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Tips For Negotiating With A Swap Dealer In Distress

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Over the past two months, 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.

Under the U.S. Bankruptcy Code and the U.S. Special Resolution Regimes, swaps and certain securities agreements receive different treatment than other types of financial agreements.

This article discusses the treatment of swaps and certain securities agreements following the bankruptcy filing, receivership or sale of a distressed bank swap counterparty and highlights some concrete steps practitioners can take to protect their clients from some of the consequences of a dealer in distress.

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 prebankruptcy 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 a 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.

Nondebtor 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 and regulations promulgated thereunder by the Federal Deposit Insurance Corp. not only contain similar provisions limiting the rights of creditors but also provide safe harbors from these restrictions for nondebtor parties to securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements and similar agreements like 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, referred to as the U.S. Special Resolution Regimes, pursuant to the Orderly Liquidation Authority and signed into law as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The intent of the U.S. Special Resolution Regimes is to allow regulators time to transfer the assets, including the QFCs, of the insolvent entity to a new banking institution — a so-called bridge bank — that operates the insolvent entity and holds its assets until either a purchaser can be found or the insolvent entity is liquidated.

The U.S. Special Resolution Regimes, among other things, restrict parties to QFCs with U.S. global systemically important banking organizations — or GSIBs — or any of their U.S. affiliates or branches from terminating their QFCs, 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 QFC to a bridge bank. These restrictions remain in place until the later of 5 p.m. ET on the business day or 48 hours following the commencement of the relevant proceedings, also known as 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 affected entities within their jurisdiction.

The market standard International Swaps and Derivatives Association master agreement 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.

QFCs 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 QFCs, 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 nondebtor 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. Special Resolution Regimes will apply. The nondebtor 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 nondebtor'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 nondebtor'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. Special Resolution Regimes will then cease to apply and the nondebtor 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 agreement following an acquisition or other transfer of assets is limited to two scenarios: a merger without assumption and a credit event upon a merger.[2]

A merger without assumption and its attendant termination rights would be triggered when two conditions are met: (1) the distressed bank is merged with, or substantially all of its assets are transferred to, another entity; and (2) either the resulting entity or acquirer fails to assume the distressed bank's obligations under the ISDA agreement or any credit support — such as a guarantee — no longer supports the obligations under the ISDA agreement.

Similarly, the right to terminate an ISDA agreement following a credit event upon a merger will be triggered only when (1) the distressed bank is acquired by, merged with or substantially all of its assets are transferred to another entity;[3] and (2) 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 acquirer has the capital to purchase the distressed bank.

Absent the failure of the acquirer to assume all the distressed bank's obligations under the ISDA agreement, or the scenario in which the resulting entity is materially less creditworthy than the distressed bank prior to the acquisition, the nonbank party will not have the right to terminate the ISDA agreement.

The rights of a party to terminate a QFC 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.

Key Takeaways

While we may not have any control over whether our swap counterparty becomes insolvent or otherwise distressed, it is important to act prophylactically to try to alleviate some of the consequences.

Ensuring possession of an executed guarantee, where applicable, and having relationships with more than one swap dealer can absorb some of the economic and operational fallout of dealing with a swap counterparty in distress.

Additionally, actions such as analyzing your rights under the agreement vis-à-vis the distressed dealer and formulating a plan of action upon the first sign of distress can provide for a smoother closeout process and potentially larger recovery if trades need to be terminated.

[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 article, 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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