

# update



Second in a Series of Updates Regarding the New Bankruptcy Law

## Utility and Financial Contract Provisions Enacted By the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

In this second in a series of updates on the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act"), we will discuss the principal changes affecting utility companies, their unregulated futures and forward contract trading units and other parties trading in financial contracts, including firms trading in the securities, futures and forward contract markets. Unless otherwise noted, the amendments noted take effect on October 17, 2005.

### Provisions Regarding Utility Companies

#### ***Current Situation.***

The Act substantially improves the position of a utility confronting the bankruptcy of a customer by amending § 366 of the Bankruptcy Code. Currently, the practice in large chapter 11 cases includes the entry of an *ex parte* "first day" order that requires utilities to continue serving the debtor and creates a procedure which imposes on the utility the burden of proving that payment of its invoices for postpetition service *is not* adequately assured merely by the promise of an administrative claim. It is often difficult for these utilities to convince the bankruptcy court that they are entitled to a deposit or other form of adequate assurance beyond the mere promise of an administrative claim, especially if the debtor had little or no prepetition deposit posted with the utility. Thus, while other suppliers can demand COD payment for postpetition goods or services, bankruptcy courts frequently order continued utility service based on the promise of an administrative claim alone (sometimes augmented by projected loan or cash collateral availability, "good payment history" or a prepetition deposit). Lengthy notice, billing and disconnect procedures under state law or utility tariffs can allow a large receivable to build while the utility watches the debtor's financial condition decline to administrative insolvency, resulting in an unpaid *postpetition* claim in addition to the utility's *prepetition* claim.

#### ***Limitation on Acceptable Forms of Adequate Assurance.***

The Act solves these problems by enumerating acceptable forms of adequate assurance in new § 366(c)(1) to those commonly accepted by utilities outside of bankruptcy: (i) a cash deposit; (ii) a letter of credit; (iii) a certificate of deposit; (iv) a surety bond; (v) a prepayment for utility consumption; or (vi) another form of security that is mutually agreed on between the utility and the debtor or the trustee. Although subsection (vi) is an open-ended "catch all," the requirement that an alternate form of security be "mutually agreed on between the utility and the debtor or the trustee" prevents the imposition of a disagreeable alternative on the utility. These limitations greatly enhance the negotiating position of the utility and appropriately place the burden of establishing adequate assurance on the debtor.

#### ***Longer Negotiating Period in Chapter 11.***

The Act permits a utility company to alter, refuse, or discontinue service in a Chapter 11 case if the debtor fails to provide adequate assurance of payment satisfactory to the utility within 30 days after the petition date. The deadline remains 20 days in other cases, such as Chapter 7 liquidations. The Act bolsters the utility's power to refuse to accept adequate assurance which the utility deems unacceptable by adding language requiring that the adequate assurance proposed by the debtor be "satisfactory to the utility." As under the current version of § 366, no motion to modify the stay is required to disconnect service; however, utilities sometimes seek such approval to avoid challenges based on the prohibitive terms of the "first day" utility order.

### ***Limited Judicial Discretion in Resetting the Amount of Assurance.***

Section 366(c)(3)(A) permits the court, upon request of a party in interest and after notice and a hearing, to modify the amount of an adequate assurance payment. Debtors may invoke this provision when confronted with a demand for a deposit based on state law or a utility tariff for several months' average cost of service. For example, debtors sometimes agree to waive or shorten state law or tariff-based disconnection notice in exchange for a reduced deposit. In court and in negotiations with the debtor, utilities benefit from the fact that, while the court may adjust the amount, it may not impose a different form of adequate assurance not listed. Most importantly, this section benefits utilities by overruling current practice and prohibiting the court from considering several factors commonly cited as a justification for excusing a deposit or other form of adequate assurance: (i) the absence of security prior to the bankruptcy filing; (ii) the debtor's timely payment for utility service prior to the bankruptcy filing; or (iii) the availability of an administrative expense claim.

### ***No Court Order Needed To Set Off Prepetition Deposit.***

Finally, the Act eliminates the need for utilities to file a motion to modify the automatic stay in order to apply a prepetition security deposit against unpaid prepetition utility charges. Not only does this allow prompt recovery, it blocks the debtor's argument that the deposit should be held as security for postpetition, as well as prepetition, service.

## **Provisions Regarding Parties to Financial Contracts**

### ***Current Law.***

The Act substantially broadens the express protection from interference by bankruptcy cases and receiverships with the rights of parties under various types of financial contracts. Congress decided to protect securities, commodities and forward contract markets due to panic and a chain reaction from the failure of a large participant. Thus, special provisions override the generally applicable automatic stay, avoidance and executory contract provisions of the Bankruptcy Code that promote liquidity and equality of distribution among creditors for a failed firm and create causes of action to increase the size of the bankruptcy estate.

Under current law, parties to forward contracts, commodities contracts, domestic and foreign futures contracts, leverage transactions, swap agreements, repurchase agreements, and securities contracts, such as options, margin and similar guarantees to clearing agencies, already enjoy some protection from the automatic stay provisions of the Bankruptcy Code with respect to the liquidation of futures, forwards and options and from the avoidance, as preferences or constructively fraudulent transfers, of margin and settlement payments. See 11 U.S.C. §§ 362, 546(e), 546(f), 546(g), 546(h), 555, 556, 559, 560; *Williams v. Morgan Stanley Capital Group, Inc. (In re Olympic Natural Gas Co.)*, 294 F.3d 737, 742 (5th Cir. 2002). Parties also receive protection from the nullification of *ipso facto* clauses frequently used to trigger liquidation of such contracts. In recognition of the vast expansion in the type and volume of transactions, the Act expands the classes of protected contracts and expressly protects from bankruptcy interference common actions that serve as precursors to the actual liquidation of the debtor's positions. These changes will greatly enhance the ability of participants in the financial and commodities markets to protect themselves from a counterparty's bankruptcy.

### ***Expansion of Types of Protected Financial Contracts.***

The Act amends the definition of "repurchase agreement" to include agreements providing for the transfer of mortgage-related securities, mortgage loans, and interests in such securities or loans. A similar amendment to the definition of "securities contract" results in the inclusion of mortgage loan transactions. The definition of "swap agreement" is also expanded to include newer types of financial products and to set forth criteria under which future products may be included within this definition. These types of transactions will now be exempt from the automatic stay and protected from avoidance.

In addition, to accommodate the financial efficiency of cross-product netting between parties, the Act adds "master netting agreement" to the list of safe harbor contracts. A "master netting agreement" is

defined as "an agreement providing for the exercise of rights, including rights of netting, setoff, liquidation, termination, acceleration, or close out, under or in connection with one or more [safe harbor contracts], or any [related] security arrangement or other credit enhancement..." New § 546(j) protects from avoidance prepetition transfers made pursuant to a master netting agreement, unless the transfer is intended to delay, hinder or defraud creditors. In addition, new § 561 expressly permits the termination, liquidation, acceleration or offset of amounts due under a master netting agreement or across different categories of safe harbor contracts. Under the current Bankruptcy Code, netting is only permitted within each product category rather than across categories. Such cross-category netting of products covered by a master netting agreement is only permitted, however, to the extent that a particular category is already covered by a safe harbor provision. In other words, new § 561 cannot elevate the status of a contract that is not otherwise entitled to safe harbor protection.

***Expansion of Protected Parties.***

The definitions of "financial institution" and "forward contract merchant" also are broadened. The definition of financial institution now will include federally-insured credit unions. A federal reserve bank qualifies under the new definition of "forward contract merchant." In addition, a new definition of "financial participant" is added to afford the protections of the various safe harbor provisions to an entity with one or more agreements or transactions of the type described in § 561(a) of a total gross principal value of at least \$1,000,000,000 on any day during the previous 15-month period or with gross mark-to-market positions of at least \$100,000,000 in one or more such agreements or transactions on any day during the previous 15-month period. These provisions protect a company with large hedging positions, even though its principal business is not trading futures or forward contracts.

***Clarifies Post-Bankruptcy Liquidation Actions.***

The Act expands the current protection of the right to liquidate open positions to other customary liquidation activity in the event of a default based on a bankruptcy filing. While "liquidation" should be construed to include a non-bankrupt party's actions to terminate, accelerate or offset open positions, the Act avoids any ambiguities. It also applies such protection to the newly expanded classes of protected financial agreements.

***Measure of Damages from Rejection or Liquidation.***

New § 562 specifies the means of calculating damages resulting from the liquidation of financial contracts by the non-bankrupt party or the rejection of financial contracts, including master netting agreements, which are "burdensome" to the debtor because the non-bankrupt party is "in the money." Damages will be measured as of the earlier of (i) the date of rejection or (ii) the date or dates of liquidation, termination, or acceleration. If there does not exist any commercially reasonable manner to determine value as of either of these dates, then damages shall be calculated on the earliest subsequent date on which value can be determined in a commercially reasonable manner. In the case of an objection to valuation by the non-debtor participant, the debtor or trustee bears the burden of proof. Any claim under § 562 is considered to be a prepetition claim, similar to other contract rejection claims.

***Corollary Changes to Federal Deposit Insurance Act and Federal Credit Union Act.***

The Act provides needed consistent treatment for financial contracts with insolvent counterparties that cannot be debtors under the Bankruptcy Code. It amends § 11(e)(8)(D) of the Federal Deposit Insurance Act (the "FDIA") and § 207(c)(8)(D) of the Federal Credit Union Act (the "FCUA") to establish broad definitions of "securities contract," "commodity contract," "forward contract," "repurchase agreement," and "swap agreement." These definitions are modernized and brought in line with the definitions contained in the Bankruptcy Code. For example, "securities contracts" in § 1821(e)(8)(D)(ii) of the FDIA is defined to include contracts for the purchase, sale or loan of a security (or indices thereof), certificates of deposit, mortgage loan (or interest thereon), options on the foregoing, combinations of the foregoing or any margin, guaranty, reimbursement agreement or security agreement related to the foregoing. A similarly broad scope protecting documents ancillary to the central futures, forward, swap or repurchase transaction applies in the other definitions. The FDIA and

FCUA are similarly amended to include a definition of "transfer" that closely resembles the definition contained in § 101(54) of the Bankruptcy Code.

## Conclusion

Utility companies, unregulated affiliates and other parties to financial contracts will benefit from the significantly broadened protections afforded by the Act. Please do not hesitate to contact any member of Schiff Hardin's Bankruptcy and Creditors' Rights Practice Group listed below if you have questions about the application of these provisions to your company or you would like a copy of our first update on the impact of the Act on landlords and creditors generally.

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## Schiff Hardin Bankruptcy, Workouts and Creditors' Rights Practice Group

Schiff Hardin's Bankruptcy, Workouts and Creditors' Rights Practice Group represents clients on all sides of corporate reorganizations, restructurings, workouts, liquidations, foreclosures, and bankruptcies. This includes debtors, secured and unsecured lenders, major trade creditors, lessors, and committees of unsecured creditors and equity holders.

Our trial lawyers have successfully litigated lender liability, fraud, fraudulent transfer, and preference cases in all levels of the federal and state judicial systems. We represent clients who initially hire us for bankruptcy matters, as well as regular firm clients who are landlords or institutional lenders, in secured and unsecured financing, real estate lending, floor plan financing, venture capital lending, and leveraged buyout financing.

We hope that you found the information in this alert helpful. This is the second in a series of alerts that we plan to issue about this important legislation and is the start of more regular communication from the group to our clients and friends of the firm. You can access the first part of this series by [clicking here](#).

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