

# Credit Issues in Swaps and Derivatives

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February 23, 2010

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## Credit Exposure Under Swaps

- **Credit exposure may be very great**
  - **Varies by type of transaction, volume of trading**
- **Can be extremely volatile or “binary”**
- **May be one-sided if a counterparty consistently takes one side of the market**
- **May be very large on a “gross” basis, and relatively small on a “net” basis**
- **May be difficult to predict or to value as market conditions change**

## Insolvency Regimes

- **What insolvency regime would you be dealing with?**
  - **Bankruptcy Code**
  - **Banking laws**
    - **Federal Deposit Insurance Act (“FDIA”)**
    - **National Bank Act**
    - **State banking laws**
  - **State insurance laws**
  - **Foreign bankruptcy laws**
  - **“Assignments for the benefit of creditors”**
  - **Some combination of the above or other specialized regimes**

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## Liquidation versus Reorganization

- **The powers that can be exercised in an insolvency proceeding may depend on the expected outcome**
  - **Liquidation:**  
To liquidate the assets of the insolvent entity and distribute the proceeds to the entity's creditors
  - **Reorganization:**  
To restore the entity to financial health and return it to normal operation

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## How Can the Proceeding Interfere with Your Contracts?

### ■ Preferences

- Invalidates transfers of property of the debtor after it becomes insolvent (or is deemed to be so) that have the effect of “preferring” a particular creditor
- A creditor is “preferred” if it receives a larger portion of its claim than other similarly situated creditors

## How Can the Proceeding Interfere with Your Contracts?

*continued*

### ■ Fraudulent Transfers or Conveyances

- Avoids transfers by the debtor before the commencement of the proceeding if the transfer was intended to, or had the effect of, defrauding the debtor’s creditors.
- Transactions at risk are generally those that take place when
  - The debtor was insolvent AND
  - The creditor did not pay a “reasonably equivalent” consideration for the transfer

## How Can the Proceeding Interfere with Your Contracts?

*continued*

- **The “Automatic Stay”**
  - **Generally prohibits, among other things:**
    - Collect any pre-petition claims against the debtor,
    - Creating, perfecting or enforcing a lien against property of the debtor,
    - Exercising rights of setoff
    - Commencing lawsuits
    - Giving notices of termination or default

## How Can the Proceeding Interfere with Your Contracts?

*continued*

- **Restrictions on Setoff**
  - **What is a “setoff”?**
    - If you owe the debtor money, and the debtor owes you money, and both amounts are currently due, the amounts are applied against each other
    - The party that owes the greater amount will be obliged to pay only the excess

## How Can the Proceeding Interfere with Your Contracts?

*continued*

- **Most insolvency regimes permit the exercise of pre-existing rights of setoff, but do not create them**
- **Many regimes prohibit the exercise of a right of setoff until any stay is lifted**
- **Most impose other limits, relating to when the claim arose, whether the setoff would grant too great a benefit as compared to other creditors, and other factors**

## How Can the Proceeding Interfere with Your Contracts?

*continued*

- **Repudiation or Rejection**
  - **Trustee, conservator or receiver may “reject” or repudiate a contract if the contract is disadvantageous to the debtor’s estate.**
  - **The other party may be entitled damages for the debtor’s breach, but cannot enforce the contract.**
  - **In bank insolvencies, the damages may be measured on the date the proceeding begins – no matter when repudiation occurs.**

## How Can the Proceeding Interfere with Your Contracts?

*continued*

- **Unwritten or Unrecorded Agreements**
  - Bank insolvency laws often include provisions that are intended to protect receivers and conservators from unwritten or “unrecorded” agreements.
  - May invalidate an agreement or provision, even if the contract satisfies the “statute of frauds” or “parole evidence rule” in the relevant jurisdiction.

## How Can the Proceeding Interfere with Your Contracts?

*continued*

- **Transfer or Assignment**
  - Trustee in bankruptcy may assign executory contracts, even if the contract or applicable law prohibits assignment.
  - Bank insolvency provisions are generally even broader, permitting assignment of any and all contracts.
  - Any assignment, standing alone, may not form the basis for an event of default under the contract.

## How Can the Proceeding Interfere with Your Contracts?

*continued*

- **Ineffectiveness of *Ipso Facto* Clauses**
  - **Creditor cannot terminate or modify a contract simply because the creditor's counterparty is the subject of an insolvency proceeding.**
  - **If the contract isn't terminated until after the case begins, the debtor's credit rating or creditworthiness also cannot be used to terminate or modify the contract.**

## Impact on Swap Agreements

*continued*

- **To avoid these problems:**
  - **Provisions were added to the Bankruptcy Code, the FDIA and the NYBL.**
  - **The provisions of the FDIA expressly supersede any contrary provision of state or federal law.**
  - **In addition, FDICIA — adopted primarily to protect payment systems — also protects netting rights under master agreements between covered institutions.**
- **Together, these provisions provide substantial protection to many market participants, and were further perfected in 2005.**

## What Types of Transactions Protected

- The contracts protected differ to some degree, though were largely unified by 2005 amendments to include:
  - Securities contracts
  - Repurchase agreements
  - Forward contracts
  - Commodity contracts
  - Swap Agreements
- Master netting agreements are now expressly afforded protection as well

## Net Result of Protective Provisions

- Derivatives counterparties are generally well protected in bankruptcy, FDIC or New York/national bank proceedings, relative to other creditors
  - Generally can terminate contracts if they fit into a protected category
  - Generally can net obligations under different transactions together, if they fit into the same protected category
  - Generally can retain, liquidate and apply collateral
  - Payments made prior to bankruptcy generally are not subject to clawback

**NOTE:** If a counterparty doesn't actually exercise its special right to terminate, it will be vulnerable to the trustee's (or other party's) other powers

## Risks remain . . . .

- There may be limitations on the ability of a counterparty to exercise rights that appear to be protected by the safe harbor provisions (e.g., the *Metavante* decision)
- Derivative counterparties may be affected by insolvency law provisions that apply to transactions in which derivatives are embedded (e.g., the *Dante* decision)
- The law continues to develop, due to possible new legislation and new interpretations of existing provisions

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