Proskauer

Dealing with a Swap Dealer in Distress

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Over the past several weeks, the markets have been roiled by banks in financial distress. Some banks have received influxes of capital, while others were taken over by regulators or a competitor. Banks and the global economy more generally continue to face uncertainty. Customers and counterparties of distressed banks have unique economic, legal and operational challenges.

This client alert discusses the treatment of swaps and certain securities agreements following the bankruptcy filing, receivership, or sale of a distressed bank swap counterparty.

Termination Rights Following an Insolvency Event

The U.S. Bankruptcy Code includes provisions intended to allow debtors some time after a bankruptcy filing to assess the situation and to attempt to realize value from their pre-bankruptcy assets. Certain contractual provisions, such as the right to terminate an agreement based on a bankruptcy filing, the right to foreclose on collateral, and the right to set-off, are unenforceable under the Bankruptcy Code absent approval by the Bankruptcy Court. However, acknowledging that these limitations could have deleterious effects on the securities and commodities markets, the Bankruptcy Code includes safe harbors for these types of agreements from the automatic stay and other provisions of the Bankruptcy Code limiting creditors' rights. Non-debtor parties to swap agreements, master netting agreements, repurchase agreements and certain other types of securities agreements are permitted to terminate or accelerate these agreements, calculate amounts due and owing, set-off mutual obligations and foreclose on collateral. In the case of a receivership, the Federal Deposit Insurance Act (the "FDIA") and regulations promulgated thereunder by the Federal Deposit Insurance Corporation ("FDIC") contain similar provisions limiting the rights of creditors but also provides safe harbors from these restrictions for non-debtor parties to securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements, and similar agreements ("Qualified Financial Contracts" or "QFCs"). Note that a loan is not included in the definition of Qualified Financial Contract and therefore not exempt from the automatic stay under the FDIA.

In 2017, the FDIC and other regulatory agencies adopted rules (the “U.S. Resolution Regime”) pursuant to the Orderly Liquidation Authority signed into law as part of The Dodd-Frank Wall Street Reform and Consumer Protection Act. The intent of the U.S. Resolution Regime is to allow regulators time to transfer the assets (including the QFCs) of the insolvent entity to a new banking institution (a “Bridge Bank”) which operates the insolvent entity and holds its assets until either a purchaser can be found or the insolvent entity is liquidated. The U.S. Resolution Regime, among other things, restricts parties to Qualified Financial Contracts with U.S. global systemically important banking organizations (“GSIBs”) (or any of their U.S. affiliates or branches) from terminating their Qualified Financial Contracts, setting-off against other obligations, and liquidating collateral if such rights arise solely as a result of the GSIB’s insolvency or entry into resolution proceedings. These rules also limit the applicability of any provisions that would prevent the transfer of the Qualified Financial Contract to a Bridge Bank. These restrictions remain in place until the later of 5:00 pm ET on the business day or 48 hours following the commencement of the relevant proceedings (the “Stay Period”). A number of other jurisdictions globally have enacted similar, though not identical rules (such as the European Union’s Bank Recovery and Resolution Directive) that apply automatic stays to agreements with impacted entities within their jurisdiction.

The market standard ISDA Master Agreement (the “ISDA”) governing derivatives transactions provides parties the right to terminate all transactions if the other party to the transaction is subject to the appointment of a receiver, liquidator, conservator or other similar entity, upon the filing of a bankruptcy or insolvency petition, or immediately upon the occurrence of any similar insolvency event (each an “Insolvency Event”). Qualified Financial Contracts such as repurchase agreements and securities lending agreements typically include similar termination rights. Absent an Insolvency Event or a failure to otherwise meet its obligations under Qualified Financial Contracts, the mere fact that a swap counterparty is in distress will not normally give the other party a right to terminate the agreement.[1]

The treatment of a QFC with an insolvent bank counterparty is dependent on whether the bank counterparty is deemed to be a GSIB. Following the occurrence of an Insolvency Event, if the bank counterparty is not a GSIB, the Bankruptcy Code or FDIA will apply. The non-debtor may terminate each QFC, determine amounts owed or owing under each agreement, set-off mutual obligations and foreclose on any collateral they hold to the extent they are in-the-money. If the bank counterparty is deemed to be a GSIB, the U.S. Resolution Regime will apply. The non-debtor counterparty is restricted from terminating any QFCs, setting-off, foreclosing on collateral, or preventing the transfer of any QFCs to the Bridge Bank until the end of the Stay Period.

If a non-debtor's QFC with a GSIB has been transferred to a Bridge Bank before the end of the Stay Period, the Bridge Bank replaces the insolvent entity as party to the QFC. The Bridge Bank is not a bankrupt entity and is not in receivership despite the fact that the Bridge Bank came into existence as a result of a bankruptcy or receivership. As such, the standard Insolvency Event termination rights will not apply following the transfer of the QFC to a Bridge Bank. If a non-debtor's QFC with a GSIB has not been transferred to a Bridge Bank before the end of the Stay Period, the restrictions in the U.S. Resolution Regime will then cease to apply and the non-debtor may terminate each QFC, determine amounts owed or owing under each agreement, set-off mutual obligations and foreclose on any collateral they hold to the extent they are in-the-money.

Termination Rights Following the Sale of a Swap Counterparty

As in the case of an Insolvency Event, the mere fact that a swap counterparty is in distress and was acquired by another entity will not normally give the other party a right to terminate its swaps, repurchase agreements or other similar securities agreements with the distressed bank counterparty. Repurchase agreements and other securities agreements such as securities lending agreements generally do not include termination rights upon the acquisition of a distressed counterparty, absent some other failure by the counterparty to perform its obligations under the relevant agreement. The right to terminate transactions under an ISDA following an acquisition or other transfer of assets is limited to two scenarios: a "Merger Without Assumption" and a "Credit Event Upon Merger".[2]

A Merger without Assumption and its attendant termination rights would be triggered when two conditions are met – (i) the distressed bank is merged with, or substantially all of its assets are transferred to, another entity and (ii) either the resulting entity or acquiror fails to assume the distressed bank's obligations under the ISDA or any credit support (such as a guarantee) no longer supports the obligations under the ISDA. Similarly, the right to terminate an ISDA following a Credit Event Upon Merger will be triggered only where (i) the distressed bank is acquired by, merged with, or substantially all of its assets are transferred to, another entity[3] and (ii) the surviving or resulting entity is materially less creditworthy than the distressed bank immediately prior to the acquisition or merger (an unlikely occurrence if the acquiror has the capital to purchase the distressed bank). Absent the failure of the acquiror to assume all of the distressed bank's obligations under the ISDA, or the scenario where the resulting entity is materially less creditworthy that the distressed bank prior to the acquisition, the non-bank party will not have the right to terminate the ISDA.

The rights of a party to terminate a Qualified Financial Contract with a distressed bank can be complicated. The specific terms of the individual agreement need to be analyzed in conjunction with the evolving status of the distressed bank before attempting to terminate any QFC.

[1] Parties may include individually negotiated termination rights that are triggered in a distress scenario. Such rights are likely to be fact specific and need to be analyzed on a case-by-case basis.

[2] While not the subject of this Client Alert, we note that the consequences of a Merger Without Assumption and Credit Event Upon Merger and the methodology for calculating amounts owed under an ISDA following a Merger Without Assumption and Credit Event Upon Merger differ slightly.

[3] Note that a Credit Event Upon Merger may also be triggered by a substantial change in the capital structure of the distressed bank achieved through the issuance of preferred stock, convertible debt or any other form of ownership interest where the distressed bank is materially less creditworthy following such issuance.

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