July 2, 2015

District Court Holds Swap Claim Assignee Not A Swap Participant Entitled To Safe Harbor Rights

Overview

The District Court for the Central District of California recently held that an assignee that acquired rights to a terminated swap agreement was not a "swap participant" under the Bankruptcy Code and, therefore, could not invoke safe harbors based on that status to foreclose on collateral in the face of the automatic stay.[1] The court ruled that the assignee acquired only a right to collect payment under the swap agreement, not the assignor's rights under the Bankruptcy Code to exercise remedies without first seeking court approval.

Background

In April 2006, Sliaukat and Mahmooda Chohan (the "Debtors") entered into an interest rate swap agreement (the "Swap Agreement"), documented by an ISDA Master Agreement (the "Master Agreement", and together with the Swap Agreement, the "ISDA"), with U.S. Bank, N.A. (the "Bank"). The parties also entered into a cross-collateralization agreement that secured the Debtors' obligations under the swap agreement with collateral the Debtors' pledged to the Bank for separate loan transactions. In June 2012, the Bank notified the Debtors that (i) an event of default had occurred under the ISDA, (ii) it was exercising its right pursuant to the ISDA to early terminate all transactions thereunder, and (iii) accordingly, the Debtors owed the Bank an "Early Termination Amount" of $527,385. Rather than exercise its rights as a secured party, the Bank added the Early Termination Amount to the outstanding balance of the Debtors' loans.

Six months later, the Bank assigned to A62 Equities, LLC ("A62") its interests in the loan and security agreements, including its rights under the ISDA and cross-collateralization agreement. Although the Master Agreement contains a general anti-assignment clause (generally prohibiting assignment absent the counterparty's prior written consent), it permits each non-defaulting party to assign all or part of its interest in any amount payable to it by a defaulting party upon early termination of all transactions following an event of default without the need to obtain prior consent. This standard provision was not modified by the parties to the ISDA, and the Bank never sought or obtained the Debtors' consent.

[1] *A62 Equities LLC* v. *Chohan (In re Chohan),* No. 8:14-CV- 01192, 2015 WL 3541824 (C.D. Cal. May 28, 2015).

Over a year after the Bank assigned its interests to A62, the Debtors filed for bankruptcy, following which A62 informed the Debtors that A62 intended to conduct a foreclosure sale of the Debtors' assets to reduce the Debtors' obligations under the ISDA. The Debtors filed an emergency motion to stay the sale, arguing that it would violate the automatic stay. A62 maintained that it was exercising rights in connection with a "swap agreement" (as defined in the Bankruptcy Code) and, thus, the sale was protected by the section 362(b)(17) and section 560 "safe harbor" provisions of the Bankruptcy Code, which broadly exempt from the automatic stay a "swap participant's" (as defined in the Bankruptcy Code) exercise of any contractual rights to terminate, liquidate or accelerate a swap agreement.

The bankruptcy court held that having failed to obtain the Debtors' consent to the assignment, A62 acquired only the Bank's right to payment under the ISDA, not an interest in the ISDA itself. As a result, A62 was not a "swap participant" under the Bankruptcy Code – "an entity that, at any time before the filing of the petition, has an outstanding swap agreement with the debtor" – and thus, was not entitled to the protections of sections 362(b)(17) and 560. A62 appealed to the district court.

Analysis

The district court affirmed, noting that it appeared to be the first court in the country to analyze whether safe harbor protections extend to assignees of terminated swap agreements, and anticipating that its decision would be controversial.

The district court first considered whether A62 became a swap participant by virtue of the Bank's broad assignment of its rights under the ISDA. The court recognized that if the Bank had not assigned its rights under the ISDA to A62, it would have "arguably" been a "swap participant" exempt from the automatic stay. The district court concluded, however, that the rights A62 obtained under the assignment were more limited. It reasoned that post-termination, the parties' only surviving rights and obligations under the Swap Agreement related to making and collecting payments, and that the only right that the Bank could assign A62 at that point was the Bank's right to collect the Early Termination Amount. Additionally, the district court noted that the ISDA's anti-assignment provision in any event would have barred a broader assignment without the Debtors' consent. Accordingly, the district court agreed that the Bank did not assign A62 "an interest in a swap agreement," but only a right to payment thereunder.[2]

The district court next considered whether the status of "swap participant" could be assigned (and whether the Bank did so as part of its assignment of its rights to payment). The court held that even if the Bank was a "swap participant" that had the right to institute the foreclosure sale notwithstanding the automatic stay, it could not assign its status as a swap participant under sections 362(b)(17) and 560.

---

[2] Despite the emphasis on the nature of the rights the Bank assigned to A62, neither the bankruptcy court nor the district court reviewed the actual assignment documents, which were never made part of the record. *Id.* at *5.

The district court noted that the Bankruptcy Code's definition of a "swap participant" is unclear and does not address whether an entity may become a swap participant via assignment. Accordingly, the district court turned to the statute's legislative history for guidance. It concluded that Congress was principally concerned with protecting swap participants from continued exposure to market volatility when a counterparty to a swap agreement declared bankruptcy, as well as avoiding the risk that the debtor could cherry-pick self-serving transactions while rejecting others under a single master agreement. The district court maintained that Congress gave swap participants the right to terminate, accelerate and liquidate swap agreements (as well as the right to offset or net out termination values and other payment amounts arising under the swap agreement) notwithstanding the automatic stay to safeguard against these risks. The district court found that the concerns animating the enactment of sections 362(b)(17) and 560 were not present in circumstances where a swap agreement was terminated prepetition and termination damages were calculated. According to the district court, any assignee of the right to collect termination damages could assess for itself whether to accept the debtor's credit risk and thus does not need the protections of the swap safe harbors. The primary risk for such an assignee consists of the recovery risk of a sum certain against a bankrupt counterparty.

Finally, the district court noted that ruling in A62's favor would create a substantial risk of arbitrage – i.e., permitting claim purchasers to accumulate "super-priority" claims by purchasing terminated swap claims. The district court found that facilitating such a market would not serve Congress' objectives in "protecting the innovat[ive] use of swap agreements to hedge against interest rate risk." The district court, in this context, did not address section 553(a)(2), which provides limited protections to an acquirer of swap and other safe harbored claims that are otherwise protected by sections 362(b)(17) and 560 who seeks to offset such claims against any obligations owed to the debtor.

Conclusion

The district court's decision in *A62 Equities* raises serious questions about an assignee's ability to invoke the safe harbors in bankruptcy in connection with swap and other qualified financial contracts. It remains to be seen whether courts in other jurisdictions will follow *A62 Equities*, but for the time being, *A62 Equities* stands for the proposition that the assignment itself of the right to collect an early termination amount under a swap agreement does not convey the swap safe harbor protections under the Bankruptcy Code to the assignee of such right should the defaulting party subsequently file for bankruptcy protection.

* * *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Kelley A. Cornish
212-373-3493
kcornish@paulweiss.com

Alice Belisle Eaton
212-373-3125
aeaton@paulweiss.com

Brian S. Hermann
212-373-3545
bhermann@paulweiss.com

Alan W. Kornberg
212-373-3209
akornberg@paulweiss.com

Elizabeth R. McColm
212-373-3524
emccolm@paulweiss.com

Andrew N. Rosenberg
212-373-3158
arosenberg@paulweiss.com

Jeffrey D. Saferstein
212-373-3347
jsaferstein@paulweiss.com

Stephen J. Shimshak
212-373-3133
sshimshak@paulweiss.com

Manuel S. Frey
212-373-3127
mfrey@paulweiss.com

Erica G. Weinberger, Kyle J. Kimpler and Jaime A. Madell contributed to this client alert.