The current financial crisis has highlighted the fact that the complexity of certain financing and financial instruments made it virtually impossible to determine the true extent of the risk faced by lenders and other financial companies. Since the collapse of Lehman Brothers and the bailout of major U.S. banks, terms such as "credit default swaps" have entered into the lexicon of everyday conversations, and lawyers are increasingly facing the intricate nature of twenty-first century finance. Indeed, the Lehman Brothers bankruptcy has showed how Byzantine financial instruments involving counterparties throughout the world can add an intricate layer to the resolution of a debtor's affairs.

Among the ubiquitous complex financial instruments are so-called “derivatives,” e.g., swaps, options or futures, which are risk-shifting agreements that derive their value from the value of an underlying asset. The widespread use of derivatives has meant that financial institutions have potentially enormous exposure should a counterparty file bankruptcy.

The filing of a bankruptcy petition affords important protections to the debtor, for example, the automatic stay of section 362 and the right to assume or reject executory contracts. Yet in the case of certain complex financial instruments, i.e., derivatives, these protections are not available: specifically, the financial contract provisions of the Bankruptcy Code are generally intended to permit nondebtor parties to take action that is otherwise prohibited by the Code. In other words, the Code contains a number of interrelated provisions that provide special rights and safe harbors to nondebtor counterparties in specified categories of financial transactions—commodity contracts, securities contracts, forward contracts, repurchase agreements, swap agreements, and master netting agreements. In the words of two commentators, the safe harbors “are necessary, it is thought, for the protection of financial markets . . . . Without these safe harbors, markets might suffer serious shocks – perhaps even a systemic liquidity crisis, causing markets to collapse—when debtors enter bankruptcy.” Edward R. Morrison & Joege Riegel, Financial Contracts and the New Bankruptcy Code: Insulating Markets From Bankruptcy Debtors and Bankruptcy Judges, 13 Am. Bankr. Inst. L. Rev. 641, 642 (2005).

Thus, with huge amounts at stake in derivatives, it is of great importance for nonfiling counterparties to close out their transactions and to be able to rely on the safe harbors offered by the Bankruptcy Code. However, these safe harbors are available only to certain classes of protected counterparties exercising certain protected rights under specific types of protected transactions. Accordingly, the interpretation of these provisions has assumed heightened relevance to debtors and their counterparties.

A significant recent decision in this area is Hutson v. E.I. DuPont de Nemours & Co. (In re National Gas Distribs., LLC), 2009 U.S. App. LEXIS 2830 (4th Cir. Feb. 11, 2009), where the Fourth Circuit held that “forward commodity agreement” encompasses agreements that are individually negotiated, physically settled and not traded on a
financial exchange or market. In that case, the chapter 11 trustee filed adversary proceedings to avoid as fraudulent conveyances numerous gas supply contracts made with the debtor’s customers during the year before the petition was filed. The customers countered that the contracts at issue were “commodity forward agreements” (included in 11 U.S.C. § 101(53B)’s definition of “swap agreement”). The bankruptcy court denied the customers’ motions to dismiss and for summary judgment, finding that the agreements were simply those of a single end-user to purchase a commodity and therefore not exempt from avoidance. On direct appeal, the Fourth Circuit, on a case of first impression, reversed and remanded. “Forward contracts” are not confined to financial markets, the court held, and since every “forward contract” is also a “forward agreement,” it followed that the agreements enumerated in section 101(53B)(A)(i) were not limited to those within financial markets. Second, the court held that the contracts at issue contained “real hedging elements,” and the fact that they involved the actual delivery of a commodity did not preclude their inclusion as “commodity forward agreements.”

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Authoritative Analysis, Law Reviews and Journals:
• For analysis of Code sections 555, 556, 559 through 562, see Collier on Bankruptcy, chs. 555, 556, 559, 560, 561 & 562
• For discussion of limitations on avoiding powers for certain financial transactions, see Collier on Bankruptcy, ¶¶ 546.06, 546.07, 546.08, 546.110
• For discussion of exceptions to the stay for the exercise of contractual rights by swap participants and under master netting agreements, see Collier on Bankruptcy, ¶ 362.05[16], [25]
• For discussion of safe harbors related to close out of complex financial instruments, see Collier Lending Institutions and the Bankruptcy Code, ¶ 2.08
• Bruce H. White & Bryan L. Elwood, Are You Sailing in Safe Harbors? An Overview of Various Bankruptcy Code Safe-Harbor Protections, 26-10 ABIJ 44
• Shmuel Vasser, Derivatives in Bankruptcy, 60 Bus. Law. 1507, August, 2005.

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