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The global financial crisis and related flood of insolvencies has triggered a material shift in structured lending practices to embrace constructs that avoid or minimize not only insolvency risks but also exposure to insolvency processes. Leading this paradigm are “safe harbored” structures under the U.S. Bankruptcy Code<sup>1</sup> – qualifying repurchase agreements, securities contracts and similar instruments – which rapidly are replacing traditional short-to-long-term financing structures throughout the developed world.

Safe harbored structures provide numerous benefits to lenders. At its core, such structures permit lenders to exercise remedies notwithstanding an intervening insolvency and to do so directly against collateral. While borrowers conversely lose some control over collateral, they benefit from materially lower costs of funds that are a direct result of the enhanced protections accorded lenders.

Safe harbor transactions dominate the U.S. mortgage loan warehouse lending market, as well as the financing of any other mortgage-related asset qualifying for safe harbor treatment, with a recent \$1.5 trillion market value.<sup>2</sup> Such favorable treatment has pushed lenders and borrowers to increasingly explore the structural limits of safe harbor qualifying transactions and this has been supported by decisions in U.S. courts placing expansive boundaries on the types of financial structures qualifying for safe harbor treatment.

With continued favorable court rulings, the growth of safe harbor transactions will continue as lenders seek better structured credit opportunities and borrowers lower costs. This article explores this growth in the U.S. market and related U.S. and U.K. case law.

### **Bankruptcy Code Safe Harbors**

Repurchase agreements and securities contract safe harbor structures dominate the U.S. market, permitting lenders to exercise remedies largely free from intervening bankruptcy proceedings that add costs and delay lender recoveries.

Section 101(47) of the Bankruptcy Code defines a “repurchase agreement” as an agreement for the sale of certain qualifying assets with a simultaneous agreement by the seller to buy back such assets at a date not later than one year after such transfer.<sup>3</sup> Lenders widely use repurchase

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<sup>1</sup> 11 U.S.C. § 101 et seq.

<sup>2</sup> Tri-party Repo Statistical Data, Federal Reserve Bank of New York (Apr. 9, 2014), available at [http://www.newyorkfed.org/banking/tpr\\_infr\\_reform\\_data.html](http://www.newyorkfed.org/banking/tpr_infr_reform_data.html) (last visited May 9, 2014).

<sup>3</sup> 11 U.S.C. § 101(47).

agreements to finance mortgage-related assets because, under Section 559 of the Bankruptcy Code, the right of the lender to cause the liquidation, termination or acceleration of a repurchase agreement “shall not be stayed, avoided or otherwise limited by [the Bankruptcy Code] or by order of [a court].”<sup>4</sup> In the event of a bankruptcy filing of a repo seller, the lender can accelerate the transaction, and begin the process of liquidating the collateral immediately – an obvious benefit to a lender in a distressed situation. In addition, Section 362(b)(7) provides that the automatic stay does not apply to an action to “offset or net out any termination value, payment amount or other transfer obligation arising under or in connection with a [repurchase agreement].”<sup>5</sup>

In addition to the repurchase agreement safe harbor, financial participants can also avail themselves of similar safe harbor treatments if their financing is structured as a “securities contract.” Section 741(7)(A) of the Bankruptcy Code defines as “securities contract” as “[A] contract for the purchase, sale, or loan of a security . . . a group or index of securities . . . or interests therein (including an interest therein or based on the value thereof), or option on any of the foregoing, . . . and including any repurchase or reverse repurchase transaction on any such security . . . interest, group or index, or option (whether or not such repurchase or reverse repurchase transaction is a “repurchase agreement,” as defined in section 101 [of the Bankruptcy Code]).”<sup>6</sup> Unlike repurchase agreements, securities contracts do not need to meet the one-year limitation to qualify as safe harbored. But the types of financial institutions that can exercise securities contract safe harbor rights are limited; the repurchase agreement safe harbor rights can be exercised by any entity that is a party to a qualifying repurchase agreement.<sup>7</sup> Securities contracts are entitled to the same benefits under Section 561 of the Bankruptcy Code as repurchase agreements, giving the lender the ability to accelerate the transaction, and begin the process of liquidating the collateral immediately.

The Bankruptcy Code provides another incentive to structure transactions as repurchase agreements or securities contracts in the Section 546 safe harbor. Section 546(e) exempts settlement payments and transfers made by or to financial institutions, including repo participants, from being avoidable as constructive fraudulent transfers or preferential transfers. In addition to financial institutions under a securities contract, Section 546 specifically applies to repo participants under Section 546(f) and swap participants under 546(g). This allows the exercise of remedies under a repurchase agreement or securities contract to not only be exempt from the automatic stay, as discussed above, but also relieves lenders of the burden of setting aside reserves to address debtor attempts to avoid settlement payments or transfers received pre-petition.

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<sup>4</sup> 11 U.S.C. § 559.

<sup>5</sup> 11 U.S.C. §362(b)(7).

<sup>6</sup> 11 U.S.C. § 741(7)(A).

<sup>7</sup> Compare 11 U.S.C. § 555 with 11 U.S.C. § 559.

## Notable Cases Concerning Safe Harbored Contracts

To put the safe harbors into perspective, it is helpful to understand the genesis and development of the statutory provisions.<sup>8</sup> The earliest safe harbor provisions, enacted with the modern U.S. Bankruptcy Code in 1978, applied only to commodities clearing organizations and in connection with various types of commodities contracts. These provisions exempted certain margin payments from avoidance as preferential transfers and provided limited relief<sup>9</sup> from the automatic stay to setoff mutual debts. They were included in the 1978 bill that became the modern Bankruptcy Code based on congressional testimony arguing that the U.S. financial system was fragile and the insolvency of one trader might create a “domino” effect if a broker was not permitted to liquidate the trader’s positions.<sup>10</sup> A single case was cited to support this position, *Gelderman v. Lane*,<sup>11</sup> in which a commodities trader filed a counterclaim against his broker on the grounds that the liquidation of his positions for failing to meet a margin call was unconscionable, which the court rejected.

Subsequent amendments to the Bankruptcy Code expanded the early safe harbor to include the securities markets, along with the contractual right to liquidate, accelerate and terminate, with the 1982 amendments, and to repurchase agreements and swap agreements, with the 1984 and 1990 amendments, respectively. In 2005, in the wake of the well-publicized collapse of hedge-fund Long Term Capital Management, Congress added protections for the netting of derivatives contracts and greatly expanded the definitions of safe harbored contracts by listing specific types of known derivatives and other financial contracts, including “securities contracts.” Congress again amended the safe harbor provisions in 2006 to strengthen the early termination and netting provisions.<sup>12</sup>

Despite the first safe harbor appearing on the books over 35 years ago, and five subsequent amendments, there is surprisingly little U.S. case law on what financial contracts satisfy the various safe harbor provisions. This fact, along with the results reached in the limited reported cases, is a contributing factor to the domination of safe harbored structures in U.S. lending circles. Of the few cases that have considered whether a particular financial transaction qualifies as a safe harbor contract, the vast majority construe the statutory language broadly. Indeed, of the lower court decisions seeking to limit the reach of the safe harbors that have been appealed,

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<sup>8</sup> For a more in-depth review of the statutory and legislative history behind the safe harbor provisions, see Steven L. Schwarcz & Ori Sharon, *The Bankruptcy-Law Safe Harbor for Derivatives: A Path Dependence Analysis* available at [http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=5890&context=faculty\\_scholarship](http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=5890&context=faculty_scholarship).

<sup>9</sup> The first safe harbor only provided limited relief from the automatic stay in that a debtor could request that the bankruptcy court impose the automatic stay if the setoff might harm the estate. S.R.REP. NO. 989, 95th Senate, 2d Sess. 50 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5837; H.R.REP. NO. 595, 95th Cong., 2d Sess. 342 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6298.

<sup>10</sup> Testimony of Stuart D. Root. Bankruptcy Reform Act of 1978: Hearings before the Subcommittee on Improvements in Judicial Machinery of the Committee on the Judiciary, United States Senate, Ninety-fifth Congress, first session, on S. 2266 and H.R. 8200, November 28, 29 and December 1, 1977, p. 521, *available at* [http://www.archive.org/stream/bankruptcyreform1978unit/bankruptcyreform1978unit\\_djvu.txt](http://www.archive.org/stream/bankruptcyreform1978unit/bankruptcyreform1978unit_djvu.txt).

<sup>11</sup> 527 F.2d 571 (8th Cir. 1975).

<sup>12</sup> H.R. REP. NO. 109-648, at 1 (2006).

most have been overruled.<sup>13</sup> A survey of recent cases shows a clear judicial trend toward an even more inclusive reading of the safe harbor provisions under the Bankruptcy Code.

The premise that an ordinary financial transaction could be safe harbored likely took root in earnest with the *Enron* decision in 2009.<sup>14</sup> There, the U.S. District Court for the Southern District of New York determined that payments made to holders of Enron's commercial paper, \$1.1 billion of which were redeemed prior to maturity through the Depository Trust Company, were exempted under Section 546(e) from avoidance as fraudulent transfers and preferences because they were "settlement payments" as defined in Section 741(8) of the Bankruptcy Code "made in the securities trade to consummate securities transactions."<sup>15</sup> The Second Circuit affirmed, noting that "the absence of a financial intermediary that takes title to the transacted securities during the course of the transaction is [not] a proper basis on which to deny safe harbor protection."<sup>16</sup>

The Second Circuit took another step in broadening the application of the safe harbors in 2013 with its decision in *Quebecor World*.<sup>17</sup> In that case, an affiliate of the debtor issued private placement notes through "Note Purchase Agreements." The agreements contained a prepayment provision and a "make-whole" premium. To minimize tax liability in connection with the redemption of the notes, the notes were first purchased by an affiliate of the issuer and then redeemed. CIBC Mellon, a financial institution, served as trustee for the noteholders. Within 90 days of the transaction, the issuer filed bankruptcy and the official committee of unsecured creditors in the case sought to avoid the payments to noteholders as preferences. The Second Circuit held that the agreements were securities contracts because they provided for both the original purchase and "repurchase of the notes." In finding that the payments were safe harbored under Section 546(e), the court rejected the committee's argument that not all the noteholders were financial institutions and CIBC Mellon served as a mere conduit. The court reasoned that nothing in the statutory language limited "[a] transaction involving one of these financial intermediaries, even as a conduit, [which] necessarily touches upon these at-risk markets."<sup>18</sup>

There are very few reported decisions similar to the Delaware bankruptcy court's decisions in *In re American Home Mortgage, Inc.* ("*Calyon*")<sup>19</sup> and *In re HomeBanc Mortgage Corp.*<sup>20</sup> that have construed the meaning of "repurchase agreement." *Calyon* concerned a contract providing for the transfer of mortgage loans or interests therein from the debtors to certain purchasers (for which Calyon served as agent) in exchange for the transfer of funds and for the later resale of the mortgage loans from the purchasers to the debtors. Following a default by the debtors and two

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<sup>13</sup> See, e.g., *In re Nat'l Gas Distributors, LLC*, 369 B.R. 884 (Bankr. E.D.N.C. 2007) *rev'd* 556 F.3d 247 (4th Cir. 2009) (holding that simple gas supply contracts were exempted from avoidance as fraudulent conveyances as swap agreements); *In re MBS Mgmt. Servs., Inc.*, 432 B.R. 570, 576-77 (Bankr. E.D. La. 2010) *rev'd* 690 F.3d 352 (5th Cir. 2012) (holding that an ordinary electrical supply contract was a safe harbored derivative contract).

<sup>14</sup> *AFLA, S.A.B. de C.V. v. Enron Creditors Recovery Corp. (In re Enron Creditors Recovery Corp.)*, 422 B.R. 423 (S.D.N.Y. 2009).

<sup>15</sup> *Id.*

<sup>16</sup> *In re Enron Creditors Recovery Corp.*, 651 F.3d 329, 338 (2d Cir. 2011).

<sup>17</sup> *Official Comm. of Unsecured Creditors of Quebecor World (USA) v. Am. United Life Ins. Co. (In re Quebecor World (USA) Inc.)*, 719 F.3d 94 (2d Cir. 2013).

<sup>18</sup> *Id.* at 100.

<sup>19</sup> *In re American Home Mortgage, Inc.*, Adv. No. 07-51704, 2008 WL 60292 (Bankr. D. Del. January 4, 2008).

<sup>20</sup> No. 07-51740, 2013 WL 211180 (Bankr. D. Del. Jan. 18, 2013).

weeks after their bankruptcy filing, Calyon exercised its contractual right to transfer servicing of the mortgages. The debtors argued that the contract was a secured financing, not a repurchase agreement and disputed Calyon's right to exercise remedies post-petition. The bankruptcy court employed a plain reading of Section 555 of the Bankruptcy Code and determined that Calyon could exercise its rights post-petition, notwithstanding that the contract was not documented on an industry standard form.

*HomeBanc* concerned numerous transactions where HomeBanc obtained financing under a master repurchase agreement, which had a "zero purchase price" and were payable on demand. The bankruptcy trustee for HomeBanc argued that the individual transactions under the master repurchase agreement could not qualify as repurchase agreements under the Bankruptcy Code because the securities had to be transferred in exchange for funds. The bankruptcy court adopted the defendants "bucket theory," holding that adequate consideration was provided to satisfy the statutory definition of a repurchase agreement because each transaction served as consideration for every other transaction under the terms of the master repurchase agreement.<sup>21</sup> Thus, the court did not view the transactions in a vacuum, and the court's holding underscores the important role that contractual language included a financial transaction plays in potentially qualifying for the safe harbors.

Some cases that have taken a narrower view of the safe harbor provisions, but these cases represent the minority and appear to have limited precedential import. For example, after the Second Circuit's decision in *Quebecor World*, the Delaware bankruptcy court in *Qimonda Richmond, LLC*, declined to extend the Section 546(e) safe harbor to payments made on a letter of credit issued by Citibank serving as collateral for the debtors' bond issuance, because the court found that letters of credit are excluded from the definition of a "security" in Section 101(49)(B)(i) of the Bankruptcy Code.<sup>22</sup> Citibank argued that the court should follow *Quebecor World*, but the bankruptcy court distinguished that case because it did not concern a letter of credit, which the bankruptcy characterized as an independent from any "securities transaction." Citibank also argued that the payment made on the letter of credit was a "transfer made ... to a financial institution ... in connection with a securities contract" because its function was to enhance the creditor rating on the debtors' bond issue, which qualified as a "securities contract."<sup>23</sup> The bankruptcy court declined to decide this issue at the motion to dismiss stage, so the decision really only serves as a caution in the use of letters of credit – which could be easily circumnavigated by applying the payments directly toward redemption of the bonds – and the court has yet to provide important guidance on whether bonds and/or indentures constitute "securities contracts."

Another recent case appears to limit what was previously considered a very adverse decision from derivatives counterparties. In the highly publicized case of *Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Services Ltd.*,<sup>24</sup> the U.S. Bankruptcy Court for the Southern District of New York held that a "flip" clause that subordinated payments to Lehman

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<sup>21</sup> *EPLG I, LLC v. Citibank, National Association et al. (In re Qimonda Richmond, LLC, et al.)*, 467 B.R. 318 (Bankr. Del. March 26, 2012).

<sup>22</sup> *Id.* at 322

<sup>23</sup> *Id.* at 323

<sup>24</sup> *Lehman Brothers Special Financing Inc. v. BNY Corporate Trustee Services Ltd.*, 422 B.R. 407 (S.D.N.Y. 2010).

Brothers Special Financing Inc. (“LBSF”) in a swap agreement, was unenforceable as an “ipso facto” clause. Implicitly, in so holding, the court did not apply the safe harbor of Section 560, which protects swap counterparties from the Bankruptcy Code’s general prohibition on “ipso facto” clauses. The decision also is notable because the U.K. courts reached the opposite conclusion as the court in *BNY* on essentially the same set of facts.<sup>25</sup>

An important open question remained after the *BNY* decision. The court found that the “flip” clause was contained in a collateral document, not within the swap agreement itself. Would the bankruptcy court have invalidated the clause if it had been found within the swap agreement? The court’s subsequent decision in *Michigan State Housing Development Authority v. Lehman Brothers Derivatives Products Inc.*<sup>26</sup> suggests not. There, the court overruled LBSF’s argument that a “liquidation paragraph,” which provided an alternative means of calculating the settlement payment if the swap was terminated as a result of LBSF’s bankruptcy, should be unenforceable as an “ipso facto” clause.<sup>27</sup> The bankruptcy court held that the “liquidation paragraph” was enforceable because it was part of the swap agreement and that “liquidation” as set out in Section 560 included the right to calculate the settlement amount.<sup>28</sup>

## Conclusion

The safe harbor provisions are perceived as critically important to financial transactions by lenders, particularly since we are only a few years removed from the worst financial recession in memory. The push to qualify ordinary financial transactions as safe harbor contracts has met with little resistance from the courts. One seeming result is a shifting of the burden in U.S. bankruptcies from lenders and other providers of capital who can avail themselves of the safe harbor provisions to other creditors, such as trade vendors. Certainly, the current safe harbors have come a long way since the enactment of the first safe harbor provision based on the potential “domino” effect from the failure to liquidate a trader’s margin positions. In the absence of any trend-reversing decisions from the circuit courts, or an unlikely decision from the U.S. Supreme Court, Congress ultimately will need to consider whether safe harbor provisions still serve the role it initially intended.

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<sup>25</sup> See *Belmont Park Investments Pty Limited v BNY Corporate Trustee Services Limited and Lehman Brothers Special Financing Inc.*, [2011] UKSC 38.

<sup>26</sup> *Michigan State Housing Development Authority v. Lehman Brothers Derivatives Products Inc.*, 502 B.R. 383 (S.D.N.Y. 2013).

<sup>27</sup> *Id.* at 392.

<sup>28</sup> *Id.* at 395.