CLEARY GOTTLIEB STEEN & HAMILTON

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Securities, Forward and Commodity Contracts and Repurchase and Swap Agreements under U.S. Insolvency Laws

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I. GOVERNING LAW

A. With specified exceptions, all "persons" (individuals, corporations and partnerships) that reside or have a domicile, a place of business or property in the United States, as well as municipalities, are eligible for relief under the substantive provisions of the federal Bankruptcy Code (the "Code").

1. A person may not be a debtor under Chapters 7 or 11 of the Code if it is a domestic insurance company, bank, thrift or credit union or a foreign insurance company, bank, thrift or credit union engaged in business as such in the United States.

a. As discussed below, state law governs delinquency proceedings (typically, rehabilitation or liquidation proceedings) of insurance companies. Insurance companies are not "financial institutions" under the provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") discussed below. Although an insurance company might qualify as a "financial institution" under the provisions of the Federal Reserve Board's Regulation EE (discussed below), there is a substantial question as to whether the provisions of FDICIA supersede state law governing insurance delinquency proceedings by virtue of the McCarran-Ferguson Act. Cf. U.S. Dep't of Treasury v. Fabe, 113 S.Ct. 2202 (1993) (interplay of Ohio priority statute and federal superpriority statute).

b. The Federal Deposit Insurance Act ("FDIA"), discussed below, will likely govern conservatorship or receivership proceedings of institutions the accounts of which are insured by the Federal Deposit Insurance Corporation ("FDIC"). FDIC-insured institutions are "financial institutions" under FDICIA. State law (as well as foreign law) will likely govern proceedings in respect of a state branch or agency of a non-U.S. bank. See, e.g., New York Banking Law Section 606. Proceedings in respect of a federal branch or agency of a non-U.S. bank would be subject to the International Banking Act (12 U.S.C. § 3102(j)). But see Agency for Dep. Ins. v. Sup. of Banks, 310 B.R. 793 (S.D.N.Y. 2004) (New York branch of Yugoslav bank can be subject to ancillary bankruptcy proceedings under Code).

c. The Federal Credit Union Act ("FCUA") will likely govern the insolvency proceedings of federally-insured credit unions. The FCUA contains provisions almost identical to the "qualified financial contract" provisions of the FDIA discussed below, with two significant exceptions: "qualified financial contracts" do not include "commodity contracts," and the "written agreement" requirements of the FCUA differ from those of the FDIA (and have not been interpreted in any policy statement of the National Credit Union Administration). In addition, the FCUA "qualified financial contract" provisions contain an error, that while almost certainly typographical, could be interpreted to eliminate certain termination protections in the case of a liquidation. But see 68 Fed. Reg. 32355 (May 30, 2003) (NCUA indicates in preamble to new regulation (12 C.F.R. § 709) adding "swap agreements" as qualified financial contracts that it will enforce FCUA as if typographical error did not exist). Federally-insured credit unions are "financial institutions" under FDICIA. The Pending Bankruptcy Legislation described below would amend the FCUA to add "swap agreements" and "commodity contracts" as "qualified financial contracts" and would correct the typographical error in the FCUA.

d. The Federal Housing Enterprises Financial Safety and Soundness Act ("FHEFSSA") will likely govern conservatorship proceedings of the Federal National Mortgage Association ("FNMA") and the Federal Home Loan Mortgage Corporation ("FHLMC") and affiliates. FHEFSSA contains provisions for the enforcement of contracts as prescribed in regulations to be issued under FHEFSSA. FHEFSSA's impact on close-out and netting rights is unclear. Proposed amendments to FHEFSSA could clarify some of these issues. FNMA and FHLMC have been designated as "financial institutions" under FDICIA (see attached).

2. "Stockbrokers" and "commodity brokers" may not be debtors under Chapter 11 (but may be debtors under Chapter 7) of the Code, although they will likely be "financial institutions" under FDICIA, particularly under Regulation EE.

3. Stockbrokers that are members of the Securities Investor Protection Corporation ("SIPC") may also be the subject of proceedings under the Securities Investor Protection Act of 1970 ("SIPA") and will be "financial institutions" under FDICIA.

4. Commodity brokers regulated by the Commodity Futures Trading Commission and 1940 Act-registered mutual funds have been the subject of federal law court-supervised equity receiverships, including the March, 2001 receivership of certain funds in the Heartland Group.

5. Under Section 782 of the Code and related provisions of the Federal Reserve Act, the Federal Reserve Board may appoint a conservator or receiver to act as trustee for an uninsured state member bank or an Edge corporation that operates, or operates as, a multilateral clearing organization. Such a trustee has certain additional powers possessed by the FDIC under the FDIA.

6. A "foreign representative" for a debtor may commence proceedings ancillary to a "foreign proceeding" under Section 304 of the Code, in order to administer assets located in the United States or seek other appropriate relief. As a general matter, subject to certain exceptions, applicable <u>foreign</u> substantive law is likely to, and U.S. procedural law will, apply in such an ancillary proceeding. <u>But see</u> <u>Koreag, Controle et Revision v. Refco F/X Associates, Inc. (In re Koreag, Controle et Revision S.A.)</u>, 961 F.2d 341 (2d Cir. 1992) (bankruptcy court should apply local (U.S.) law to determine extent of debtor's interest in property); <u>In re Board of Dirs. of Hopewell Int'l Ins. Ltd.</u>, 238 B.R. 25 (Bankr. S.D.N.Y. 1999), (applying local (U.S.) law to determine whether accounts receivable are assets and where they are located for venue of § 304 proceeding). H.R. 975 (the "<u>Pending Bankruptcy Legislation</u>") includes a new Chapter 15 of the Code that is based on the UNCITRAL Model Law on Cross-Border Insolvency. Titles V and IX of the Pending Bankruptcy Legislation are attached hereto. The version of the legislative history attached hereto relates to a version of the Pending Bankruptcy

Legislation that is nearly identical to H.R. 975 (with the significant exception that the provision regarding asset-backed securities has been dropped from consideration and provisions regarding credit unions have been added).

7. The Code defines "corporation" to include a "business trust." In In re Secured Equip. Trust of Eastern Air Lines, 38 F.3d 86 (2nd Cir. 1994), the court held that a trust created as a vehicle to facilitate a secured financing was not a business trust, and hence ineligible for bankruptcy protection. Pension plans are also generally not "persons" eligible for Code protection. See, e.g., In re Parade Realty, Inc., 134 B.R. 7 (Bankr. D. Hawaii 1991); In re Cahill, 15 B.R. 639 (Bankr. E.D. Pa. 1981).

B. Subject to certain possible exceptions, the "securities contract," "forward contract," "commodity contract," "repurchase agreement," and "swap agreement" provisions of the Code will apply in any proceeding under Chapters 7, 9 or 11 of the Code or in any ancillary proceeding under Section 304 of the Code.

1. If the non-bankrupt counterparty is a "governmental unit" (and thus not a "person") as defined in the Code, it might not enjoy the full scope of protections under the forward and commodity contract provisions of the Code.

2. In a Chapter 9 proceeding of a debtor municipality, the anti-avoidance provisions protecting preferential and fraudulent transfers in connection with securities, forward and commodity contracts, repurchase and swap agreements (hereinafter collectively referred to as "protected contracts") will apply to the same extent as under Chapters 7 and 11.

3. Although the provisions protecting the exercise of liquidation and termination rights under protected contracts state that they apply in any proceeding under Title 11, there is some uncertainty as to their applicability in a Chapter 9 proceeding due to the failure to refer to the provisions in Section 901 of the Code. See County of Orange v. Nomura Securities International, Inc., Adv. No. 94-02480 (Bankr. S.D. Cal.) (complaint dismissed) (challenging close-out of repurchase agreements under Section 559). Title V of the Pending Bankruptcy Legislation would make clear that the provisions of the Code relating to protected contracts apply fully in a Chapter 9 proceeding.

4. In an ancillary proceeding under Section 304 of the Code, although it appears that the provisions protecting the exercise of liquidation and termination rights under protected contracts should apply by their terms, one court has recently held to the contrary. See In re: Petition of the Board of Directors of Compania General de Combustibles S.A., 269 B.R. 104 (Bankr. S.D.N.Y. 2001) (court in Section 304 proceeding enjoined action against U.S. property even though swap participant unable to terminate swap agreement upon bankruptcy of Argentine debtor under Argentine law). Nor is it clear that the anti-avoidance provisions protecting preferential and fraudulent transfers would apply. Title IX of the Pending Bankruptcy Legislation would make clear that all the protected contract provisions will apply in a proceeding under Chapter 15 (which will replace Section 304).

C. Certain further limitations, discussed below, arise in a proceeding under SIPA.

D. The protected contract provisions of the Code do not by their terms apply in equity receiverships of commodity brokers or mutual funds.

II. SEVERAL PROVISIONS OF THE CODE IMPAIR CREDITORS' RIGHTS.

A. The "trustee" (including a debtor-in-possession) has the right under Section 365 of the Code to assume (and assign) or reject most executory contracts of the debtor, notwithstanding so-called "ipso facto" clauses automatically terminating contracts on the basis of the bankruptcy of a counterparty and notwithstanding clauses prohibiting the assignment thereof.

1. The right to assume or reject executory contracts might give a trustee the power to "cherry pick" between transactions, including those documented by the parties under a master agreement; i.e., to assume (or assume and assign) transactions favorable to the trustee and reject transactions favorable to the counterparty.

a. Provisions in master agreements that provide that all transactions thereunder constitute a single agreement should operate to prevent selective assumption/rejection, but are untested.

2. The protected contract provisions (discussed below) protect the exercise of contractual liquidation and termination rights, notwithstanding a trustee's general right to assume or reject executory contracts.

a. If a counterparty did not exercise a liquidation or termination right, the trustee would continue to have the power to assume or reject protected contracts, subject, perhaps, to the provisions of FDICIA discussed below.

b. The trustee's right, if any, and as limited by FDICIA, to cherry pick between transactions in such circumstances would only apply in the case of securities, forward and commodity contracts and repurchase agreements; the trustee apparently could not cherry pick between transactions consummated under a master swap agreement. See Code § 101(53B) (definition of "swap agreement").

3. It is not entirely clear when the damages recoverable upon the liquidation or termination (whether by the counterparty or upon a rejection by a trustee) of a protected contract are to be measured -- at or about the time of the filing of the petition, at the time of termination, or at some other time specified in the relevant contract.

a. In general, the rejection of an executory contract constitutes a breach thereof immediately before the date of the filing of the petition. Code § 365(g)(1).

b. The claim arising from rejection of an executory contract under Section 365 of the Code is, in general, to be determined and allowed the same as if such claim had arisen before the date of the filing of the petition. Code § 502(g).

c. Accordingly, if for some reason a counterparty did not terminate a protected contract upon the bankruptcy of the debtor, and the trustee later rejected that contract or agreement, damages arising from the rejection might be measured as of an earlier date -- the filing of the petition or the day before. See, e.g., In re O.P.M. Leasing Services, Inc., 79 B.R. 161 (S.D.N.Y. 1987); In re Aslan, 909 F.2d 367 (9th Cir. 1990). But see, e.g., In re Lavigne, 114 F.3d 379 (2d Cir. 1997); In re Good Hope Chem. Corp., 747 F.2d 806 (1st Cir. 1984), cert. denied, 471 U.S. 1102 (1985).

d. Similarly, even if a counterparty terminates a protected contract upon learning of the bankruptcy of the debtor (or if such a contract or agreement is automatically terminated upon bankruptcy) damages may be measured as of a date earlier than the date on which the counterparty terminates the contract or agreement or learns of the termination thereof. This could lead to the inability to recover or claim damages for losses actually suffered by a counterparty. Cf. Tew v. Arizona Retirement System, 69 B.R. 608 (S.D. Fla. 1987), rev'd on other grounds, 873 F.2d 1400 (11th Cir. 1989) (Buyer under repurchase agreement not entitled to recoup interest that had accrued during the two-day period between the Seller's bankruptcy petition and the Buyer's liquidation of the securities purchased under the repo); In re Thrifty Oil Co., 322 F.3d 1039 (9^{th} Cir. 2003) (damages upon termination of swap agreement not disallowed as unmatured interest).

4. The Code does not address the enforceability of contractual damage provisions (such as "Limited Two-Way Payment" provisions) that limit the recovery of damages by the debtor from the non-defaulting party on account of the early termination of a forward or commodity contract or swap agreement based on the bankruptcy of the debtor. See Drexel Burnham Lambert Products Corp. v. Midland Bank PLC, 92 Civ. 3098 (MP), 1992 U.S. Dist. LEXIS 21223 (S.D.N.Y. Nov. 9, 1992) (limited two-way payment provision found enforceable as a valid liquidated damages clause that was not unconscionable or contrary to public policy; the case was settled). See also Final Report of Trustee in In re Granite Partners, L.P. (S.D.N.Y. April 18, 1996) (the "Askin Report") at 294-96.

B. The filing of a petition under the Code operates as an automatic stay against the taking of actions against the debtor or its property.

1. In general, the automatic stay would operate to prohibit the taking of remedial actions absent court approval, such as the exercise of setoff rights or the liquidation of collateral. The stay on the exercise of setoff rights does not compel the creditor to pay its obligation to the debtor. See Citizens Bank of Maryland v. Strumpf, 516 U.S. 16 (1995) (bank, in order to protect its setoff rights, may temporarily withhold payment of a debt that it owes to the debtor without violating the automatic stay).

2. There are certain exceptions to the operation of the automatic stay in connection with protected contracts, as described below.

C. The trustee generally has the ability to avoid pre-petition "preferences," "fraudulent transfers" and "unperfected" security interests, as well as certain pre-petition setoffs and post-petition transfers.

1. Exceptions apply to certain transfers in respect of protected contracts, as described below.

2. In general, an avoidable preference is:

    a. a transfer of an interest of the debtor in property;

    b. to or for the benefit of a creditor;

    c. on account of an antecedent debt;

    d. made while the debtor was insolvent (which is presumed for the 90-day period prior to the filing of the petition);

    e. made on or within 90 days prior to the date of the filing of the petition or, in the case of a transfer to an "insider," within one year prior to the date of the filing of the petition; and that

    f. enables the creditor to receive more than it would have received had the payment not been made and the debtor had been liquidated under Chapter 7.

3. Exceptions exist for certain transfers for "new value" (including in exchange for the release of a security interest) or made in the ordinary course of business.

4. The rule of Levit v. Ingersoll Rand Fin. (In re Deprizio), 874 F.2d 1186 (7th Cir. 1989), that the presence of a guarantee from an insider may extend the preference period to one year, has generally been reversed in October, 1994 amendments to the Code.

5. In general, a "fraudulent transfer" avoidable under Section 548 of the Code is a transfer made within one year prior to the filing of the petition that was made with actual intent to hinder, delay or defraud creditors, or that was made for less than reasonably equivalent value if the debtor was insolvent at the time of the transfer or became insolvent as a result of the transfer.

6. As a "hypothetical judicial lien creditor" under Section 544(a) of the Code, a trustee has the ability to avoid security interests that were not perfected under applicable law at the time of the filing of the petition. Although the literal language of the protected contract provisions of the Code protects against the avoidance of unperfected security interests, cf. the SIPC letters, discussed below, in which SIPC requires an affidavit regarding the perfection of the counterparty's security interest in securities collateral.

7. Under Section 549 of the Code, a trustee may avoid post-petition transfers of property that are not authorized under the Code or by the court.

8. Under Section 553 of the Code, a trustee may avoid certain pre-petition setoffs, certain assignments of claims made to a creditor during the 90-day preference period, and the incurrence of debts by a creditor in order to obtain a right of setoff.

9. Under Section 510(b) of the Code, claims arising from the purchase or sale or a security of the debtor or of an "affiliate" of the debtor might be subject to mandatory subordination. Courts have recently interpreted Section 510(b) broadly to apply to a debtor's failure to sell its own securities. See, e.g., In re Betacom of Phoenix, 240 F.3d 823 (9th Cir. 2001). The interplay of Section 510(b) and the protected contract provisions of the Code is unclear.

III. EXCEPTIONS FOR FORWARD AND COMMODITY CONTRACTS, SWAP AGREEMENTS, REPURCHASE AGREEMENTS AND SECURITIES CONTRACTS.

There are several statutory exceptions from the foregoing provisions in the case of protected contracts, i.e., "securities contracts," "forward contracts," "commodity contracts," "repurchase agreements" and "swap agreements." Title IX of the Pending Bankruptcy Legislation would clarify and expand several of the provisions described below.

A. Transactions Covered.

1. "Securities contract" is defined in the Code 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."

   a. At least one court has held that reverse repurchase transactions that did not fall within the definition of "repurchase agreement" (because of the type of securities involved) could be securities contracts. In re Residential Resources, 98 B.R. 2 (Bankr. D. Ariz. 1989). Similarly, in a case involving a post-1982 but pre-1984 repurchase agreement (i.e., after the adoption of the securities contract provisions but prior to the adoption of the repurchase agreement provisions), a court has held the Buyer entitled to the anti-preference protections that are part of the securities contract provisions of the Code (although the court did not expressly hold the repurchase agreement to be a securities contract). Jonas v. Farmer Bros. Co. (In re Comark), 124 B.R. 806 (Bankr. C.D. Cal. 1991) aff'd, 145 B.R. 47 (Bankr. 9th Cir. 1992). See also In re Hamilton Taft & Co., 114 F.3d 991 (9th Cir., 1997) (transfer under repurchase agreement covered by anti-avoidance provisions relating to securities contracts). See also the Alert Memorandum attached hereto regarding In re Weisberg, 193 B.R. 916 (B.A.P. 9th Cir. 1996), a Ninth Circuit Bankruptcy Appellate Panel decision that was affirmed by the Ninth Circuit in which the Court held that a margin loan benefits from the "securities contract" provisions of the Code; Granite Partners, L.P. v. Bear Stearns & Co., Inc., 17 F. Supp. 2d 275 (S.D.N.Y. 1998), in which the court refused to recharacterize a repurchase agreement as a secured loan where the Bond Market

Association form of repurchase agreement was clear that the objective intent of the parties was that the transaction be treated as a purchase and sale, but denied motion to dismiss in respect of a repurchase agreement documented solely by an "ambiguous" confirmation; In re County of Orange, 31 F. Supp. 2d 768 (C.D. Ca. 1998) (reverse repos not collateralized loans in the context of California municipal debt limitations). But see Lombard-Wall Inc. v. Columbus Bank & Trust Co. et. al., No. 82 B 11556 (Bankr. S.D.N.Y., bench decision, September 16, 1982) (prior to adoption of repurchase agreement provisions, court characterized transactions as a secured loan and buyer was thus subject to automatic stay in liquidating securities); RTC v. Aetna Casualty & Surety Co. of Illinois, 25 F.3d 570 (7th Cir. 1994) (in insurance context, concluding that repurchase and reverse repurchase agreements were in the nature of a collateralized loan); In re Criimi Mae, 251 B.R. 796 (Bankr. D. Md. 2000) (evidentiary hearing needed to decide whether a repurchase agreement was a secured loan or a purchase and sale).

2. "Forward contract" is defined in the Code (as amended in 1990) as:

"a contract (other than a commodity contract) for the purchase, sale, or transfer of a commodity . . . 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, including, 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." (Emphasis added.)

a. See In re Olympic Natural Gas Company, 294 F.3d 737 (5^{th} Cir. 2002) (natural gas contracts are "forward contracts"); In re Mirant Corp., 310 B.R. 548 (Bankr. N.D. Tex. 2004) (same).

3. "Commodity contract" is defined in the Code as:

"(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."

4. "Repurchase agreement" is defined in the Code as follows:

"'Repurchase agreement' (which definition also applies to a reverse repurchase agreement) means 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 United States or any agency of the United States 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 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."

5. "Swap agreement" is defined in the Code 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."

a. This definition was amended in October, 1994 expressly to include "spot foreign exchange agreements." Although the FDIA was not similarly amended, the FDIC has issued a regulation to encompass spot foreign exchange agreements within the definition of "swap agreement." See Section VI.A.5. infra.

b. A Bankruptcy Court has held that "Forward Freight Agreements" between two end-users and providing for a cash settlement between a contract rate and the average rate of the Baltic Freight Index were "swap agreements," notwithstanding the bankrupt's contention that a financial intermediary needed to be involved for the agreements to be "swap agreements." In re Interbulk, Ltd. v. Louis Dreyfus Corp., 240 B.R. 195 (Bankr. S.D.N.Y. 1999).

B. Counterparties Protected.

1. In general, to have the full range of Code protections with respect to "securities contracts" with the debtor, the counterparty must be a "stockbroker," "financial institution" or "securities clearing agency"; with respect to "forward contracts" with the debtor, the counterparty must be a "forward contract merchant"; with respect to "commodity contracts" with the debtor, a "commodity broker"; with respect to "repurchase agreements" with the debtor, a "repo participant"; and with respect to "swap agreements," a "swap participant." The failure to so qualify, however, may not impair certain anti-avoidance protections if the debtor is a "forward contract merchant," "commodity broker," "stockbroker," "financial institution," "securities clearing agency," "repo participant" or "swap participant."

2. "Forward contract merchant" is defined as a "person" (which term excludes "governmental units") "whose business consists in whole or in part of entering into forward contracts as or with merchants in a commodity . . . 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."

   a. The court in In re Mirant Corp., 310 B.R. 548 (Bankr. N. D. Tex.) held that for counterparty to be a " forward contract merchant" it must have entered into forward contracts "as a participant seeking profit in the forward contract trade."

   b. The court in In re Mirant Corp., 303 B.R. 319 (Bankr. N.D. Tex. 2003) held that Bonneville Power Administration was a "governmental unit" and therefore not a "forward contract merchant".

3. "Commodity broker" is defined in the Code as a "futures commission merchant, foreign futures commission merchant, clearing organization, leverage transaction merchant, or commodity options dealer . . . with respect to which there is a customer . . . ."

4. "Stockbroker" is defined as a "person" (which term excludes "governmental units") that has a "customer" (as defined in Section 741 of the Code) and that is engaged in the business of effecting transactions in securities for the account of others or with members of the general public, from or for such person's own account.

   a. A dealer that engaged primarily in purchases of GNMA securities with financial institutions but which had no "customer" was held not to be a "stockbroker" in In re SSIW Corp., 7 B.R. 735 (Bankr. S.D.N.Y. 1980).

   b. Some courts have held that the bankrupt itself has to be a "customer" of the "stockbroker". See, e.g., In re Residential Resources, supra. But see, e.g., In re Baker & Getty Financial Services, Inc., 106 F.3d 1255, 1262 (6th Cir. 1997).

5. "Financial institution" is defined as a "Federal Reserve bank or an entity (domestic or foreign) that is a commercial or savings bank, industrial savings bank, savings and loan association, trust company, or receiver or conservator for such entity". In addition, a "financial institution" is defined to include a customer of such a "financial institution" where the institution acts as agent or custodian for the customer in connection with a securities contract, as well as, in connection with securities contracts, investment companies registered under the Investment Company Act of 1940.

   a. Certain state-chartered non-FDIC banking-type institutions may not be "financial institutions" under the Code. See, e.g., In re Republic Trust & Savings Co., 59 B.R. 606 (Bankr. N.D. Okla. 1986).

6. "Repo participant" is defined as any "entity" (which term includes "governmental units") that has an outstanding repurchase agreement with the debtor on any day during the period beginning 90 days before the date of the filing of the petition.

   a. If a transfer to a repo counterparty made prior to the 90 day pre-filing period is subject to avoidance, either as an "insider" preference or as a fraudulent transfer, the counterparty might not be protected under Section 546(f) of the Code. It might, however, be protected under Section 546(e) of the Code if either the counterparty or the debtor is a "stockbroker," "financial institution" or "securities clearing agency." See In re Hamilton Taft & Co., supra (stockbroker could rely on Section 546(e) and did not have to meet the 90 day requirement of Section 546(f) as the more specific statutory provision for repurchase agreements).

   b. Although it did not consider whether the counterparty was a "repo participant" under the Code, one bankruptcy court has found a participant in repurchase agreements with a debtor broker-dealer to be a "customer" within the meaning of Section 741(2) of the Code, thus entitling the counterparty to priority status under Section 752. Relying on Cohen v. Army Moral Support Fund (In re Bevill, Bresler, & Shulman Asset Mgmt. Corp.), 67 B.R. 557 (D.N.J. 1986) (in which the court found a counterparty in a repurchase agreement transaction to be a "customer" under SIPA), the court found the parties had contemplated a relationship in which they would trade in securities as broker-dealer and customer and the debtor had acted in a fiduciary capacity. Swink & Co., Inc. v. Davidson, 142 B.R. 874 (Bankr. E.D. Ark. 1992).

7. "Swap participant" is defined in the Code as an "entity" (which term includes "governmental units") that at any time before the filing of the petition has an outstanding swap agreement with the debtor.

   a. Under this definition, it is not clear that the beneficiary of a guarantee issued by the debtor in respect of a swap would on that basis be a "swap participant" or that the guarantor of a swap would be a "swap participant."

C. Liquidation and Termination Protections.

   1. Under Section 555 of the Code, the "contractual right" of a stockbroker, financial institution or securities clearing agency to cause the "liquidation" of a securities contract because of the bankruptcy or financial condition of the debtor is not to be stayed, avoided, or otherwise limited by operation of any provision of the Code or by the order of a court in any proceeding under the Code, unless, where the debtor is a stockbroker or securities clearing agency, such order is authorized under the provisions of SIPA or any statute administered by the SEC.

      a. "Contractual right" is defined in Section 555 to include a "right set forth in a rule or bylaw of a national securities exchange, a national securities association, or a securities clearing agency."

      b. One court has held that the contractual rights protected under Section 555 include only those based on the bankruptcy or financial condition of the debtor. In re Amcor Funding, 117 B.R. 549 (D. Ariz. 1990). See also In re Enron Corp., 306 B.R. 465 (Bankr. S.D.N.Y. 2004) (same for swap agreement under Section 560).

2. Under Section 556 of the Code, the "contractual right" of a commodity broker or forward contract merchant to cause the "liquidation" of a commodity contract or forward contract because of the bankruptcy or financial condition of the debtor is not to be stayed, avoided, or otherwise limited by operation of any provision of the Code or by the order of a court in any proceeding under the Code.

    a. The legislative history to Section 556 indicates that the right to "liquidate" a commodity contract is only the right to close out an open position, but does not constitute the right to transfer collateral with respect thereto. As described below, however, Section 362(b)(6) protects certain rights regarding the liquidation of collateral securing forward and commodity contracts.

    b. "Contractual right" is defined in Section 556 to include "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 evidence in writing, arising under common law, under law merchant or by reason of normal business practice."

    c. See In re R.M. Cordova Int'l, Inc., 77 B.R. 441 (Bankr. D.N.J. 1987) (termination of contracts for purchase of coconut oil protected by Code § 556).

3. Under Section 559 of the Code, the "contractual right" of a repo participant to cause the "liquidation" of a repurchase agreement because of the bankruptcy or financial condition of the debtor is not to be stayed, avoided, or otherwise limited by operation of any provision of the Code or by the order of a court in any proceeding under the Code, unless, where the debtor is a stockbroker or securities clearing agency, such order is authorized under the provisions of SIPA or any statute administered by the SEC.

    a. "Contractual right" is defined in Section 559 to include "a right set forth in a rule or bylaw, applicable to each party to the repurchase agreement, or 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."

    b. It would not appear that the Code would protect the right of a purchaser of securities under a hold-in-custody repo to compel delivery of the securities from the bankrupt.

4. Under Section 560 of the Code, the "contractual right" of a swap participant to "cause the termination of a swap agreement" because of the bankruptcy or financial condition of the debtor, or to "offset or net out" any "termination values or payment amounts" arising under or in connection with any swap agreement is not to be stayed, avoided, or otherwise limited by operation of any provision of

the Code or by order of a court or administrative agency in any proceeding under the Code.

a. Unlike the forward, commodity and securities contract and repurchase agreement provisions, the swap agreement provisions of the Code address offset rights not only in Section 362 (in the context of exceptions from the automatic stay) but also in this termination provision.

b. "Contractual right" is defined in Section 560 to include "a right, whether or not evidenced in writing, arising under common law, under law merchant, or by reason of normal business practice."

c. The protections of Section 560 of the Code (and the other provisions relating to swap agreements described below in "Setoff and Collateral Liquidation Protections") should apply to the exercise of "contractual" netting rights among separate swap transactions not documented under a master agreement, notwithstanding the reference to "any" swap agreement. See Section 102(7) of the Code.

d. The Ninth Circuit has held that a claim for damages upon termination of an interest rate swap agreement was not a disallowable claim for unmatured interest. In re Thrifty Oil, supra.

5. Stockbrokers that are members of SIPC are typically liquidated in proceedings under SIPA, rather than under the Code.

a. The provisions of the Code apply, however, in a proceeding under SIPA. See In re Gov't Securities Corp. v. Camp, 972 F.2d 328 (11th Cir. 1992), cert. denied, 113 S. Ct. 1366 (1993).

b. As noted above, Sections 555 and 559 of the Code except from their protections orders issued under SIPA. Sections 556 and 560, however, should supersede any such orders.

c. A SIPC trustee in a stockbroker liquidation may, and typically will, seek an order barring the exercise of certain setoff and foreclosure rights, and the exercise of liquidation rights under repurchase and securities lending transactions, with the debtor. We understand from informal conversations with SIPC that the standard stay order would not stay the exercise of liquidation rights in connection with forward securities transactions (but would stay foreclosure on any collateral pledged in connection with such transactions).

d. SIPC has determined, in a letter dated February 4, 1986, from Michael E. Don, Deputy General Counsel, to Robert A. Portnoy, Deputy Executive Director and General Counsel of the Public Securities Association, that, as to repurchase agreements falling within the Code definition of "repurchase agreement," the standard proposed order that SIPC will seek will still bar their immediate liquidation pursuant to insolvency default clauses, but that SIPC would consent (and would urge the trustee to consent) to their liquidation upon the receipt of an appropriate affidavit (and similar additional documentation) from the counterparty. The letter states SIPC's hope that it could make the determinations necessary for its consent to close-out within four to five days after the initiation of a liquidation proceeding, or more rapidly in periods of particular market volatility.

(i) The letter specifically would require an affidavit of the counterparty attesting that the affiant has no knowledge of any fraud involved in the transactions and that it has a perfected security interest in the underlying securities.

(ii) The letter also indicates that SIPC might perform the debtor's obligations under a repurchase agreement, in order to obtain the subject securities to satisfy customer claims.

e. Similar letters (with similar conditions) were issued by SIPC in 1988 regarding securities lending transactions. Furthermore, SIPC has more recently indicated in letters that the SIPC-obtained stay would not be sought against the liquidation by financial institution and stockbroker counterparties of cash collateral under securities lending transactions or against the drawing of letters of credit in connection therewith.

f. A similar letter (with similar conditions) was issued by SIPC in 1996 regarding repurchase transactions, whether or not falling within the Code definition of "repurchase agreement." See attached Alert Memorandum.

g. SIPC issued a letter in June, 2002 clarifying that the 1986, 1988 and 1996 letters would also apply where the buyer (in the case of a repurchase transaction) acquires title to rather than a security interest in the underlying securities and where the securities lender (in the case of a securities lending transaction) acquires ownership of assets received as "credit support" rather than a security interest therein. The letter also extends the letters regarding cash collateral under securities lending transactions to repurchase agreements where the SIPC member being liquidated is the buyer of securities.

D. Setoff and Collateral Liquidation Protections.

1. Sections 362(b)(6), 362(b)(7) and 362(b)(17) of the Code except from the Code's automatic stay and the stay arising from the filing of an application for a protective decree under SIPA certain actions in connection with protected contracts.

a. These provisions do not clearly provide exceptions from the court-ordered stay typically obtained by SIPC in a proceeding under SIPA.

b. These provisions do not clearly provide exceptions to the ability of a Bankruptcy Court, under Section 105(a) of the Code, to issue any order that is "necessary or appropriate to carry out" the provisions of the Code. See In re Lenny Steven Smith, No. LA 84-10591-CA (C. D. Cal. May 21, 1984) (granting ex parte temporary restraining order against enforcement of margin loans by creditors; case settled prior to decision on the merits); In re Criimi Mae, No 98-2-315 DK (Bankr. D. Md. 1998), (citing telephonic hearing of debtor's request for temporary restraining order against re-registration of securities purchased under a reverse repo; court denied debtor's request upon purchaser's consent not to sell the securities without judicial authorization).

2. Section 362(b)(6) provides an exception from the automatic stay and the stay arising from a SIPA filing for the setoff by a commodity broker, forward contract merchant, stockbroker, financial institution or securities clearing agency of any mutual debt or claim under or in connection with commodity contracts, forward contracts or securities contracts that constitutes the setoff of a claim against the debtor for a "margin payment" or "settlement payment" 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, guarantee, secure or settle commodity, forward or securities contracts.

3. Section 362(b)(7) provides an exception from these stays for 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 "any payment" due from the debtor under or in connection with a "margin payment" or "settlement payment" arising out of repurchase agreements against cash, securities, or other property held by or due from such repo participant to margin, guarantee, secure or settle repurchase agreements.

    a. "Margin payment" is defined for purposes of Sections 362(b)(6) and (b)(7) as any "payment or deposit of cash, a security or other property, that is commonly known to the securities trade as original margin, initial margin, maintenance margin, or variation margin, or as a mark-to-market payment, or that secures an obligation of a participant in a securities clearing agency" and as a "payment or deposit of cash, a security, or other property, that is commonly known to the commodities trade as original margin, initial margin, maintenance margin, or variation margin, including mark-to-market payments, settlement payments, variation payments, daily settlement payments, and final settlement payments made as adjustments to settlement prices."

    b. "Margin payment" is also defined for purposes of Section 362(b)(6) as a "payment or deposit of cash, a security or other property, that is commonly known in the forward contract trade as original margin, initial margin, maintenance margin, or variation margin, including mark-to-market payments, or variation payments."

    c. "Settlement payment" is defined for purposes of Sections 362(b)(6) and (b)(7) as a "preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade."

d. "Settlement payment" is also defined for purposes of Section 362(b)(6) as "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 any other similar payment commonly used in the forward contract trade."

e. Several courts have broadly construed the phrase "settlement payment" in the context of the "repurchase agreement", "securities contract", "commodity contract" and "forward contract" provisions of the Code. See In re David, 193 B.R. 935 (Bankr. C.D. Cal. 1996) (payments into a margin account either "settlement payments" or "margin payments", even if payments could not be traced to specific settlements or margin calls); In re Hamilton Taft & Co., supra, ("settlement payment" includes initial transfer of securities to stockbroker under reverse repurchase agreement); Yeagley v. Farmer's Commodities Corp., 220 B.R. 402 (Bankr. D. Kan. 1998); Jonas v. RTC (In re Comark), 971 F.2d 322 (9th Cir. 1992); Jonas v. Farmers Bros. Co. (In re Comark), 124 B.R. 806 (Bankr. C.D. Cal. 1991), aff'd, 145 B.R. 47 (Bankr. 9th Cir. 1992); Bevill, Bresler & Schulman v. Spencer Savings & Loan Ass'n, 878 F.2d 742 (3rd Cir. 1989); Cohen v. Savings Building & Loan Co. (In re Bevill, Bresler & Schulman Asset Mgmt. Corp.), 896 F.2d 54 (3d Cir. 1989) (court allowed setoff of payable arising from obligation to transfer purchased securities, which were owned by creditor but owed to debtor, against "settlement payment" receivable arising from debtor's breach of the initial sale provision of a different repurchase transaction; court did not allow setoff of payable arising from obligation to transfer income owned by debtor); In re Olympic Natural Gas, supra, ("settlement payment" includes net payments under a series of natural gas contracts); In re Mirant Corp., supra, (termination payments under natural gas contracts); In re Financial Management Sciences, Inc., 261 B.R. 150 (Bankr. W.D. Pa.) (payments for securities made through "stockbroker," "financial institution" and "securities clearing agency" intermediaries at off-market prices constituted "settlement payments" protected under Section 546(e) from avoidance as fraudulent transfers; the court, however, denied defendants' requests for summary judgment on the trustee's state law claims of money had and received, unjust enrichment, and conversion, indicating that Section 546(e) might not provide a defense to such actions).

f. In addition, the Tenth Circuit rejected the argument that a "settlement payment" must be in connection with a "securities contract" to be immune from avoidance. See Kaiser Steel Corp. v. Pearl Brewing Co., 952 F.2d 1230 (10th Cir. 1991); Kaiser Steel Corp. v. Charles Schwab & Co., Inc., 913 F.2d 846 (10th Cir. 1990). See also In Re Resorts International, 181 F.3d 505 (3rd Cir. 1999) (LBO payment to a stockholder made through a financial institution a settlement payment); PHP Liquidating v. Robbins, 291 B.R. 592 (D. Del. 2003) (stock redemptions cleared through stockbrokers settlement payments); In re Comark, 971 F.2d 322, 325 (9th Cir. 1992) (citing Kaiser for the proposition that " a settlement is 'the completion of a securities transaction'"); In re Hechinger Investment Co. of Delaware, 274 B.R. 71 (D.Del. 2002) (following In re Resorts in finding LBO payment to a stockholder made through a financial institution to be a settlement payment; unlike the court in In re Financial Management Sciences, supra, the Hechinger court found that Section 546(e) supersedes a state law unjust enrichment claim). But see Matter of Munford, Inc., 98 F.3d 604 (11th Cir. 1996) (even if LBO payments "settlement payments," not made to stockbroker or financial institution); Zahn v. Yucaipa Capital Fund, 218 B.R. 656 (D.R.I. 1998) (same); In Re Healthco Int'l Inc., 195 Bankr. 971 (Bankr. D. Mass. 1996) (LBO transfers not settlement payments); Integra Realty Resources v. Fidelity Capital Appreciation Fund, 198 Bankr. 352 (Bankr. D. Colo. 1996) (transfer of shares in connection with a spin-off not a settlement payment); In re Kaiser Merger Litigation, 168 B.R. 991 (D. Colo. 1994) (payment for right to purchase preferred stock that may or may not issue not a "settlement payment", even though contract "may arguably fall" within definition of "securities contract"); Wieboldt Stores, Inc. v. Schottenstein, 131 B.R. 655 (N.D. Ill. 1991) (LBO payments not settlement payments); In re REVCO D.S., Inc., 1990 Bankr. LEXIS 2966 (Bankr. N.D. Oh. Dec. 17, 1990) (questioning approach in Kaiser v. Schwab, supra, under which LBO payments to selling shareholders are settlement payments); Jewel Recovery, L.P. v. Gordon, 196 B.R. 348 (N.D. Tex. 1996) (§546(e) does not apply to strictly private stock transaction); In re Grand Eagle Companies, 288 B.R. 484 (Bankr. N.D. Ohio 2003) (parties cannot convert payment under private transaction into a "settlement payment" by "funneling" payments through a financial institution).

4. The analogous provision for swap agreements, Section 362(b)(17), uses the phrase "any payment," rather than margin or settlement payment, and protects the setoff by a swap participant of any mutual debt and claim under or in connection with any swap agreement that constitutes the setoff of a claim against the debtor for "any payment" due from the debtor under or in connection with any swap agreement against 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.

   a. While not entirely clear, it would seem that a "payment" obligation could include an obligation to deliver property, such as an obligation to deliver or release collateral. Cf. Bevill, Bresler, supra ("settlement payment" includes transfer of securities under repurchase agreement).

5. The structure of the Code's setoff protections raises doubts as to whether "cross-product" netting would be enforceable free from the automatic stay.

   a. Setoff between "securities contracts," "forward contracts" and "commodity contracts" is expressly protected.

   b. There are strong arguments that other cross-product netting is protected in the event the creditor and the debtor have entered into an appropriate agreement providing for such netting, either as "recoupment" or as setoff falling within the protections of Code §§ 362(b)(6), (7) and (17). Cf.

Reliant Energy Services, Inc. v. Enron Canada Corp., 349 F.3d 816 (5th Cir. 2003).

c. Even if other cross-product netting is not protected from operation of the automatic stay, the creditor would be treated as a secured creditor to the extent of its setoff right. Code § 506.

d. Cf. In re Dow Corning Corporation, Case No. 95-21512 (Slip op., Bankr. E.D. Mich. March 27, 1996) (automatic stay lifted to allow First National Bank of Chicago to set off foreign exchange payable against loan receivable).

E. Anti-Avoidance Protections.

1. Section 546(e) of the Code protects from avoidance as a preference or constructive fraudulent transfer any pre-petition margin or settlement payment made by or to a commodity broker, forward contract merchant, stockbroker, financial institution or securities clearing agency.

   a. One court has held that § 546(e) did not protect margin or settlement payments from avoidance as constructive fraudulent transfers when made in respect of trades which were not ordinary course transfers, but rather the result of massive fraud. In re Adler Coleman Clearing Corp., 263 B.R. 406, 480-84 (S.D.N.Y. 2001).

2. Section 546(f) of the Code protects from avoidance as a preference or constructive fraudulent transfer any pre-petition "margin payment" or "settlement payment" made by or to a repo participant in connection with a repurchase agreement.

3. Section 546(g) of the Code protects from avoidance as a preference or constructive fraudulent transfer any pre-petition "transfer" under a swap agreement, made by or to a swap participant in connection with a swap agreement.

   a. "Transfer" is defined broadly in the Code to mean "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption."

   b. Because of concerns that this provision limits its protections to transfers "under" a swap agreement, it has been suggested that agreements ancillary to a swap agreement, such as a security agreement, be incorporated into the swap agreement.

   c. A Bankruptcy Court has confirmed that the provision's protections are limited to transfers "under" a "swap agreement" (pointing to a prior version of the Pending Bankruptcy Legislation, which would amend this provision, as support for its conclusion), holding that attachment of the counterparty's assets to enforce obligations owed under a swap agreement is not a transfer "under" that swap agreement and therefore not protected by § 546(g). Interbulk, Ltd. v. Louis Dreyfus Corp., 240 B.R. 195 (Bankr. S.D.N.Y. 1999).

4. Sections 546(e), (f) and (g) do not protect from avoidance a fraudulent transfer made with actual intent to hinder, delay or defraud creditors and taken other than in good faith. See also Code § 548(d)(2).

5. Sections 546(e), (f) and (g) do not protect from avoidance post-petition transfers, including transfers occurring during a contractual grace period following an involuntary filing.

6. Section 553(b)(1) contains related provisions protecting certain otherwise avoidable setoffs in connection with protected contracts. Issues may arise, however, with cross-product pre-petition setoff. Furthermore, there are no express protections in Section 553(a) in connection with protected contracts from the power of a trustee to avoid the assignment of claims and incurrence of debts avoidable under Section 553(a).

IV. GOVERNING LAW -- BANKS AND THRIFTS.

A. The conservatorship and receivership provisions of the Federal Deposit Insurance Act ("FDIA") will apply in most circumstances to insolvent federally and state chartered banks and thrifts.

B. The conservatorship and receivership provisions of the FDIA would not apply in the case of non-federally insured banks, thrifts, and branches and agencies of foreign banks. Although there is an argument that the FDIA would apply in the case of a non-insured federal branch of a foreign bank, it does not appear that the OCC accepts this argument.

1. Legislation was enacted in 1993 in New York that amends the New York Banking Law provisions applicable to, among other things, the liquidation of New York branches of foreign banks.

2. Although the OCC has rendered an opinion that collateral pledged by a foreign bank or its federal branch will break the "ring-fence" applicable to federal branch proceedings, it is not at all clear that multibranch netting will be enforceable in light of the ring-fence. Note that federal branch proceedings would encompass all assets of a foreign bank in the United States, including those that would otherwise be subject to a proceeding under the New York Banking Law.

C. The conservatorship and receivership provisions of the FDIA might not apply in the case of a non-FDIC conservator for a national bank acting under the Bank Conservation Act or a non-FDIC conservator for a thrift acting under the Home Owners' Loan Act.

D. State law, including state law avoidance powers, may apply in a conservatorship or receivership proceeding under the FDIA, especially in the case of a non-"federalized" proceeding for a state-chartered institution. Cf. 12 U.S.C. § 1821(g)(4) and 1821(c)(3).

E. It is possible that the Code could apply to a state-chartered non-FDIC insured banking institution. See part III.B.5.b., supra.

F. Foreign law may apply to a creditor's rights against a foreign branch of a U.S. bank or thrift.

G. It is possible that a U.S. branch of a foreign bank could be the subject of ancillary proceedings under Section 304 of the Code. See Agency for Dep. Ins. v. Sup. of Banks, 310 B.R. 793 (S.D.N.Y. 2004)

V. SEVERAL PROVISIONS OF THE FDIA IMPAIR CREDITORS' RIGHTS.

A. Even though the FDIA does not contain a Code-like automatic stay, the FDIC as conservator or receiver has ability to enforce contracts, notwithstanding contractual provisions providing for termination, default, acceleration or exercise of rights upon insolvency or appointment of a conservator or receiver. 12 U.S.C. § 1821(e)(12).

1. Statutory exceptions for qualified financial contracts (discussed below), Federal Home Loan Bank or Federal Reserve Bank extensions of credit, D&O insurance, and depository institution bonds.

2. The FDIC takes the position that this provision renders ipso facto clauses unenforceable. See also McAndrews v. Fleet Bank of Massachusetts, N.A., 989 F.2d 13 (1st Cir. 1993) (FIRREA provision invalidating ipso facto clause in lease does not effect an unconstitutional taking). See also FDIC General Counsel Statement on NextBank (copy attached) (FDIC view that receivership of NextBank not an enforceable "early amortization event" in credit card receivable securitization transaction).

3. Cf. Bank One, Texas v. FDIC, 16 F. Supp. 2d 698 (N.D. Tex. 1998) (automatic lease termination based on "ipso facto" clause).

B. FDIC has ability to disaffirm or repudiate contracts and leases to which depository institution is a party (12 U.S.C. §1821(e)(1)) if:

1. Conservator or receiver, in its discretion, determines contract or lease to be burdensome;

2. Disaffirmance or repudiation determined by conservator or receiver, in its discretion to promote orderly administration of institution's affairs.

3. Rights to be exercised within "reasonable" period following appointment of conservator or receiver.

4. Right to repudiate not expressly limited under the FDIA to "executory" contracts, as under Section 365 of the Code. FDIC and RTC have taken position in policy statements that repudiation power extends to secured debt obligations and collateralized letters of credit and put obligations. Cf. IBJ Schroder Bank & Trust Co., as Trustee v. RTC as Conservator for Franklin Savings Assoc., 26 F.3d 370 (2d Cir. 1994) (repudiation of secured bonds valid); Howell v. FDIC, 986 F.2d 569 (1st Cir. 1993) (repudiation of severance agreements). But see LaMagna v. FDIC, 828 F. Supp. 1 (D.D.C. 1993) (FDIC cannot repudiate non-executory contracts); Marsa v. Metrobank, 825 F. Supp. 658 (D.N.J. 1993) and Fresca v. FDIC, 818 F. Supp. 664 (S.D.N.Y. 1993) (court questioned but did not render a

decision as to whether FDIC could ever repudiate a non-executory contract). See also Security Pacific National Bank v. RTC, 63 F.3d 900 (9th Cir. 1995) (upon repudiation of subordinated debt, debtholder's claim remains subordinated); Lawson v. FDIC, 3 F.3d 11 (1st Cir. 1993) (characterizing a CD as an executory contract that could be repudiated).

5. Damages recoverable upon repudiation -- 12 U.S.C. §1821(e)(3).

   a. Measured as of the date of appointment of conservator or receiver, not as of date of repudiation.

   b. Limited to actual direct compensatory damages, and do not include:

      (1) punitive or exemplary damages;

      (2) lost profits or opportunity;

      (3) pain and suffering.

      Compare McMillian v. FDIC, 81 F.3d 1041 (11th Cir. 1996) (employee had claim for severance pay); Monrad v. FDIC, 62 F.3d 1169 (9th Cir. 1995) (FDIC liable for claim for severance pay); Office and Professional Employees International Union v. FDIC, 27 F.3d 598 (D.C. Cir. 1994) (union had valid claim for severance pay based on repudiation of collective bargaining agreement; court compares to treatment of standby letters of credit), DPJ Company Limited Partnership v. FDIC, 30 F.3d 247 (1st Cir. 1994) (borrower entitled to reliance damages based on repudiation of loan commitment), FDIC v. Parkway Executive Office Center, 1998 U.S. Dist. LEXIS 275 (E.D. Pa. January 9, 1998) (FDIC liable for repudiation of loan commitment), FDIC v. Craft, 157 F.3d 697 (9th Cir. 1998) (borrower can set off amounts owed under promissory note against damages from repudiation of loan commitment), Citibank (South Dakota), N.A. v. FDIC, 857 F. Supp. 976 (D.D.C. 1994) (repudiation of non-compete provision may give rise to provable claim for damages), Modzelewski v. RTC, 14 F.3d 1374 (9th Cir. 1994) (one officer had vested claim, another did not, upon repudiation of salary continuation agreement), Fresca v. FDIC, supra, (repudiation of medical and life insurance plan gave rise to provable claim for damages), and ALLTEL Financial v. FDIC, 194 F.3d 1036 (9th Cir. 1999) (no future damages recoverable for repudiation of data processing contract), Nashville Lodging v. FDIC, 934 F. Supp. 449 (D.D.C. 1996) (breach of refinancing agreement), Interpleader Between Westport Bank & Trust Co., 1996 U.S. App. LEXIS 18306 (2d Cir., July 25, 1996) (officers not entitled to assets in "rabbi" or "secular" trusts in connection with disaffirmed employment contracts), Heiko v. FDIC, 1995 U.S. Dist. LEXIS 3407 (S.D.N.Y. March 15, 1995) (cost of cover not recoverable in non-QFC), Howell v. FDIC, supra, (officers' claims for severance pay not claims for actual compensatory damages), Lawson, supra (post-receivership interest on certificate of deposit "lost profits"), Crocker v. RTC, 839 F. Supp. 1291 (no vested claim for consulting fees and bonuses upon repudiation), Employees' Retirement System of Alabama v.

Resolution Trust Corp., 840 F. Supp. 972 (S.D.N.Y. 1993) (FDIC not liable for future interest on repudiated zero-coupon bonds, but plaintiffs entitled to fair market value at time of repudiation), Hennessey v. FDIC, 58 F.3d 908 (3rd Cir. 1995) (no claim for severance pay upon repudiation), McCarron v. FDIC, 111 F.3d 1089 (3rd Cir. 1997) (same), and Credit Life Insurance Co. v. FDIC, 1994 WL 587787 (D.N.H. Oct. 18, 1994) (no damages recoverable for repudiation of standby letter of credit).

FDIC and RTC have consistently taken the position that "contingent" claims generally are not provable against a failed bank or thrift. See, e.g., FDIC and RTC policy statements on collateralized put obligations and letters of credit. See also Del E. Webb McQueen Dev. v. RTC, 69 F.3d 355 (9th Cir. 1995) (claim under standby letter of credit not accrued and unconditionally fixed prior to receivership and thus priority 7 claim, subordinate to most claims, pursuant to 12 C.F.R. § 360; RTC not required to make ratable distribution).

c. Collateral for a repudiated claim only secures the amount of the claim upon repudiation, and no more. See, e.g., FDIC v. Mahoney, 141 F.3d 913 (9th Cir. 1998) (collateral for real estate lease); RTC v. Ford Motor Credit Corporation, 30 F.3d 1384 (11th Cir.1994) (equipment lessor entitled to no damages for repudiation of lease not entitled to collateral); Unisys v. RTC, 979 F.2d 609 (7th Cir. 1992) (same); LB Credit Corp. v. RTC, 1994 WL 48596 (N.D.Ill. Feb. 16, 1994) (same); Fleet National Bank v. FDIC, 843 F. Supp. 787 (D. Mass. 1994) (security interest in repudiated sublease); LB Credit Corp. V. RTC, 796 F. Supp. 358 (N.D.Ill. 1992) (equipment lease). Cf. FDIC v. U.S. Trust Co., 793 F. Supp. 368 (D. Mass. 1992) (FDIC has no right to repudiate a letter of credit supporting a lease to which failed bank was a party). See also RTC v. United Trust Fund, 57 F.3d 1025 (11th Cir. 1995) (applying principle to proceeds of letter of credit draw by lessor).

d. Claims for damages resulting from the repudiation of a contract are, like other unsecured non-deposit claims, subordinated to the claims of depositors. Battista v. FDIC, 195 F.3d 1113 (9th Cir. 1999).

e. Specific rules for qualified financial contracts (discussed below), leases, contracts for the sale of real property, service contracts.

f. The FDIC recently proposed a rule relating to post-insolvency interest for receiverships with surplus funds. 66 Fed. Reg. 65144 (December 18, 2001). Cf. Waterview Mngmt. Co. v. FDIC, 257 F.Supp.2d 31 (D.D.C. 2003).

6. The FDIC has recently adopted a rule, 12 C.F.R. § 360.6, stating that, subject to the qualifications contained therein, it shall not use its powers under 12 U.S.C. § 1821(e) to repudiate or disaffirm a contract to reclaim "financial assets" (defined as "cash or a contract or instrument that conveys to one entity a contractual right to receive cash or another financial instrument from another entity") transferred by an insured depository institution in connection with a securitization or

participation, nor shall it avoid an otherwise enforceable securitization or participation agreement for lack of compliance with the "contemporaneous" requirement of 12 U.S.C. §§ 1821(d)(9), 1821(n)(4)(I) and 1823(e) (discussed below). Treatment by the FDIC as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation, 65 Fed. Reg. 49,189 (2000). Attached hereto are materials prepared by this firm on behalf of the Loan Syndications and Trading Association in connection with the treatment of loan participations in FDIA (and Code) proceedings.

7. See Hackel v. FDIC, 858 F. Supp. 289 (D.Mass. 1994) (lease and note integrally related; therefore repudiation of lease constituted repudiation of note); Capital Guidance v. NCNB Texas National Bank, 1991 WL 210740 (S.D. Tex. Oct. 7, 1991) (court questioned whether FDIC could repudiate one of two leases where leases were part of an integral agreement); WRH Mortgage, Inc. v. S.A.S. Associates, 214 F.3d 528 (4th Cir. 2000) (repudiation of lease released obligation on related note).

8. See FDIC v. Source One Mortgage Services Corp., 844 F. Supp. 40 (D. Mass. 1994) (servicing company entitled to net out termination fees during interim period between date FDIC notified it of disaffirmance and effective date of disaffirmance).

9. One court stated in dicta that the RTC could repudiate a contract entered into by a subsidiary of a failed thrift. Bender v. Centrust Mtg. Corp., 833 F. Supp. 1525 (S.D. Fla. 1992).

C. Although not as automatic as the Code's automatic stay, FDIC as conservator may request, and a court shall grant, a 45-day stay of any "judicial" action to which the institution or conservator is a party, and as receiver a 90-day stay of such judicial actions.

1. At least one District Court has held that this provision does not entitle the FDIC as conservator to obtain a stay against a non-judicial foreclosure on real estate. FDIC as conservator for Trinity Valley Savings and Loan Ass'n v. Columbia Savings & Loan Ass'n, Civ. 89-CV-2203-JTC (N.D. Ga., Nov. 1, 1989).

D. FDIC has the power selectively to transfer assets and liabilities, with specific exceptions for qualified financial contracts. This power can effectively destroy setoff rights. See, e.g., In re F&T Contractors, Inc., 718 F.2d 171 (6th Cir. 1983); FDIC v. Citizens Bank & Trust Co., 592 F.2d 364 (7th Cir.), cert. denied, 444 U.S. 829 (1979); Nashville Lodging Co. v. FDIC, supra (transfer of loan and repudiation of related refinancing agreement); Shaffer Clark Leasing Co. v. FDIC, 1997 U.S. App. LEXIS 66 (10th Cir. 1997) (transfer of note and repudiation of related lease). Cf. Franklin Bank v. FDIC, 850 F.Supp. 845 (N.D. Cal. 1994) (delivery of receiver's certificate payment in full, thus destroying setoff right, even though payment on certificate less than 100% of claim). But see FDIC v. Marine Midland Credit Corp., 17 F.3d 715 (4th Cir. 1994) (bridge bank assumed counterclaim; even if it had not done so, claimant under participation agreement could assert recoupment). The power to transfer assets overrides contractual restrictions to the contrary. See RTC v. Charles House Condominium Ass'n, 853 F. Supp. 226 (E.D. La. 1994) (right of first refusal ineffective). See also Waterview Mngmt. v. FDIC, 105 F.3d 696 (D.C. Cir. 1997) (right of RTC to transfer asset did not abrogate associated liability);

D-F Fund VIII, L.C.C. v. Valley Ranch Development Co., 1999 WL 97929 (N.D. Tex. Feb. 11, 1999) (same).

1. In this regard, one court has held that the setoff of general unsecured claims would not be allowed, since this would be in derogation of a state "depositor preference" statute (i.e., a statute providing that depositors must be paid in full prior to any distribution to general unsecured non-deposit creditors). FDIC v. Miller, 671 F. Supp. 1286 (D. Kan. 1987).

2. The FDIA provides for depositor preference in the case of all FDIC-insured institutions. Accordingly, general creditors, such as unsecured derivatives creditors, are unlikely to recover anything in a receivership of an FDIC-insured institution. Cf. Commercial Properties Development Corp. v. RTC, 1993 WL 541851 (E.D. La. December 20, 1993) (lessor's claim for monies expended during conservatorship have priority over depositors' claims).

E. FDIC may have the ability under the FDIA and other applicable law to avoid "preferences," fraudulent transfers and other transfers.

1. 12 U.S.C. § 91, the National Bank Act preference provision, apparently applies in most cases pursuant to 12 U.S.C. §§ 1821(c)(2)(B), (c)(3)(B) and (c)(9)(A) (generally giving FDIC powers of conservators and receivers under other provisions of law).

   a. While most of the case law under Section 91 is relatively old, there are five relatively recent reported cases thereunder involving an FDIC challenge to a transfer by a national bank. Bank One, Texas, N.A. v. Prudential Insurance Co. of America, 878 F. Supp. 943 (N.D. Tex. 1995) (foreclosure on collateral pursuant to ipso facto clause not preferential); First National Bank of Central Texas v. Bank One, Texas, Civ. Act. No. W-93-CA-030 (W.D. Tex. August 4, 1993) (agreement tied to failure of MBank Dallas, entered into six months prior to failure, found preferential); MCorp. v. Clarke, 755 F. Supp. 1402 (N.D. Tex. 1991) and MBank New Braunfels v. FDIC, 772 F. Supp. 313 (N.D. Tex. 1991) (repayment of federal funds not preferential); FDIC v. Goldberg, 906 F.2d 1087 (5th Cir. 1990) (transfer to insider on eve of insolvency void).

   b. Provision voids, among others, transfers "made with a view" to prefer a creditor, "in contemplation of insolvency."

      (i) Case law is generally clear that the view to prefer is on the part of the debtor, and not the creditor, and that the creditor's knowledge or motivation is irrelevant. See, e.g., Aycock v. Bradbury, 77 F.2d 14 (10th Cir.), cert. denied, 296 U.S. 589 (1935).

      (ii) There is no "preference period" under the National Bank Act provision as under Section 547 of the Code.

      (iii) Cf. FDIC Advisory Opinion 91-2 (January 11, 1991) regarding "ordinary course of business" exception to the National Bank Act preference provision.

2. 12 U.S.C. § 1821(e)(11) provides that "[n]o provision of this subsection [repudiation of contracts] shall be construed as permitting the avoidance of any legally enforceable or perfected security interest in any of the assets of any depository institution except where such an interest is taken in contemplation of the institution's insolvency or with the intent to hinder, delay, or defraud the institution or the creditors of such institution." There is a statutory exception for qualified financial contracts.

   a. While the provision could be viewed as affirmatively giving the FDIC the power to avoid transfers "taken" in contemplation of insolvency or with intent to hinder, delay or defraud, the provision should be viewed as a "savings" clause, i.e., even though the power to repudiate is not the power to avoid a security interest, this anti-avoidance provision does not derogate from those powers the FDIC may have to avoid transfers in contemplation of insolvency or actual intent fraudulent transfers.

   b. RTC Policy Statement on Collateralized Borrowings supports this reading, as do certain statements in a memorandum of law filed by the RTC in IBJ Schroder Bank & Trust Co., as Trustee v. RTC as Conservator for Franklin Savings Assoc., 803 F. Supp. 878 (S.D.N.Y. 1992), rev'd on other grounds, IBJ Schroder, supra. See also Cheshire, infra.

3. As noted above, FDIC may have ability under state law to avoid preferences, fraudulent transfers and other transfers. See, e.g., Section 381.74 of Title 18 of Oklahoma statutes (Oklahoma Commissioner may, in connection with liquidation or reorganization of an Oklahoma-chartered savings association, void any lien, other than an attorney's lien or mechanic's lien, obtained within four months of the Commissioner's taking of possession of the association, apparently even if taken for contemporaneous value and not on account of an antecedent debt).

F. FDIA contains certain claims procedures, including "expedited" procedures for the determination of certain secured claims. The effect of the claims procedures may be to delay (or deny) judicial review. See, e.g., Rosa v. RTC, 938 F.2d 383 (3rd Cir.), cert. denied 112 S.Ct. 582 (1991). The Second and Third Circuits have held that the claims procedures apply to a claim "secured" by an attorney's retaining lien. See RTC v. Elman, 949 F.2d 624 (2d Cir. 1991), and FDIC v. Shain, Schaffer & Rafanello, 944 F.2d 129 (3rd Cir. 1991).

G. FDIA contains a provision, 12 U.S.C. § 1825(b), requiring FDIC consent to foreclosure on property of the FDIC. The FDIC and RTC have issued policy statements giving their consent to foreclosure in certain instances.

H. FDIA's Written Agreement and Related Requirements, 12 U.S.C. §§ 1821(d)(9), (n)(4)(I) and 1823(e).

   1. These provisions essentially codify the D'Oench, Duhme doctrine. The doctrine, however, is not co-extensive with the statute. See, e.g., DuPont v. FDIC. 32 F.3d 592 (1994), reh'g denied 95 F.3d 458 (D.C. Cir. 1995). The viability of the common-law doctrine is questionable after the Supreme Court's decision in O'Melveny, infra. In fact, the federal circuit courts of appeals are currently split

on the issue of whether the D'Oench, Duhme doctrine is still applicable common law. Compare FDIC v. Deglau, 207 F.3d 153 (3d Cir. 2000), DiVall Insured Income Fund, L.P. v. Boatmen's First National Bank of Kansas City, 69 F.3d 1398 (8th Cir. 1995), and Murphy v. FDIC, 61 F.3d 34 (D.C. Cir. 1995) with Murphy v. FDIC, 208 F.3d 959 (11th Cir. 2000), cert. granted sub nom. Murphy v. Beck, 530 U.S. 1306 (2000), and following settlement cert. dismissed, 531 U.S. 1049 (2001), Federal Financial Co. v. Hall, 108 F.3d 46 (4th Cir. 1997), and Inn at Saratoga Associates v. FDIC, 60 F.3d 78 (2d Cir. 1995).

2. 12 U.S.C. § 1823(e) provides that any agreement that diminishes the right, title or interest of the FDIC in an asset:

   a. must be in writing;

   b. must be executed by depository institution and counterparty contemporaneously with the acquisition of the asset by the depository institution;

   c. must be approved by Board of Directors or Loan Committee of the depository institution and reflected in minutes of such committee; and

   d. must be maintained continuously, since the time of execution, as an official record of the depository institution.

3. 12 U.S.C. § 1821(d)(9) provides that an agreement that fails to comply with 12 U.S.C. § 1823(e) shall not form the basis of, or substantially comprise, a claim against the receiver or the FDIC in its corporate capacity.

   a. 12 U.S.C. § 1821(d)(9) expands the application of these requirements from the traditional "holder-in-due course" type cases in which an obligor on a note asserts an unwritten side agreement against the FDIC to affirmative claims against the FDIC. Cf. AFSCME v. FDIC (In re NBW Commercial Paper Litigation), 826 F. Supp. 1448 (D.D.C. 1992) (§ 1821(d)(9) did not bar fraud and Securities Act claims, but fraud claims were barred under D'Oench; eliminates "asset" requirement in § 1823(e) cross-reference).

   b. Several courts have commented on the "asset" requirement. See John v. RTC, 39 F.3d 773 (7th Cir. 1999) (deception in thrift's sale of home not barred by statute when only asset thrift received in non-loan transaction was cash); DuPont v. FDIC, supra (escrow agreement, extended by conduct of parties, was not an asset of bank); Murphy v. FDIC, 38 F.3d 1490 (9th Cir. 1994) (letter of credit a liability, not asset). Compare Brookside Assocs. v. Rifkin, 49 F.3d 990 (9th Cir. 1995) (common-law doctrine not limited to assets; no mention of O'Melveny). See also the FDIC's discussion of the "asset" requirement in the policy statement referred to in 8. below.

4. Courts have applied the written agreement requirements to claims against subsidiaries of insured institutions in FDIC conservatorship or receivership. See, e.g., Robinowitz v. Gibraltar Savings, 23 F.3d 951 (5th Cir. 1994); Sweeney v.

RTC, 16 F.3d 1 (1st Cir. 1994); Victor Hotel Corp. v. FCA Mortgage Corp., 928 F.2d 1077 (11th Cir. 1991); FDIC v. Banks, 1996 U.S. Dist LEXIS 5682 (E.D. Pa., April 30, 1996). But see Lesal Interiors, Inc. v. Echotree Assocs. L.P., 47 F.3d 607 (3rd Cir. 1995) (§ 1823(e) inapplicable to claims against subsidiary). Courts have also applied the requirements to claims involving contracts assigned to a bank or thrift prior to its failure. See, e.g., FDIC v. Hoover-Morris Enterprises, 642 F.2d 785 (5th Cir. 1981). Cf. Sahni v. American Diversified Partners, 83 F.3d 1054 (statute prohibiting injunctions against assets of failed savings bank applied to injunction against third-tier subsidiary); In re Landmark Land, 1997 U.S. App. LEXIS 6476 (4th Cir. 1997) (anti-injunction statute not applicable to trust assets).

5. In North Arkansas Medical Center v. Barrett, 962 F.2d 780 (8th Cir. 1992), the Eighth Circuit held that a security agreement forming the basis of a secured creditor's claim must meet the written agreement requirements.

   a. Acknowledging that the written agreement requirements had originally arisen out of the bank's lending function, the court nevertheless found that application of the doctrine to security agreements was consistent with the law's purpose of protecting a bank's assets, permitting the FDIC to respond quickly to a bank failure, and preventing collusion between bank employees and favored customers.

   b. Despite press reports to the contrary, the court did not appear specifically to consider whether the contemporaneity test would require that the grant of the security interest in the collateral by the bank occur contemporaneously with the bank's acquisition of the collateral, although there is language in the opinion to this effect. Instead, an examination of the lower court decision and the FDIC's briefs indicate that, although the creditor had a non-possessory 21-day security interest perfected under state law (an aggressive holding), there was no writing sufficient to meet the written agreement requirements. The FDIC did not raise the contemporaneity point and the Court did not seem to analyze it.

6. On March 23, 1993, the FDIC adopted a policy statement designed to address concerns raised by North Arkansas.

   a. According to the statement, if, in general, a security agreement is undertaken in the ordinary course of business for adequate consideration as an arm's length transaction, then the FDIC as conservator or receiver will not seek to avoid an otherwise legally enforceable and perfected security interest solely because the collateral subject to the security interest "(a) was not acquired by the financial institution contemporaneously with the approval and execution of the security agreement granting the security interest and/or (b) may change, increase, or be subject to substitution from time to time during the period that the security interest is enforceable and perfected."

      (i) Notwithstanding this statement, however, the FDIC stated its intention to retain the right to redeem or prepay any secured obligation of a financial institution by repudiation or otherwise.

b. This policy statement is consistent with advisory opinions issued by the FDIC on December 15, 1989 and April 2, 1991.

c. Perhaps a creditor's concern in this connection should not be so much with the FDIC, but with third parties (who, in several recent holder-in-due-course type cases, have succeeded in asserting, as successor to the FDIC (by asset purchase), the written agreement requirements and D'Oench). See, e.g., Bell & Murphy & Assocs. v. Interfirst Bank Gateway, N.A., 894 F.2d 750 (5th Cir. 1990).

7. Statements in North Arkansas were characterized as "broad dicta" in Thigpen v. FDIC, 983 F.2d 644 (5th Cir. 1993) (written agreement requirements do not apply to sale of asset in a "non-banking" transaction).

8. The FDIC issued a policy statement regarding the written agreement requirements that contains "Guidelines for Use of D'Oench and Statutory Provisions" that, according to the FDIC, are "discretionary and evolving by nature but nevertheless will serve to moderate the circumstances" in which the FDIC will enforce the written agreement requirements. Among other things, the Guidelines provide that D'Oench and the statutory provisions may not be asserted without Washington approval where the "borrower or claimant took all reasonable steps to document and record the agreement or understanding with the institution and there is no evidence that the borrower or claimant participated in some activity that could likely result in deception of banking regulators, examiners, or the FDIC regarding the assets or liabilities of the institution."

I. The Supreme Court ruled that there is generally no federal common law that supplements the FDIC's rights as receiver, and, therefore, the FDIC steps into the shoes of the insolvent institution and obtains no greater rights than the institution, other than those specified in the FDIA and other relevant receivership statutes. O'Melveny & Myers v. FDIC, 512 U.S. 79 (1994). Cf. Solomon v. RTC, 115 S.Ct. 43 (1994) (remand on basis of O'Melveny of case involving repudiation of rent-controlled lease).

J. In Murphy v. FDIC, 38 F.3d 1490 (9th Cir. 1994) the Ninth Circuit vacated its earlier decision in which it had held that a letter of credit issued by a failed bank was not enforceable because the reimbursement obligation was not collateralized in accordance with federal banking statutes.

VI. EXCEPTIONS FOR QUALIFIED FINANCIAL CONTRACTS.

There are several statutory and regulatory exceptions from the foregoing provisions in the case of qualified financial contracts ("QFCs"). Title IX of the Pending Bankruptcy Legislation would clarify and expand several of the provisions described below.

A. Transactions Covered.

1. Securities Contract -- refers to Code definition.

a. Provides for additional items that may be the subject of a securities contract -- mortgage loans, mortgage-related securities and any interest in mortgage loans or mortgage-related securities.

b. The court in Norwood Joint Venture v. RTC, Civil Action No. 89-2-950, February 15, 1990 (D. Colo.), concluded that a mortgage loan was itself a securities contract. Facts in that case were unusual, however, and the case involved allegations that there were tying arrangements that included mortgage loans. Under a more conventional set of facts, the court in Heiko v. FDIC, 1995 U.S. Dist. LEXIS 3407 (S.D.N.Y. March 15, 1995), citing a prior version of this outline, held that a mortgage refinancing agreement was not a QFC because it was not bought or sold in a secondary market. See also FDIC v. Parent Funding Corp., 82 F.3d 417 (6th Cir. 1996) (mortgage servicing agreement not a qualified financial contract); Nashville Lodging, supra; Conroy v. FDIC, 1995 U.S. Dist. LEXIS 14888 (D. Mass. Sept. 15, 1995); First Federal v. Mount Maumee Partnership, 1994 Conn. Super. LEXIS 1461 (Conn. Super. Ct. June 6, 1994).

2. Forward Contract -- refers to Code definition.

a. Note that the Code was amended in June, 1990 to clarify certain aspects of the "forward contract" provisions (e.g., to clarify that foreign exchange contracts involving currencies that are not the subject of futures contracts are "forward contracts"). It is not clear whether the FDIA has incorporated these "clarifying" changes.

3. Commodity Contract -- refers to Code definition.

4. Repurchase Agreement -- refers to Code definition.

a. Additional items that may be subject to repurchase agreements: mortgage-related securities, mortgage loans and interests in mortgage loans.

b. A participation in a commercial loan is not itself a repurchase agreement, but repurchase agreements involving such participations are intended to be protected.

c. An FDIC regulation, 12 C.F.R. 360.5 (attached), provides that certain repurchase agreements involving qualified foreign government securities constitute "repurchase agreements".

5. Swap Agreement -- similar to Code definition but includes two types of transactions not included in the Code definition of swap agreements -- interest rate and currency futures. Also, FDIA definition refers to interest rate and currency options "purchased."

a. As noted above, the FDIC regulation also provides that spot foreign exchange agreements constitute "swap agreements".

B. Unlike under the Code, any counterparty to a QFC is entitled to the benefits of the QFC provisions.

C. Benefits of QFC Status.

1. Exercise of Certain Rights -- Generally.

   a. The QFC provisions protect the exercise of certain "self-help" rights to terminate and liquidate QFCs, rights under security arrangements in connection with QFCs, and offset and netting rights in connection with QFCs. However, the QFC provisions do not, for example, protect the right of a purchaser of securities under a hold-in-custody repo to compel delivery of the securities from the FDIC as conservator or receiver.

   b. Unlike under the Code, FDIA does not expressly require that rights be contractual rights. Even though the FDIA does not require that rights be contractual, the written agreement requirements may make contractual rights necessary in order to benefit from the QFC protections. Cf. FDIC v. State Bank of Virden, 893 F.2d 139 (7th Cir. 1990) (setoff denied because of failure to comply with 12 U.S.C. §1823(e)); OCI Mortgage Corp. v. Marchese, 774 A.2d 940 (Conn. 2001) (same).

   c. Status as a QFC does not, as a general matter, give the creditor rights it does not possess under contract or applicable law, does not compel specific performance on the part of the FDIC, and does not elevate an unsecured claim to secured status.

2. When Exercise of Rights Protected.

   a. Default based on Conservatorship alone -- liquidation, termination, netting and offset rights are not protected from conservator's power to enforce contracts.

   b. Default by a Conservator -- QFC provisions expressly protect exercise of liquidation, termination, netting and offset rights in the event of a default "enforceable under applicable non-insolvency law" by a conservator.

   c. Default based on Receivership alone --

      (i) Liquidation, termination, netting and offset rights are protected from receiver's right to enforce contracts and to assign assets and liabilities unless receiver transfers all QFCs between counterparty, its affiliates and the failed institution to another depository institution and provides notice of the transfer to the counterparty by the close of business on the business day following the receiver's appointment. Depository institution transferee could be an insured branch of a non-U.S. bank.

      (ii) Frequently, notices of transfer have not complied with the statutory mandates. Counterparty, upon learning of a receivership, should generally take steps to ascertain the FDIC's intentions with respect to QFCs.

      (iii) In addition, counterparties have often received transfer notices long after a receivership occurs, due to lack of internal procedures at counterparties designed to route the notices to the responsible parties. (Often, the notices are sent to the person designated in the notice provisions of a QFC, and that person may no longer be with the firm.) Counterparties might therefore consider streamlining internal procedures and checking notice provisions in QFCs.

(iv) In the case of unsecured swaps with Home Savings, the RTC, after sending a notice of transfer, sent counterparties a notice indicating that a mistake had been made and that no transfer had in fact occurred.

3. The receiver is required to transfer all or no QFCs between a counterparty, its affiliates and a failed institution. This is designed to preserve cross-collateralization, setoff and netting rights, but counterparty may need contractual agreement (meeting the written agreement requirements) to rely on such rights.

4. Although a conservator or receiver is entitled to repudiate QFCs, the damages in that event are measured as of date of repudiation, and expressly include reasonable costs of cover.

5. The concern that a conservator or receiver could selectively repudiate QFCs can be remedied by the inclusion of a contractual default based on the repudiation of one QFC. In this regard, the FDIC has stated that it has determined not to "exercise any potential power as a conservator selectively to enforce or to repudiate QFCs with the same counterparty that are subject to a bilateral netting contract." 59 Fed. Reg. 37730, n.15 (July 25, 1994).

6. Unless the FDIC determines that a transfer (as defined in the Code) was taken with actual intent to hinder, delay or defraud creditors, that transfer may not be avoided under 12 U.S.C. § 1821(e)(11). See RTC v. Cheshire Management Co., 18 F.3d 330 (6th Cir. 1994) (anti-avoidance provision did not apply to post-receivership judgment lien). (Cheshire contains a good discussion of the QFC provisions of the FDIA.) In this regard, see also Stebbins Realty Corp. v. FDIC, 1994 WL 312916 (D.N.H. June 29, 1994) (pre-judgment attachment valid against FDIC); Midlantic National Bank/North v. Federal Reserve Bank of New York, 814 F. Supp. 1195 (S.D.N.Y. 1993) ("restraining notice" not equivalent to a lien giving creditor priority); GWN Petroleum Corp. v. OK-Tex Oil & Gas, Inc., 998 F.2d 853 (10th Cir. 1993) (no garnishment of mineral rights proceeds in the hands of the FDIC); FDIC v. McFarland, 243 F.3d 876 (5th Cir. 2001) (declining to extend the principle in Cheshire to assignees of the FDIC or RTC).

7. FDIC and RTC policy statements on written agreement requirements.

a. These policy statements provide that if the following steps are taken, a QFC (and any ancillary agreement) and a "fed funds" transaction will be deemed to be in compliance.

(i) QFC or "fed funds" transaction must be evidenced by a writing (which can be a confirmation, and which need not be signed unless otherwise required by applicable non-insolvency law) that is sent reasonably contemporaneously with the transaction.

(ii) QFC or "fed funds" counterparty relies in good faith on evidence of depository institution's authority to enter into transaction.

(a) Evidence can consist of extract of resolution, or

(b) Written representation by a depository institution official of rank of vice president or higher.

(iii) Counterparty has copies of documents used to meet requirements of (i) and (ii).

b. The policy statements do not define "fed funds" transaction.

c. The policy statements do not, however, eliminate other concerns, such as state statutes of fraud or concerns based on a depository institution's lack of authority to enter into a transaction.

8. FDIC and RTC proposed regulations regarding QFCs that have not yet been published for comment. 58 F.R. 25412 (1993) (to be codified at 12 C.F.R. § 1622).

VII. GOVERNING LAW -- INSURANCE COMPANIES AND INSOLVENCY

A. Insurance companies may not be debtors under the Code.

B. State law governs delinquency proceedings (typically, rehabilitation or liquidation proceedings) of insurance companies.

1. Insurance insolvency statutes enacted in most states are based on either the Insurers Rehabilitation and Liquidation Act (promulgated by the National Association of Insurance Commissioners Model) (the "NAIC") or the Uniform Insurers Liquidation Act (the "UILA").

2. Despite for the most part being based on one or the other of these model statutes, many differences, sometimes significant, exist between the different state statutes.

3. In certain respects, the pre-1998 NAIC model act and UILA resemble the Code (without the provisions of the Code governing protected contracts).

a. Statutes enacted in certain states resemble the FDIA, without the QFC provisions.

4. Very few statutes or cases address the rights of capital market transactions counterparties.

5. Great uncertainty for derivative counterparties.

C. The commencement of an insolvency proceeding.

1. The commissioner in most states is authorized to commence a rehabilitation or liquidation proceeding against an insurance company when, among other things, it is in such condition that the further transaction of business would be hazardous to its policyholders, its creditors or the public.

2. The commissioner has a significant amount of discretion in interpreting applicable statutes, and such discretion typically is exercised in a manner conducive to protecting policyholders and preserving the insurer (in a rehabilitation) or arranging an orderly disposition of its assets (in a liquidation).

VIII. SEVERAL PROVISIONS OF INSURANCE INSOLVENCY STATUTES IMPAIR CREDITOR'S RIGHTS.

A. Many statutes include provisions that address the treatment of contracts of the delinquent insurer.

1. Statutes based on the pre-1998 NAIC model typically authorize the commission to "affirm or disavow" contracts of the insurer.

    a. Unlike Section 365 of the Code, such provisions are not expressly limited to executory contracts.

    b. Some statutes enable the commissioner to <u>assume or reject</u> executory contracts of insurers.

    c. In January, 1998, the NAIC published a revision of their Insurers Rehabilitation and Liquidation Model Act that provides protections, analogous to the QFC provisions of the FDIA, for QFCs (as defined therein). Those QFC provisions, with some changes, have been adopted in Connecticut and Michigan.

2. Such a right might give the commissioner the power to "cherry pick" between transactions, including those documented by the parties under a master agreement; <u>i.e.</u>, to assume (or assume and assign) transactions favorable to the counterparty.

3. Statutes based on the pre-1998 NAIC model typically provide that the commencement of a proceeding shall not be deemed to be an "anticipatory breach" of any contract of the insurer.

    a. It is unclear whether such a provision would invalidate a contractual termination provision or would merely deprive the nondefaulting party of a common law right to terminate.

    b. Certain statutes include provisions, similar to the "anti-ipso facto" prohibitions of Section 365(e) of the Code, that invalidate contractual termination provisions based on the insolvency or financial condition of the insurer.

B. Certain statutory provisions regarding the treatment of claims against delinquent insurers may impair the rights of capital market transactions counterparties.

1. Most statutes provide that policyholders' claims are to be paid in full before other creditors, including general creditors, receive anything from the distribution of an insolvent insurer's assets.

2. Most statutes provide that holders of "contingent claims" do not share in the distribution of an insolvent insurer's assets. Unfortunately, most statutes do not define the phrase "contingent claim"; conceivably, it could include amounts owed in connection with certain kinds of derivatives.

C. Numerous statutory provisions may result in delay in the exercise of contractual and legal rights.

1. Most statutes authorize the commissioner to seek a sweeping injunction of all actions against the insurer. Typically the commissioner will obtain a first day order that enjoins, inter alia, setoffs and the exercise of rights against collateral.

2. Other typical related provisions provide that (1) no action may be brought or maintained against an insurer being liquidated and (2) no action in the nature of attachment, garnishment or levy of execution may be commenced against a delinquent insurer.

3. In this regard, see Garamendi v. Executive Life Insurance Co., 21 Cal. Rptr. 2d 578 (Cal. Ct. App. 1993) (reverse repo with subsidiary of life insurance company deemed a secured loan and stay of proceedings applied to subsidiary's creditors).

D. Many state statutes include broad "preference" provisions that could possibly the used to "claw back" payments already made under certain types of derivative products, including, in certain states, without a showing of preferential intent. State fraudulent transfer statutes will likely apply in an insurer delinquency proceeding.

E. The applicable statutes generally provide that mutual debts and credits are to be set off. The scope of such provisions, and their applicability to capital markets transactions are, however, uncertain.

F. In Matter of Mutual Benefit Life Insurance Co., 609 A.2d 768 (N.J. Super. Ct. App. Div. 1992), the New Jersey conservatorship court held that certain post-"petition" amounts accrued under swap agreements constituted administrative expense claims of the highest priority. The pre-"petition" amounts, however, were general unsecured claims, subordinate to policyholder claims.

IX. BILATERAL "NETTING CONTRACTS" UNDER FDICIA

A. The bilateral netting provisions of FDICIA provide for the enforceability of a "netting contract" between two "financial institutions" according to the contract's terms, i.e., only the net amount under the contract will be due and owing, notwithstanding the failure of a party to the contract and notwithstanding any stay, injunction, avoidance or similar proceeding or order.

1. FDICIA thus supplements the Code's and the FDIA's provisions for protected contracts and QFCs (e.g., clearly to protect "cross-product" netting under the Code).

2. FDICIA's provisions would also apply in any non-Code or FDIA proceeding regarding a "financial institution."

B. The stated purpose of these provisions is to reduce systemic risk within the banking system and financial markets arising from transactions between financial institutions.

C. "Netting contract" is defined to include any contract between two or more "financial institutions" that is governed by federal, state or local law and that provides for the netting of present or future payment obligations or entitlements among the parties (including liquidation or close-out values relating to payment obligations or entitlements).

1. "Financial institution" means registered brokers and dealers and futures commission merchants, certain depository institutions, and any other institution as determined by the Federal Reserve Board ("FRB"). The FRB has determined that certain CHIPs members that are not otherwise "financial institutions" qualify as such for purposes of FDICIA. FDICIA specifically provides that affiliates of broker-dealers that are engaged in the business of entering into netting contracts may be determined by the FRB to be "financial institutions."

2. The Federal Reserve Board adopted Regulation EE in 1994, which expands the definition of "financial institution" 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 -- (1) 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 counterparties that are not its affiliates; or (2) had total gross mark-to-market positions of at least $100 million (aggregated across counterparties) in one or more financial contracts on any day during the previous 15-month period with counterparties that are not its affiliates. . . ." 12 C.F.R. § 231.1 (copy attached). "Financial contract" is defined to mean a QFC (as defined in the FDIA), "except that a forward contract includes a contract with a maturity date two days or less after the date the contract is entered into (i.e. a 'spot' contract)."

   Because of the interplay between this definition and the "grandfather" provision of Regulation EE, there is some concern that counterparties that did not receive representations on March 7, 1994 relating to financial institution status could not rely on Regulation EE. The Associate General Counsel to the FRB issued a letter (copy attached), and the FRB amended Regulation EE (copy attached) to reduce concerns in this regard. The FRB has determined by letters dated June 21, 1994, July 10, 1996, January 21, 1997 and July 7, 1998 (copies attached) that the Student Loan Marketing Association, the Farm Credit System Banks, FNMA, FHLMC and the Federal Home Loan Banks are "financial institutions" for purposes of the netting provisions of FDICIA. It would appear that such status would be retroactive with respect to financial institutions under FDICIA, but, because of the "grandfather" provision in Regulation EE, that neither Sallie Mae, the Farm Credit System Banks, FNMA, FHLMC, the Federal Home Loan Banks nor their Regulation EE "financial institution" counterparties can rely on such status for contracts entered into prior to June 21, 1994 (in the case of Sallie Mae and the Farm Credit System Banks), July 10, 1996 (in the case of FNMA), January 21, 1997 (in the case of FHLMC) or July 7, 1998 (in the case of the Federal Home Loan Banks).

D. The scope of FDICIA is quite unclear. Although colorable arguments may be made that the provisions protect the exercise of close-out rights, it seems equally plausible that the provisions only protect netting, but not close-out rights (e.g., in a manner consistent with the FDIA, which gives the FDIC the ability to transfer QFCs, while preserving netting rights).

1. The FDIC has stated its view that FDICIA does not protect close-out rights, and, therefore, does not supersede its ability to transfer QFCs. 59 Fed. Reg. 37730 (July 25, 1994) (copy attached).

2. In any event, FDICIA clearly prevents cherry-picking between transactions subject to a netting contract between two financial institutions.

E. Title IX of the Pending Bankruptcy Legislation would clarify and expand the netting provisions of FDICIA.