

Chapter 11: not the end of the story

With several major derivatives counterparties in or facing Chapter 11, an understanding of the legal ramifications of doing business with them is essential, say Mark Speiser and Sherri Venokur

It's Friday afternoon when a salesperson for 'Dealcom', a commodities dealer, receives a call from 'InSolvent', a chemical manufacturer and long-time client. InSolvent wants to enter into a series of plain vanilla hedging trades and to execute that day. The business would be very profitable for Dealcom, and there's even an International Swaps and Derivatives Association Master Agreement and credit support annexe in place between the parties. The salesperson tells InSolvent that, subject to agreement on pricing, Dealcom would like to do the transaction.

On the way to the trading desk, the salesperson sees the firm's in-house lawyer and tells her the good news. She asks: "Didn't InSolvent recently file under Chapter 11?" "Yes," says the salesperson, "but InSolvent sought Chapter 11 protection because of potential environmental liabilities. Its core business is sound." The salesperson is about to leave when the lawyer asks: "When does InSolvent want to trade?" When he answers "today", she says: "We need to go over a few things first."

The lawyer says it is fine for Dealcom to enter into an otherwise attractive derivatives transaction with InSolvent but, because it is now a Chapter 11 debtor, some additional steps must be taken first. An hour later, the salesperson emerges much the wiser, and eternally grateful for her sage advice...

A lawyer's fantasy? Perhaps. But in reality this is a tricky corner of bankruptcy law with plenty of traps for the unwary. Many problems stem from misconceptions about the applicability of certain provisions of the US Bankruptcy Code ('the Code') to 'post-petition' derivatives transactions. These provisions grant certain termination, liquidation and set-off rights to a non-debtor when its counterparty files a bankruptcy petition, but do not apply to transactions entered into 'post-petition' with a 'Chapter 11 debtor' such as a debtor-in-possession or a trustee in bankruptcy. Although these provisions, including Section 560 (for swap agree-



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ments) and Section 556 (for commodity and forward contracts), would permit Dealcom to terminate certain pre-petition derivatives transactions, there is considerable doubt that they would permit it to terminate post-petition transactions.

A superficially appealing solution derives from Section 363(c) of the Code. This permits a Chapter 11 debtor such as InSolvent to enter into – and a counterparty such as Dealcom to receive payments in connection with – transactions that are in the 'ordinary course' of its business, without the need for a court order. This means that, if the hedging transactions are within the ordinary course of InSolvent's business, Dealcom would not need to obtain a court order authorising the transactions, and all amounts owed to Dealcom under the transactions would be payable to Dealcom as expenses of the administration of the bankruptcy estate.

Falling short

Unfortunately, this 'solution' falls short in two important respects. First, the definition of 'in the ordinary course of business' is often the subject of dispute – even when there is a pre-petition course of dealing. If the transactions were held not to be 'in the ordinary course' of InSolvent's business, then the amounts owed to Dealcom would not qualify as administrative expenses and would not be paid.

Second, the Section 363(c) 'solution' doesn't extend beyond payment of amounts due as 'administrative expenses'. The exercise of contractual provisions such as termination, liquidation and set-off rights are subject to the automatic stay

provisions of Section 362(a)(3) of the Code. The requirement to post margin is subject to Section 364 of the Code. Section 364(a) authorises a Chapter 11 debtor to obtain unsecured credit and incur unsecured debt in the ordinary course of its business. Under Sections 364(c) and (d), Dealcom would need a court order to obtain secured credit. Consequently, even though the Isda Master Agreement between Dealcom and InSolvent includes a credit support annexe providing for the delivery of margin, Dealcom would not be able to obtain margin from InSolvent without a court order.

Similarly, if InSolvent defaulted under the agreement by, for example, failing to make a required payment under a transaction, Dealcom would be stayed by Section 362(a)(3) from exercising its contractual termination, liquidation and set-off rights against InSolvent. Unless and until Dealcom obtained a court order lifting the Section 362(a)(3) automatic stay, it would be vulnerable to market moves that could increase its exposure to InSolvent and leave it undersecured.

Dealcom would be well advised to seek a court order authorising the post-petition transactions and prospectively lifting the automatic stay to allow Dealcom to terminate the transaction. But not every order will do. Under the decision in *In re Carroll*, 903 F.2d 1266, 1270-72 (9th Cir. 1990), Dealcom would not be able to enforce specific contractual provisions, such as those for events of default, termination and set-off rights, and requirements to post margin, unless it attaches them to its motion, or sets them forth with specificity, and the court order expressly authorises those provisions.

Fortunately for Dealcom, forewarned is forearmed. Before entering into the post-petition transactions with InSolvent, it obtained an order from the bankruptcy court expressly authorising the transactions and each of the specific contractual provisions of importance to Dealcom. A lawyer's dream. ■

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¹ In a Chapter 11 case, the goal is reorganisation and rehabilitation of the business, rather than liquidation, and the debtor is presumptively left in possession of its assets and continues to manage its affairs throughout the case. Every rule has its exceptions, of course, and there are liquidating Chapter 11 cases, as well as Chapter 11 cases in which management is replaced by a court-appointed trustee