 (9th Cir. 2003).

[3] 2009 BL 41778 (M.D. Tenn. Mar. 2, 2009).

[4] *Id*. at *6.

[5] *Id*.

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