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Bankruptcy / Finance ADVISORY ■

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ABI Commission Proposes Changes to Bankruptcy Code Safe Harbors

Changes may be coming to the Bankruptcy Code's safe harbor provisions.[1] In 2012 the American Bankruptcy Institute established a Commission to Study the Reform of Chapter 11 (the "ABI Commission"), composed of many well-respected restructuring practitioners, including two of the original drafters of the Bankruptcy Code, whose advice holds great weight in the restructuring community. On December 8, 2014, after considerable discussion and analysis concerning potential reforms of the Bankruptcy Code, the ABI Commission issued its Final Report and Recommendation proposing amendments to the Bankruptcy Code. The proposed changes are broad and include material changes to many areas of the Bankruptcy Code, including the safe harbor protections that financial institutions and market participants have long depended on to protect qualified financial contracts[2] from the Bankruptcy Code's automatic stay and anti-termination provisions, among others. Consequently, although merely proposals at this time, the ABI Commission's recommendations may lead to amendments to the Bankruptcy Code that would significantly impact financial institutions and other financial market participants and the way these entities do business in certain areas of the market. The current proposed changes to the safe harbor provisions include the following:

- ***Eliminating or limiting safe harbor protections related to mortgage loans and mortgage-backed securities.*** Congress expanded the scope of the safe harbors in 2005 to include safe harbor protection for repurchase agreements and securities contracts involving mortgage loans and mortgage-backed securities. Counterparties to these protected agreements may liquidate, terminate, or accelerate those agreements upon a bankruptcy filing and without obtaining relief from the automatic stay. Thus, the 2005 expansion provided important protections for lenders in the mortgage industry. The ABI Commission proposes reverting to the pre-2005 law, thereby eliminating the safe harbor protections for mortgages and mortgage-backed securities. Alternatively, the ABI Commission proposes limiting safe harbor protections by excluding repurchase agreements that have the economic attributes of traditional mortgage warehouse facilities and that, according to the ABI Commission, are more akin to secured financing arrangements than so-called "true repurchase agreements."

- ***Limiting protection from clawback and avoidance actions.*** Under Section 546(e), a trustee cannot avoid many "settlement payments" made to financial participants or transfers made in connection with qualified financial contracts, unless those payments were made with actual fraudulent intent. These protections, according to the ABI Commission, are meant to insulate the securities transfer system rather than privately issued securities transactions. For this reason, the ABI Commission

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[1] This advisory represents Alston & Bird's first in a series of planned advisories discussing the ABI Commission's Final Report and Recommendation, its proposed amendments to the Bankruptcy Code, and its impact on secured creditors and bankruptcy cases in general.

[2] Generally, "qualified financial contracts" are securities contracts, forward contracts, commodity contracts, repurchase agreements, swap agreements, and master-netting agreements.

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proposes to exclude settlement payments made to beneficiaries of leveraged buyouts and similar transactions[3] *if the securities were privately issued*. Section 546(e) would continue to protect settlement payments for publicly issued securities and securities industries participants that act as conduits in prepetition transfers. Finally, although Section 546(e)'s protections do not protect transfers made with the actual intent to hinder, delay, or defraud creditors, there has been some dispute about whether such protections applied to equivalent actions under state law. To ensure conformity, the ABI Commission proposes amending Section 546(e) so that it provides protection against equivalent state law actions, too.

- ***No stay from exercise of remedies for remaining safe harbored transactions.*** The safe harbor provisions currently allow contract counterparties to liquidate and close out qualified financial contracts with a debtor upon a bankruptcy filing, despite the Bankruptcy Code's ipso facto clause prohibitions and automatic stay. The ABI Commission considered, but ultimately rejected, a proposal to apply a short-term stay that would have allowed debtors to assume and assign these contracts before counterparties could terminate, liquidate, and close them out.

- ***Greater clarity on the measurement of damages.*** Section 562 of the Bankruptcy Code currently provides for the use of "commercially reasonable determinants of value" to govern the measurement of damages following a rejection, liquidation, termination, or acceleration of a qualified financial contract. However, Section 562 does not define what that term means, which has led to disputes and litigation over the method used to calculate damages. The ABI Commission proposes to define "commercially reasonable determinants of value" as the determinants of value *specified in the contract* that are not manifestly unreasonable. If adopted, this would mean that contractual provisions defining these measures would ordinarily be respected.[4] If the contract is silent on this point, damages would be calculated using commercially reasonable market prices.

- ***Rendering "walkaway clauses" unenforceable.*** Unlike the Federal Deposit Insurance Act and Orderly Liquidation Authority, the Bankruptcy Code currently is silent on the treatment of "walkaway clauses." Upon the termination, liquidation, or acceleration of a financial contract based on a default, the defaulting party may still benefit from the contract. Walkaway clauses operate to eliminate the benefit of the contract to the defaulting party, even if the defaulting party is still in the money. The ABI Commission proposes (i) to include a definition of "walkaway clauses" that is consistent with other federal law and (ii) to render such clauses unenforceable in qualified financial contracts.

- ***Exclusion of supply contracts from safe harbor protection.*** The Bankruptcy Code broadly defines the types of qualified financial contracts that receive safe harbor protection. These broad definitions have allowed some courts to provide safe harbor protection to contracts for the physical supply of goods used, traded, or produced by the debtor—including contracts for the supply of gas or electricity—even though such contracts rarely affect securities transfer or commodity hedging systems or market stability.[5] Thus, the ABI Commission proposes to exclude nondealer counterparties to physical supply contracts from the benefits of the safe harbor provisions.

These proposals to amend the Bankruptcy Code's safe harbor provisions are likely to receive serious consideration from Congress. If enacted, we could see borrowing costs increase, lending programs that fuel the mortgage industry abandoned, and a resulting credit crunch that would impact both Wall Street and Main Street. Financial institutions and other financial market participants should continue to monitor—and weigh in on—these proposals in the coming months.

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3 The ABI Commission's chief focus appears to be leveraged buyouts and similar prepetition transfers. At this time, it remains unclear how this proposed amendment would apply to other transactions involving privately issued securities.

4 It is unclear at this time if the ABI Commission considers contractual provisions allowing the determination of value to be in the lender's sole discretion to be "manifestly unreasonable."

5 The ABI Commission notes that these ordinary supply contracts are to be distinguished from bona fide commodities contracts that are considered "qualified financial contracts" properly meant for safe harbor protection.

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