Legislation that would strengthen and clarify the enforceability of early termination and close-out netting provisions and related collateral arrangements in U.S. insolvency proceedings has recently been passed by both the Senate and the House of Representatives. Certain differences between the Senate version (S. 420) and the House version (H.R. 333) need to be resolved by a Conference Committee or other procedures before the legislation can be forwarded to President Bush for his signature. The netting provisions are found in Title IX of the legislation; the remainder of the legislation deals with consumer bankruptcy and other issues. The Financial Contract Provisions in Title IX have not been controversial, and the Senate and House versions of those provisions are in most respects substantively identical. The consumer bankruptcy provisions have been more controversial. The final approval of the legislation and the timing of that approval will depend on resolution of the consumer bankruptcy provisions.

Similar legislation concerning close-out netting has come close to approval several times since 1996. In fact, very similar financial contract provisions were approved by the House and the Senate in late 2000 as part of broader bankruptcy reform legislation, but the legislation did not become law because it was not signed by President Clinton. That legislation provided the basis for S. 420 and H.R. 333 when a new Congress convened in early 2001.

ISDA has been working with the Bond Market Association to secure approval of U.S. netting legislation since 1995. After discussions concerning possible improvements in law with an interagency working group organized under the auspices of the President's Working Group on Financial Markets, on April 2, 1996 (exactly five years ago!) ISDA and the Bond Market Association published a position paper entitled "Financial Transactions in Insolvency: Reducing Legal Risk Through Legislative Reform". Many of the legislative provisions proposed in that position paper can be found in similar form in Title IX of S. 420 and H.R. 333.

A. Prior U.S. Netting Legislation

The United States adopted the earliest laws providing for the enforceability of swap master agreements in insolvency. In 1989, the "qualified financial contract" ("QFC") provisions were adopted as part of FIRREA, which amended the Federal Deposit Insurance Act (the "FDIA") provisions for U.S. bank insolvency. Under the FDIA as amended by FIRREA, "swap agreements" are one form of QFC. In 1990, the U.S. Bankruptcy Code (the "Bankruptcy Code") was amended to include protection for close-out netting under "swap agreements".

After these developments in 1989 and 1990, both the FDIA and the Bankruptcy Code contained provisions that protect the rights of financial participants to terminate swap agreements, forward contracts, securities contracts, commodity contracts and repurchase agreements following the bankruptcy or insolvency of a counterparty to such contracts or agreements. Furthermore, other provisions prevent
transfers made under such circumstances from being avoided as preferences or fraudulent conveyances (except when made with actual intent to defraud and taken in bad faith). Protections also are afforded to ensure that the acceleration, termination, liquidation, netting, setoff and collateral foreclosure provisions of such transactions and master agreements for such transactions are enforceable.

In addition, the Federal Deposit Insurance Corporation Improvement Act ("FDICIA") was enacted in 1991 to protect the enforceability of close-out netting provisions in "netting contracts" between "financial institutions." FDICIA states that the goal of enforcing netting arrangements is to reduce systemic risk within the banking system and financial markets.

As markets evolved and new products were developed after 1991, the definition of "swap agreement" in the Bankruptcy Code and the FDIA proved to be too narrow to encompass all the types of transactions being documented under ISDA Master Agreements. For example, the Bankruptcy Code currently defines "swap agreement" as follows:

"(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;"

If equity derivatives and credit derivative transactions are included under this definition, it is through interpretation of the phrase "any other similar agreement." If those transactions are not swap agreements, they do fall under other protected silos such as "securities contracts" and "forward contracts". Unfortunately, there is no exception to the Bankruptcy Code's automatic stay for close-out netting between swap agreements, on the one hand, and securities contracts and forward contracts, on the other hand. For similar reasons, the enforceability of "master-master" agreements under the Bankruptcy Code is not as clear as would be desirable.

Section 546(g) of the Bankruptcy Code also limits a trustee's avoidance powers for transfers "under a swap agreement" prior to the commencement of a proceeding. The use of the phrase "under a swap agreement", however, has led to concerns with collateral arrangements that were related to but not "under" a swap agreement.

These and other issues under the Bankruptcy Code and the FDIA have made the passage of additional U.S. netting legislation one of ISDA's top priorities since 1995. While the current position is relatively strong, there is room for improvement to reflect what has happened over the 10 years since the passage of FDICIA in 1991.
B. The Pending Legislation

The summary below will concentrate on the provisions of S. 420 that are most directly related to swap agreements. This summary relies heavily on the most recent draft of the legislative history for the Financial Contract Provisions of S. 420. Reference should be made to that draft legislative history for a more complete description of Title IX of S. 420.

1. Definition of "Swap Agreement"

Section 907(a) of S. 420\(^1\) defines "swap agreement" under the Bankruptcy Code as follows:

"(53B) 'swap agreement'–

(A) means–

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

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

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

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

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

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

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

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

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

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

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

---

\(^1\) Section 901(f) of S. 420 has a substantively identical definition for the FDIA.
(II) is a forward, swap, future, or option on one or more rates, currencies, commodities, equity securities, or other equity instruments, debt securities or other debt instruments, quantitative measures associated with an occurrence, extent of an occurrence, or contingency associated with a financial, commercial, or economic consequence, or economic or financial indices or measures of economic or financial risk or value;

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

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

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

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

(B) is applicable for purposes of this title only, and shall not be construed or applied so as to challenge or affect the characterization, definition, or treatment of any swap agreement under any other statute, regulation, or rule...."

This definition of "swap agreement" provides several clear improvements over the existing definition. First, equity, credit and weather derivatives are enumerated. Second, the phrase "any other similar agreement" in the existing definition is replaced by the more specific and useful provision in clause (A)(ii) of the proposed definition. Third, clause (A)(v) confirms that the inclusion of a non-qualifying transaction does not prevent all qualifying transactions from being treated as swap agreements. Finally, clause (A)(vi) provides protection for security agreements and other credit enhancements "related to" swap agreements. This clarifies that collateral does not need to be held "under" a swap agreement to be protected from a trustee's various powers.²

2. Cross Product Master Agreements

Section 905 of S. 420 states that a master agreement for one or more securities contracts, commodity contracts, forward contracts, repurchase agreements or swap agreements will be

² S. 420 also will amend Section 546(g) of the Bankruptcy Code to replace "under a swap agreement" with "under or in connection with any swap agreement".
treated as a single QFC under the FDIA (but only to the extent the underlying agreements are themselves QFCs). This provision ensures that cross-product netting pursuant to a master agreement (such as an ISDA Master Agreement), or pursuant to an umbrella agreement for separate master agreements between the same parties, each of which is used to document one or more qualified financial contracts, will be enforceable under the FDIA.

Section 907(c) of S. 420 adds to the Bankruptcy Code new definitions of "master netting agreement" and "master netting agreement participant".

The S. 420 definition of "master netting agreement" is designed to protect the termination and close-out netting provisions of cross-product master agreements (such as the ISDA Master Agreements) between parties. Such an agreement may be used (i) to document a wide variety of securities contracts, commodity contracts, forward contracts, repurchase agreements and swap agreements or (ii) as an umbrella agreement for separate master agreements between the same parties, each of which is used to document a discrete type of transaction. The definition includes security agreements or arrangements or other credit enhancements related to one or more such agreements and clarifies that a master netting agreement will be treated as such even if it documents transactions that are not within the enumerated categories of qualifying transactions (but the provisions of the Bankruptcy Code relating to master netting agreements and the other categories of transactions will not apply to such other transactions). A "master netting agreement participant" is any entity that is a party to an outstanding master netting agreement with a debtor before the filing of a bankruptcy petition.

3. **The Bankruptcy Code Automatic Stay**

Section 907(d) of S. 420 amends section 362(b) of the Bankruptcy Code to protect enforcement, free from the automatic stay, of setoff or netting provisions in swap agreements and in master netting agreements and security agreements or arrangements related to one or more swap agreements or master netting agreements. This provision parallels the other provisions of the Bankruptcy Code that protect netting provisions of securities contracts, commodity contracts, forward contracts, and repurchase agreements. Because the relevant definitions include related security agreements, the references to "setoff" in these provisions, as well as in section 362(b)(6)(7) of the Bankruptcy Code, are intended to refer also to rights to foreclose on, and to set off against obligations to return, collateral securing swap agreements, master netting agreements, repurchase agreements, securities, securities contracts, commodity contracts, or forward contracts.

Section 907(d) of S. 420 also clarifies that the provisions protecting setoff and foreclosure in relation to securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements, and master netting agreements free from the automatic stay apply to collateral pledged by the debtor but that cannot technically be "held by" the creditor, such as receivables and book-entry securities, and to collateral that has been repledged by the creditor and securities re-sold pursuant to repurchase agreements.

4. **Relationship of the FDIA and FDICIA**

Section 902 of S. 420 provides that no provision of law, including FDICIA, shall be construed to limit the power of the FDIC to transfer or to repudiate any QFC in accordance with its powers under the FDIA. There has been some uncertainty regarding whether or not FDICIA limits the authority of the FDIC to transfer or to repudiate QFCs of an insolvent financial institution.
Section 902 -- as well as other provisions in S. 420 -- clarify that FDICIA does not limit the transfer powers of the FDIC with respect to QFCs.

Section 903(c) also amends the FDIA to clarify the relationship between the FDIA and FDICIA. There has been some uncertainty whether FDICIA permits counterparties to terminate or liquidate a QFC before the expiration of the time period provided by the FDIA during which the FDIC may repudiate or transfer a QFC in a conservatorship or receivership. Subsection (c) provides that a party may not terminate a QFC based solely on the appointment of the FDIC as receiver until 5:00 p.m. (Eastern Time) on the business day following the appointment of the receiver or after the person has received notice of a transfer, or based solely on the appointment of the FDIC as conservator, notwithstanding the provisions of FDICIA. This provides the FDIC with an opportunity to undertake an orderly resolution of an insured depository institution.

5. **Walkaway Clauses under the FDIA**

Section 902 amends the FDIA to deny enforcement to "walkaway" clauses in QFCs. A walkaway clause is defined as a provision that, after calculation of a value of a party's position or an amount due to or from one of the parties upon termination, liquidation or acceleration of the QFC, either does not create a payment obligation of a party or extinguishes a payment obligation of a party in whole or in part solely because of such party's status as a non-defaulting party.

6. **Selective Repudiation by the FDIC**

Under current law, the FDIC must transfer all QFC's with a counterparty if it transfers any QFC's with that counterparty. Selective transfer is not permitted. Current law, however, does not bar selective repudiation by the FDIC. The FDIC has announced that its policy is not to repudiate or disaffirm QFC's selectivity. Section 904 of S. 420 limits the disaffirmance and repudiation authority of the FDIC with respect to QFCs so that such authority is consistent with the FDIC's transfer authority under FDIA section 11(e)(9). This ensures that no disaffirmance, repudiation or transfer authority of the FDIC may be exercised to "cherry-pick" or otherwise treat independently all the QFCs between a depository institution in default and a person or any affiliate of such person.

7. **Bankruptcy Code Damages Timing**

Section 910 of S. 420 adds a new section 562 to the Bankruptcy Code providing that damages under any swap agreement, securities contract, forward contract, commodity contract, repurchase agreement or master netting agreement will be calculated as of the earlier of (i) the date of rejection of such agreement by a trustee or (ii) the date of liquidation, termination or acceleration of such contract or agreement. New section 562 provides important legal certainty and makes the Bankruptcy Code consistent with the current provisions related to the timing of the calculation of damages under QFCs in the FDIA.

8. **Improvements in FDICIA**

FDICIA provides for the enforceability of netting contracts between "financed institutions". Section 906(a)(2) of S. 420 expands "financial institution" to include (i) uninsured national and State member banks, irrespective of their eligibility for deposit insurance and (ii) foreign banks (including the foreign bank and its branches or agencies as a combined group, or only the foreign
bank parent of a branch or agency). The latter change will extend the protections of FDICIA to ensure that U.S. financial organizations participating in netting agreements with foreign banks are covered by FDICIA, thereby enhancing the safety and soundness of these arrangements. It is intended that a non-defaulting foreign bank and its branches and agencies be considered to be a single financial institution for purposes of the bilateral netting provisions of FDICIA (except to the extent that the non-defaulting foreign bank and its branches and agencies on the one hand, and the defaulting financial institution, on the other, have entered into agreements that clearly evidence an intention that the non-defaulting foreign bank and its branches and agencies be treated as separate financial institutions for purposes of the bilateral netting provisions of FDICIA).

FDICIA currently requires that a qualifying netting contract must be governed by the laws of the United States or one of the fifty states. Section 906(a)(3) of S. 420 broadens the definition of "netting contract" to include agreements governed by non-U.S. law.

C. Conforming Changes for the CFMA

S. 420 includes a number of technical changes designed to take account of the provisions of the Commodity Futures Modernization Act of 2000 (the "CFMA"). The most important of these changes relates to clearing organizations authorized by the CFMA.

There currently are limits on qualifying counterparties for purposes of the Bankruptcy Code provisions protecting close out of securities contracts and forward contracts. For example, the right to liquidate a securities contract can only be utilized by stockbrokers, financial institutions and securities clearing agencies. Section 907(b) of S. 420 adds a new definition of "financial participant" so that major market participants will be able to utilize the Bankruptcy Code's provisions for close out of securities contracts and forward contracts. "Financial participant" is also defined to include "clearing organizations" within the meaning of FDICIA (as amended by the CFMA). This amendment, together with the inclusion of "financial participants" as eligible counterparties in connection with "commodity contracts," "forward contracts" and "securities contracts" and the amendments made in other Sections of S. 420 to include "financial participants" as counterparties eligible for the protections in respect of "swap agreements" and "repurchase agreements", take into account the CFMA and will allow clearing organizations to benefit from the protections of all of the provisions of the Bankruptcy Code relating to these contracts and agreements. This will further the goal of promoting the clearing of derivatives and other transactions as a way to reduce systemic risk.

Daniel P. Cunningham  
Joshua D. Cohn

---

3 The Federal Reserve Board has by regulation included certain institutions, including certain foreign banks, swaps dealers and insurance companies, in the definition of a "financial institution" for purposes of FDICIA. See 12 C.F.R. Part 231.