# **Derivatives Trading Orders: Protecting the Debtor's Trading Business from Bankruptcy Termination**

July, 2006

**Reporter**

19 J. Tax'n F. Inst. 5

**Length:** 4732 words

**Author:** MARK SPEISER AND HAROLD OLSEN - Mark Speiser is a partner in the Financial Restructuring Group of Stroock & Stroock & Lavan LLP. Harold Olsen is a Special Counsel in Stroock's Financial Structuring Group.

**Highlight**

**Approaches for maintaining the value of a debtors' trading books can be found in two recent bankruptcy cases.**

**Text**

One of the most important tools of chapter 11 reorganization is the bankruptcy trustee's ability to assume favorable contracts while rejecting those that are not. Generally, a trustee or a debtor-in-possession [[1]](#footnote-2)1 enjoys these powers notwithstanding the existence of contractual provisions known as "ipso facto clauses" that purport to give the non-bankrupt party the right to terminate the relevant contract upon the occurrence of certain bankruptcy- or insolvency-triggered defaults or termination events. [[2]](#footnote-3)2

In the case of derivative contracts, such as forward contracts, swaps, securities and commodities contracts, and repurchase agreements, Congress, to minimize volatility in the financial markets, created exceptions to that general rule. [[3]](#footnote-4)3 While few would quarrel with the goal of enhancing financial market stability, in the real world these statutory provisions have the potential, by permitting counterparties to terminate, liquidate, or accelerate upon bankruptcy, to impair the bankruptcy reorganization of a company whose business is largely predicated on such derivative contracts.

Beginning with the Mirant bankruptcy filed in 2003, debtors have sought to implement systematic programs to preserve their trading business by providing incentives (1) for existing counterparties to continue to do business under existing contracts, and (2) to induce existing or new counterparties to enter into new, postpetition derivative contracts with the debtor. The following describes the approaches taken in the Mirant bankruptcy (and subsequently in the Calpine bankruptcy) in attempting to maintain the value of the debtors' trading books.

**EXECUTORY CONTRACTS GENERALLY AND THE SPECIAL PROTECTIONS FOR DERIVATIVE CONTRACTS**

A bankruptcy filing creates an estate generally consisting of "all legal or equitable interests of the debtor in property as of the commencement of the case." [[4]](#footnote-5)4 The debtor's bankruptcy estate includes its interest in executory contracts. [[5]](#footnote-6)5 Under section 362 of the United States Bankruptcy Code, [[6]](#footnote-7)6 the filing of a bankruptcy petition imposes an automatic stay on, among other things, "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." [[7]](#footnote-8)7 Accordingly, the non-debtor party to an executory contract is automatically stayed from terminating such contract, for any reason, upon the debtor's bankruptcy filing. Moreover, ipso facto clauses in executory contracts generally are unenforceable in bankruptcy. [[8]](#footnote-9)8

The protection provided by section 365 of the Bankruptcy Code helps a debtor to maximize the value of its assets by permitting it to assume or reject its executory contracts and unexpired leases with court approval. If a contract is assumed, the debtor must cure any defaults, compensate the counterparty for any actual pecuniary loss resulting from such defaults, and give adequate assurance of future performance. [[9]](#footnote-10)9 If a contract is rejected, the rejection is deemed a prepetition breach and the non-debtor counterparty has only a general non-priority claim for damages arising from such rejection. [[10]](#footnote-11)10 Courts generally apply a deferential "business judgment" standard in assessing the debtor's decision to assume or reject. [[11]](#footnote-12)11

Congress determined, however, that ipso facto termination provisions should be enforceable in bankruptcy cases for certain contracts ("Safe Harbor Contracts"), including forward contracts, swap agreements, repurchase agreements, securities contracts, commodities contracts and master netting agreements relating thereto. [[12]](#footnote-13)12 Moreover, Congress has enacted other provisions in the Bankruptcy Code (collectively with the Termination Provisions, the "Safe Harbor Provisions") which (1) exempt the non-debtor party to Safe Harbor Contracts from certain of the automatic stay provisions governing setoff, [[13]](#footnote-14)13 and from any court-imposed stay of such setoff rights, [[14]](#footnote-15)14 and (2) provide exceptions to certain avoidance provisions for transfers under Safe Harbor Contracts. [[15]](#footnote-16)15

Although the Safe Harbor Provisions protect the exercise of ipso facto termination, liquidation and acceleration rights and setoff or application of collateral, they do not exempt from the automatic stay the exercise of all rights under a derivative contract. [[16]](#footnote-17)16 For example, the Safe Harbor Provisions do not protect postpetition termination of a derivative contract for breach of a representation unrelated to the debtor's solvency, bankruptcy or financial condition.

Because ipso facto termination clauses are standard provisions in derivative contracts, the Safe Harbor Provisions have ominous implications for a debtor whose business is largely dependent on derivative contracts. Such a debtor runs the risk of losing substantially all of that trading business on the first day of the case, with no ability to obtain injunctive relief from the court.

**POSTPETITION TRADING ORDERS -- MIRANT AND CALPINE**

**Mirant Order.** The Mirant bankruptcy cases, filed in July 2003, represent the first attempt to systematically preserve a debtor's trading business in light of the Safe Harbor Provisions. Mirant involved affiliated debtors that owned or controlled, in North America alone, more than 18,000 megawatts of electric generating capacity, with rights to approximately 3.1 billion cubic feet per day of natural gas production, 2.1 billion cubic feet per day of natural gas transportation, and nearly 13.4 billion cubic feet of natural gas storage. [[17]](#footnote-18)17 These debtors relied upon a range of derivative contracts for hedging purposes, and alleged that failure to maintain existing trading positions and to engage in prospective trading activities would immediately and irreparably harm and degrade their value of the debtors' estates. [[18]](#footnote-19)18 Specifically, the debtors alleged that the exercise by existing counterparties of their ipso facto termination rights would eliminate hundreds of millions of dollars of value from the debtors' trading book and jeopardize the debtors' ability to continue necessary trading activities. [[19]](#footnote-20)19

In order to preserve their trading book, the debtors obtained interim court approval (via a "first day" Interim Order) for a program that, in broad strokes, authorized the debtor to enter into agreements with counterparties to defer exercise of their safe harbor termination rights pending entry of a final order (to be obtained within 55 days of entry of the Interim Order) that, among other things:

1. Authorized the debtors to assume, and to continue to perform and post margin under, the prepetition safe harbor contracts;

2. Authorized the exercise of any default or termination rights by the counterparty (other than ipso facto rights triggered by Mirant's initial bankruptcy filing) free of the automatic stay or any power of the court to modify, stay, avoid or otherwise limit the exercise of such rights; and

3. Granted first priority liens with respect to any collateral (including initial, maintenance or variation margin) as well as superpriority administrative expense status to Mirant's liabilities arising from postpetition market movement with respect to existing trades and postpetition trading activities.

The terms of these agreements were to be incorporated into "Assurance Agreements" entered into with the affected counterparties either prior or subsequent to the bankruptcy filing, the general terms of which were approved in the Bankruptcy Court's orders. [[20]](#footnote-21)20 Pursuant to these Assurance Agreements, ipso facto provisions in the underlying trading contracts would be replaced with a provision permitting termination for enumerated postpetition events, including conversion of the case to a liquidating case under chapter 7 of the Bankruptcy Code, appointment of a trustee, acceleration of any debtor-in-possession financing facility, or entry of any order that affected, impaired or limited the rights of the protected counterparty under the Assurance Agreement. All other default or termination provisions, including those relating to payment and breach of representations, would remain in effect. The program also contemplated authorization of, and similar protections for counterparties to, new postpetition trading contracts.

Other counterparty protections in the Mirant Interim Order included:

. Authorization for counterparties to net prepetition and postpetition amounts and obligations without distinction as to whether the transaction was entered into prepetition or postpetition. [[21]](#footnote-22)21

. Application of section 364(e) of the Bankruptcy Code, such that the vacatur, stay, or modification of the Interim Order would not affect the rights, security interests, and priorities granted to the counterparties, or the validity of any obligations incurred by Mirant, prior to receipt of written notice by the counterparty of such vacatur, stay, or modification.

. To the extent the value of any prepetition collateral held by a counterparty would exceed the aggregate value of amounts owed on existing positions (including with respect to postpetition market movements) such excess would secure postpetition trading activities.

. Factual findings that (1) any party accepting the protections of the Interim Order by entering into a prepetition or postpetition Assurance Agreement is a "forward contract merchant," "commodities broker" and/or "swap participant" as such terms are used in section 556 and 560 of the Bankruptcy Code, (2) correspondingly, the prepetition trading contracts between Mirant and such counterparties are safe harbor contracts under the Bankruptcy Code, (3) such contracts are executory contracts, and (4) entry into the Assurance Agreements was necessary to preserve Mirant's trading operation as a going concern.

In exchange, the counterparties, by entering into an Assurance Agreement or by engaging in new trades under an existing or postpetition trading contract with notice of the Interim Order, would be deemed, upon entry of the final order, to waive their ipso facto rights triggered by Mirant's initial bankruptcy filing. This waiver would not apply (in which case, the counterparty could terminate or liquidate all of its trading contracts without notice), if (1) Mirant served notice of rejection of the contract, (2) Mirant failed to meet any margin or collateral requirements or failed to make any payment due under the contract, or (3) the Interim Order was stayed, modified adversely to the counterparty, or vacated. The Interim Order provided that all contracts between Mirant and a protected counterparty would be deemed a single unified agreement for purposes of assumption and rejection (thus preventing Mirant from "cherrypicking" individual contracts). With respect to rejection, the Interim Order provided that determination of any settlement or termination payments owed would be made pursuant to the terms of such contract and measured as of the date actually terminated. [[22]](#footnote-23)22

In its Final Order, the Mirant court reaffirmed the provisions of the Interim Order on a final basis, but clarified that (1) only the assets of the debtor that was primary obligor on a given trading contract would be available to secure its obligations thereunder, and (2) the Interim Order's requirement that all contracts with a particular counterparty must be assumed or rejected as a single unified agreement applies only for purposes of assumption or rejection, and does not act as a court authorization for cross-default or cross-netting of prepetition contracts.

Subsequent to the Final Order, the court entered an amended final order (the "Amended Final Order") to implement its decision in Mirant Americas Energy Marketing L.P. v. ***Kern*** ***Oil*** & Refining Co. (In re Mirant Corp.). [[23]](#footnote-24)23 Mirant Americas Energy Marketing L.P. ("MAEM"), a debtor-subsidiary of Mirant Corp., brought an adversary proceeding against ***Kern*** ***Oil*** & Refining Co. ("***Kern***") for alleged violations of the automatic stay. MAEM supplied natural gas to ***Kern***, an ***oil*** refiner, to operate its electric cogeneration facility pursuant to a Gas Master Service Agreement, a Transaction Agreement and a Master Netting Agreement (collectively the "Agreements"). The Master Netting Agreement contained an ipso facto default provision.

The Interim Order extended by its terms to counterparties to "master agreements, 'long term confirmation agreements,' netting agreements, master netting agreements . . . and any transactions thereunder." When MAEM did not include ***Kern*** on a notice of protected counterparties under the Interim Order, ***Kern*** filed an objection. In the Final Order, the court clarified the scope of covered prepetition contracts (only those that were forward contracts, commodity contracts and/or swap agreements as defined in the Bankruptcy Code and as to which the counterparty could avail itself of the provisions of section 556 or 560) but reserved the right of any party to assert that it was such a protected party.

MAEM continued to supply gas to ***Kern*** under the Agreements for several months postpetition. It invoiced ***Kern*** for postpetition amounts, which ***Kern*** paid in the ordinary course of business. Some three months into the case, ***Kern*** wired a payment to MAEM for certain postpetition deliveries. The same day, MAEM gave ***Kern*** notice that it intended to reject the Agreements. On October 27, ***Kern*** acted to reverse the wire transfer, which by that time had been credited to MAEM's account. ***Kern*** also objected to MAEM's rejection motion, and notified MAEM that it was liquidating the Agreements in accordance with section 556 of the Bankruptcy Code.

However, ***Kern*** continued to receive natural gas from MAEM. Asserting a right of setoff against the damages it would suffer from MAEM's cessation of performance, ***Kern*** not only reversed the wire transfer, but refused to pay for the gas shipped in subsequent postpetition months.

MAEM's lawsuit alleged that ***Kern*** violated the automatic stay by (1) "liquidating" the Agreements, (2) reversing the wire transfer when the funds had been credited to MAEM's account and thus constituted estate property, and (3) setoff of its post-petition payables against its rejection damage claim. ***Kern*** alleged that the Agreements were forward contracts, and that liquidation was authorized under section 556, while the setoff was protected by section 362(b)(6) of the Bankruptcy Code.

The bankruptcy court first held that reversal of the wire transfer violated the automatic stay, as it was not the exercise of a "contractual right" protected by Section 556. Next, the court concluded that ***Kern*** improperly withheld payment of amounts arising after termination of the Agreements. In determining whether setoff was exercisable free of the automatic stay, the court addressed whether a "forward contract" was involved and whether ***Kern*** was a "forward contract merchant."

As to the first issue, the court found the definition of "forward contract" in section 101(25) of the Bankruptcy Code to be unambiguous, and that the Agreements between ***Kern*** and MAEM constituted a forward contract because "[u]nder the Agreements, MAEM agreed to sell ***Kern*** a commodity, and the Agreements had a maturity more than two days after their execution." [[24]](#footnote-25)24

As to the second issue, the bankruptcy court took the view that the Congressional purpose behind provisions dealing with forward contracts was to protect certain persons, rather than certain transactions. Rejecting MAEM's argument that any person who enters into a forward contract is a forward contract merchant, the court interpreted the definition of "forward contract merchant" in section 101(26) of the Bankruptcy Code [[25]](#footnote-26)25 to mean, "a person that, in order to profit, engages in the forward contract trade as a merchant or with merchants," and stated that the test for whether or not ***Kern*** had properly invoked section 556 was whether or not it had "entered into the Agreements as a participant seeking profit in the forward contract trade." [[26]](#footnote-27)26 Although the bankruptcy court ultimately found there was insufficient evidence in the record to determine whether ***Kern*** had met this test, it noted that although ***Kern*** was an end-user of the commodity in question, this was not dispositive as to whether or not it was a forward contract merchant and that, "[p]roducers and customers may engage in the forward contract trade and may do so (even with respect to contracts based on their own production or consumption) seeking a profit." [[27]](#footnote-28)27

Accordingly, the Amended Final Order limited the scope of the Mirant counterparty assurance program to those contracts that were forward contracts, commodity contracts and/or swap agreements, as defined in the Bankruptcy Code, and as to which the counterparty could avail itself of the provisions of section 556 or 560, but preserved the right of any party to assert that it was such a protected party.

**The Calpine Order.** Calpine Corporation and its subsidiaries sought implementation of a similar counterparty assurance program when they filed for chapter 11 protection in December 2005. Though largely based on the Mirant example, the Calpine program garnered objections from the Official Committee of Unsecured Creditors ("Committee") and other creditor constituencies. These objections centered on Calpine's effort to immediately assume over 250 prepetition trading contracts and to gain authority to engage in new postpetition trading. The objecting parties (1) were concerned that such assumptions and new business were improvident at such an early stage of the bankruptcy before the Committee had an opportunity to assess the debtors' risk management policies and to confirm that no such contracts related to projects or facilities the debtors intended to close or mothball, and (2) believed the debtors should limit their trading activities to reducing "value at risk" and should not engage in speculative trading.

These concerns were resolved through implementation of a protocol (which was filed under seal) to limit the debtors' exposure to liability pending review and ratification of the debtors' risk management policies, and an agreement on which projects should no longer be funded.

**THE SUCCESS OF POSTPETITION TRADING ORDERS AND SOME COUNTERPARTY STRATEGIES**

The Mirant program achieved what it set out to accomplish--postbankruptcy preservation of the debtor's trading business. It served as the model for a similar program in Calpine, seeking to achieve a similar goal. Other courts have granted similar protection solely to enable the debtor to engage in new postpetition trading, either in a counterparty-specific order or in an order of general applicability. [[28]](#footnote-29)28

What, then, can a counterparty do--either in negotiating its contracts or as a matter of postpetition strategy--to maximize its protection? First, the enforceability of ipso facto clauses in a "safe harbor" trading contract is the counterparty's greatest protection and greatest source of leverage in negotiating protections to enable it to continue performing postbankruptcy. [[29]](#footnote-30)29

Secondly, as demonstrated by the ***Kern*** ***Oil*** decision, there may be a question of whether a counterparty is entitled to protection from a Safe Harbor Provision. While not dispositive of the issue, it may be helpful (and certainly is not harmful) to include in the prepetition contract acknowledgements that the counterparty is a protected party (e.g., a forward contract merchant) and that the contract is a safe harbor contract (e.g., a forward contract).

Finally, when the debtor files bankruptcy or bankruptcy appears imminent, the counterparty must be ready to exercise those ipso facto provisions promptly. Delay in exercising these remedies postbankruptcy, or the transaction of postpetition business under a prepetition contract (absent preservation of rights under a Mirant-style order), may give rise to an argument that the counterparty has waived its ipso facto rights (in the former case, because the termination is not so clearly tied to the bankruptcy filing itself, and in the latter case because the counterparty has acted in a manner fundamentally inconsistent with bankruptcy termination).

Journal of Taxation and Regulation of Financial Institutions

Copyright (c) 2011 Civic Research Institute, Inc.

**End of Document**

1. 1A debtor-in-possession generally has all the powers of a chapter 11 trustee. See 11 U.S.C. 1107. [↑](#footnote-ref-2)
2. 2See 11 U.S.C. 365(e)(1). [↑](#footnote-ref-3)
3. 3See generally 11 U.S.C. 555-562. [↑](#footnote-ref-4)
4. 411 U.S.C. 541(a)(1). [↑](#footnote-ref-5)
5. 5See In re Carroll, 903 F.2d 1266, 1270-71 (9th Cir. 1990); In re Colonial Realty Co., 122 B.R. 1, 3-4 (Bankr. D. Conn. 1990). The Bankruptcy Code does not define "executory contract," but most courts have defined it as "a contract under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach [under applicable non-bankruptcy law] excusing the performance of the other." See, e.g., Vern Countryman, Executory Contracts in Bankruptcy: Part 1, 57 Minn. L. Rev. 439 460 (1973). Accord In re Riodizio, Inc., 204 B.R. 417, 421 (Bankr. S.D.N.Y. 1997) (citations omitted) (citing Enterprise Energy Corp. v. United States (In re Columbia Gas Sys., Inc.), 50 F.3d 233, 239 (3d Cir. 1995)); see also Mitchell v. Streets (In re Streets & Beard Farm Partnership), 882 F.2d 233, 235 (7th Cir. 1989); In re 375 Park Ave. Assocs., Inc., 182 B.R. 690, 697 (Bankr. SDNY 1995). [↑](#footnote-ref-6)
6. 611 U.S.C. 101 et seq. [↑](#footnote-ref-7)
7. 711 U.S.C. 362(a)(3). [↑](#footnote-ref-8)
8. 8See 11 U.S.C. 365(e). [↑](#footnote-ref-9)
9. 9See 11 U.S.C. 365(b). [↑](#footnote-ref-10)
10. 10See 11 U.S.C. 365(g)(1); 502(g). [↑](#footnote-ref-11)
11. 11See In re Klein Sleep Prods., 78 F.3d 18 (2d Cir. 1996). [↑](#footnote-ref-12)
12. 12See generally 11 U.S.C. 555, 556, 559, 560, and 561 ("Termination Provisions"). Express recognition of master netting agreements was added to the Bankruptcy Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Amendments"), effective in cases filed on or after October 17, 2005. See 11 U.S.C. 561. [↑](#footnote-ref-13)
13. 13See, e.g., 11 U.S.C. 362(b)(6) (forward contracts); 362(b)(17) (swap agreements). [↑](#footnote-ref-14)
14. 14See 11 U.S.C. 362(o). [↑](#footnote-ref-15)
15. 15See generally 11 U.S.C. 546. [↑](#footnote-ref-16)
16. 16See In re Enron Corp., 306 B.R. 465, 473 (Bankr. SDNY 2004) (swap agreement); In re Amcor Funding Corp., 117 B.R. 549, 551 (D. Ariz. 1990) (securities contract). [↑](#footnote-ref-17)
17. 17Debtors' Motion for Interim Order Authorizing the Debtors to (i) Comply With Terms of Prepetition Trading Contracts, (ii) Enter Into Postpetition Trading Contracts in the Ordinary Course of Business, (iii) Provide Credit Support Relating to Both Pre- and Post-Petition Trading Contracts, and (iv) Setting a Final Hearing to Consider The Entry of a Final Order Affirming the Interim Order and Authorizing Assumption of Prepetition Trading Contracts, dated July 14, 2003, P 8 at 2-3 (In re Mirant Corp., et al., Chapter 11 Case No. 03-46591 (DML) 11 (Jointly Administered)). [↑](#footnote-ref-18)
18. 18Id., P 16 at 6. [↑](#footnote-ref-19)
19. 19Id., P 3 at 1. [↑](#footnote-ref-20)
20. 20The court entered a Supplemental Order attaching a form of Postpetition Assurance Agreement, and the Court entered a final order (the "Final Order") approving these agreements on August 27, 2003, which was later amended as described below. [↑](#footnote-ref-21)
21. 21Ordinarily, a mutual debt and claim must both have arisen prepetition to qualify for setoff pursuant to § 553(a) of the Bankruptcy Code. [↑](#footnote-ref-22)
22. 22New section 562 of the Bankruptcy Code, added pursuant to the 2005 Amendments, provides that if the debtor or trustee rejects a safe harbor contract, or the counterparty liquidates, terminates or accelerates such contract, damages are measured as of the earlier of (i) the date of such rejection, or (ii) the date or dates of such liquidation, termination or acceleration. The Mirant orders predated the 2005 Amendments. [↑](#footnote-ref-23)
23. 23301 B.R. 548 (Bankr. ND Tex. 2004). [↑](#footnote-ref-24)
24. 24301 B.R. at 566. [↑](#footnote-ref-25)
25. 25Section 101(26) as then in effect defined a "forward contract merchant" as "a person whose business consists in whole or in part of entering into forward contracts as or with merchants in a commodity, as defined in section 761 (8) of this title, 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." [↑](#footnote-ref-26)
26. 26Id. at 568-570. The Court did note that Mirant met the test to be a forward contract merchant. [↑](#footnote-ref-27)
27. 27Id. at 570. [↑](#footnote-ref-28)
28. 28Such orders have been entered in the bankruptcies of Delta Air Lines, UAL Corp. and Pacific Gas & Electric, among others. [↑](#footnote-ref-29)
29. 29See In re Enron Corp., 306 B.R. 465, 473 (Bankr. S.D.N.Y. 2004) (bankruptcy safe harbor for termination rights only applies to rights triggered by an ipso facto condition, and not generally to any default or termination event under the contract). [↑](#footnote-ref-30)