

Trading Swap Termination Claims

By Julia Lu Fu and Troy Willitt

Nothing is certain in today's financial crisis – except that the legal system will be sorting out the rights and obligations of financial market participants for years to come. This is especially true for participants in the over-the-counter derivatives markets.

Fortunately, the tremendous growth of this largely unregulated market has been accompanied by the development of sophisticated contractual frameworks and thoughtful bankruptcy legislation expressly intended to reduce uncertainty around the amount and type of claims that are ultimately asserted by market participants following bankruptcy of a derivative counterparty.

As a general rule, the insolvency of a party entitles the counterparty to terminate all derivatives transactions between the parties. A robust contractual netting process, honored in bankruptcy, allows the parties to determine the final amount owed to or owed by the insolvent party.

As discussed below, a claim for amounts owed by an insolvent party – the “swap termination claim” – will most likely be considered an unsecured claim on the estate of such party. Parties holding swap termination claims may want to monetize those claims before the conclusion of an insolvent counterparty's bankruptcy. Swap termination claims, like other types of unsecured claims, constitute an asset class that can be traded during the course of the bankruptcy. Swap termination claims have been actively traded in several recent U.S. bankruptcies, including Enron and ASARCO, and will be actively traded in any bankruptcy of a financial institution with a significant number of over-the-counter derivatives transactions.

Sellers and buyers of swap termination claims take on unique economic and legal risk that can be managed through appropriate legal documentation. This memorandum briefly describes how (i) swap termination claims are calculated, (ii) unsecured bankruptcy claims are traded, and (iii) customary claims trading documentation should be modified when swap termination claims are purchased and sold.

Swap Termination Claims

Unlike exchange-traded futures and other derivatives products, over-the-counter derivatives products trade without a central clearing system and therefore expose parties directly to the credit risk of their counterparties. In order to mitigate counterparty credit risk, most parties enter into a master agreement (“Master Agreement”), in a form prepared by the International Swaps and Derivatives Association (“ISDA”), to govern over-the-counter derivatives transactions.

One of the pillars of the Master Agreement is a detailed contractual close-out netting process. Upon the default (including bankruptcy) of one party, the non-defaulting party can (i) terminate all transactions subject to the Master Agreement, (ii) designate an early termination date for purposes of calculating the value of the terminated transactions, and (iii) calculate a net amount owed to or owed by the insolvent party under the terminated transactions (the “swap termination amount”).¹

The non-defaulting party must deliver to the insolvent party a notice showing the calculation of the swap termination amount. The swap termination amount owed by

¹ This swap termination amount is a net amount of the “close-out amounts” (under the 2002 form Master Agreement) or “termination amounts” (under the 1999 form Master Agreement) and “unpaid amounts” owed to each party under each of the terminated transactions. The close-out amounts and the termination amounts are based on the replacement cost or value of the terminated transactions.

Memorandum

October 6, 2008

“Nothing is certain in today's financial crisis – except that the legal system will be sorting out the rights and obligations of financial market participants for years to come. This is especially true for participants in the over-the-counter derivatives markets.”

NEW YORK
WASHINGTON, DC
LONDON

www.rkollp.com

This memorandum may be considered advertising under applicable state laws.

either party may generally be set off by the payor against amounts owed by the payee, whether or not arising under the Master Agreement. As a general rule, payment obligations arising upon early termination are secured by any collateral posted² pursuant to the credit support annex to the Master Agreement (“Credit Support Annex”).³

A non-defaulting party's swap termination claim can arise in two ways: (i) if the swap termination amount is **owed by** the insolvent party, the collateral posted by the insolvent party may be less than that amount, or (ii) if the swap termination amount is **owed to** the insolvent party, the insolvent party may fail to return excess collateral posted by the non-defaulting party.

If the swap termination amount is **owed by** the insolvent party, the non-defaulting party may exercise all rights and remedies of a secured party under the Credit Support Annex and use the collateral posted by the insolvent party to satisfy the insolvent party's payment obligations. If the swap termination amount exceeds the posted collateral, then the non-defaulting party has an unsecured claim against the insolvent party for the deficiency.

If the swap termination amount is **owed to** the insolvent party,⁴ the insolvent party may exercise its rights and remedies as a secured party with respect to collateral posted by the non-defaulting party under

the Credit Support Annex. However, if the collateral posted by the non-defaulting party exceeds the swap termination amount, as a practical matter there is a risk the non-defaulting party will receive only an unsecured claim for the excess collateral.⁵

Trading Unsecured Claims

A trading market for unsecured bankruptcy claims⁶ has developed over the past twenty years. In most cases, claims trading in a bankruptcy case will begin after the debtor in the case publishes its schedule of liabilities and will continue through plan confirmation.

Claims purchased early in a bankruptcy case – *e.g.*, shortly after the debtor releases its schedule of liabilities – involve greater uncertainty around the amount, treatment and status of the claims than claims purchased subsequently, after being allowed in a bankruptcy case by stipulation or court order. Claims sold early in the case will be traded on buyer-friendly documents containing more fulsome representations, warranties and indemnities. Claims sold after a final order allowing the claim has been entered in the bankruptcy case will be considered more certain and will trade on streamlined, seller-friendly documentation.⁷

The unsecured claims trading market does not use form documentation prepared by a market association

² This assumes a “two-way” credit support arrangement under which either party may be required to post collateral. There are also some “one-way” credit support arrangements in the market under which the dealer party need not post collateral as a practical matter, either due to a high threshold amount (beyond which collateral is required) or otherwise.

³ Thanks to a “safe harbor” provision in the Bankruptcy Code for “swap participants” and “swap agreements,” actions taken to set off amounts owed to a bankrupt debtor, or realize on collateral are exempt from the “automatic stay” normally imposed by the U.S. Bankruptcy Code upon creditors of a bankrupt debtor, which prevents creditors from taking any action to collect on a claim or enforce security interest against the debtor.

⁴ For purposes of this memorandum, we assume the applicable Master Agreement provides that a non-defaulting party must pay a defaulting party the swap termination amount, if such amount is positive. There are some Master Agreements, namely those based on a 1992 form under which the parties have chosen “First Method” as the payment method, which do not require payment by a non-defaulting party to a defaulting party.

⁵ Details of this analysis will be the subject of a forthcoming memorandum on the topic. In essence, since it is contractually permissible for the secured party (the insolvent party in this case) to use, commingle and re-hypothecate the collateral, that collateral is not traceable as an asset of the non-defaulting party and therefore, assuming that such collateral is not returned, the non-defaulting party may have only an unsecured claim for the amount.

⁶ This secondary market also trades other types of claims against an insolvent party (such as reclamation claims or administrative priority claims under the Bankruptcy Code). The mechanics of trading these other claims, including the documentation used in the purchase and sale of the claims, are similar to that of general unsecured claims. The specific features of these other types of claims that should be considered, however, are beyond the scope of this memorandum.

⁷ For example, if the claims are purchased early in a bankruptcy case, the transfer documents will also include representations regarding the principal amount of the claim and the basis on which the claim arose. If a settlement or order is in effect with respect to the claim prior to the purchase, seller will also likely make a representation as to the final non-appealable status of the settlement or order.

such as ISDA or the Loan Syndications and Trading Association, Inc. (“LSTA”).⁸ However, an accepted range of “customary” documentation has emerged in the claims trading market. The documents contain detailed seller representations and warranties customized to address the specific claim being traded, and generally follow a pattern of risk allocation between buyer and seller that is accepted in the market.

Since the amount of the claim that ultimately will be allowed by the bankruptcy court is uncertain, parties must allocate the risk that the final allowed claim amount is **less** than the amount originally purchased. As a general rule, the purchase price allocable to any portion of the claim that is disallowed by final order is returned to buyer with interest. This is referred to as the “disallowance” remedy, which is triggered when the claim is reduced in whole or in part by the bankruptcy court. The disallowance remedy is effective only if seller of the claim is solvent at the time of the disallowance and financially able to return the purchase price to buyer. To reduce counterparty risk, buyer may hold back a portion of the purchase price until the claim is allowed by final order in the bankruptcy case. In a customary trade, the parties may also allocate the risk that the claim is allowed in a **greater** amount than the amount purchased by buyer under the transfer document.⁹

Rule 3001(e) of the Federal Rules of Bankruptcy Procedure sets forth the mechanism for recording the transfer of claim on the bankruptcy court’s records. The procedure is straightforward, but substantial delay and confusion (including future illiquidity of the claim) can result if this procedural matter is not dispatched promptly and accurately.

Modifications for Trading Swap Claims

Swap termination claims require modification of the documentation used to trade unsecured claims. Most importantly, given the complex nature of derivative transaction close-out netting under the Master Agreement, claim buyers generally conduct focused due diligence on the underlying swap transactions between the insolvent party and the non-defaulting party that gave rise to the swap termination claim. This due diligence will help test the valuation for the swap termination amount.

Information regarding the terminated derivatives transactions, calculation of the swap termination amount and the valuation method employed by the non-defaulting party will be crucially important when defending the swap termination claim in the bankruptcy proceeding. Therefore buyer should require seller to provide – and represent as to the completeness of – all information relevant to the termination of the swap termination amount. Buyer should also require seller to represent that the swap termination amount was calculated in accordance with the terms of the relevant Master Agreement and that the amount includes all of the amounts owing to the non-defaulting party from the insolvent party under the Master Agreement, and the non-defaulting party has no remaining obligations under or in connection with the Master Agreement.¹⁰

Buyer should ensure the non-defaulting party under the Master Agreement is required to maintain all documentation relating to the underlying swap transactions and to make these documents available to buyer (or buyer’s designee) upon request.¹¹

⁸ The LSTA has published standard documentation for secondary trading in par/near par and distressed bank loans. Certain of the representations and warranties contained in a claims trading document are analogous to provisions in an LSTA standard purchase and sale agreement for distressed bank loans. However, the remedial “disallowance” provisions found in trade claim documentation (discussed below) are markedly different from standard LSTA distressed documentation.

⁹ These provisions take three general approaches: (i) require buyer to buy any “excess claim” at the purchase rate used in the underlying trade, (ii) give buyer an option to purchase any excess claim at the purchase rate and (iii) leave the excess claim to seller.

¹⁰ Modifications to representation and warranties or other sections of the trade claim document will vary depending on the nature of the trade and the risk tolerance of the parties involved in the transaction. The points discussed in this memorandum are merely illustrative of the types of modifications that may be requested and do not constitute an exhaustive list of modifications.

¹¹ This covenant can be limited in duration and remain until the later of (i) an entry of a final order allowing the swap termination claim in the insolvent party’s bankruptcy case or (ii) the confirmation of the insolvent party’s plan of reorganization.

Importantly, the standard "no setoff" representation found in most documents governing unsecured claims trading should be reviewed in light of the facts surrounding a particular swap termination claim. Since the Master Agreement expressly authorizes either party to set off the amount owed to the other under the Master Agreement against any other amount owed by such other party, it is likely that setoff **will have occurred** and should be considered in calculating the size of the swap termination claim. The standard "no-setoff" representation should be adjusted to include appropriate exceptions for the Master Agreement's explicit right of setoff, but most importantly, buyer should understand and agree with any setoff exercised by the non-defaulting party in determining the swap termination claim. That calculation can be confirmed by seller and the non-defaulting party in representations and warranties in the purchase documentation, but a prudent buyer will want to be prepared for the worst case – being left alone to defend the non-defaulting party's setoff right in the bankruptcy proceeding upon seller's or the non-defaulting party's insolvency or breach of a promise to cooperate.

The disallowance remedy provisions contained in claims trading documentation will likely need little, if any, modification. To the extent that a swap termination claim is disallowed in whole or in part, the disallowance remedy will return the relevant portion of the purchase price plus interest to compensate buyer for the disallowance.

Finally, buyer should be sure to purchase from seller all rights of the non-defaulting party against any "Credit Support Provider" for the insolvent party under the Master Agreement. Depending upon the terms of the credit support, buyer may be able to assert a separate and independent claim against the Credit Support Provider (generally a parent or operating affiliate of counterparty). If the Credit Support Provider is insolvent, buyer will need to prosecute a parallel claim in the bankruptcy proceeding of the Credit Support Provider.

Conclusion

Swap termination claims will likely receive increased attention in the unsecured claims trading market because of current market conditions (including financial institution insolvency) and the tremendous notional amounts of existing derivative exposure. As an unsecured claim, swap termination claims may be traded on customary claims trading documentation, with modifications reflecting the history and origin of the particular claim (including setoff) and confirming the calculation of the swap termination amount under the Master Agreement. The existing market in unsecured claims has generated customary and comprehensive trading documentation that can be easily adapted for swap termination claims. Accordingly, a liquid market for swap termination claims is likely to develop.

* * *

If you have any questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below:

Julia Lu Fu

New York, NY
212 530 1892
jfu@rkollp.com

Troy Willitt

New York, NY
212 530 19160
twillitt@rkollp.com

This memorandum is provided by Richards Kibbe & Orbe LLP for educational and information purposes only and is not intended and should not be construed as legal advice.

© 2008 Richards Kibbe & Orbe LLP, One World Financial Center, New York, NY 10281, 212.520.1800, <http://www.rkollp.com>. All rights reserved. Quotation with attribution is permitted. If you would like to add a colleague to our mailing list or if you need to change or remove your name from our mailing list, please email publications@rkollp.com.