Wounded Knight Raises Questions About Bankruptcy Risks

The ongoing financial peril of Knight Capital provides an opportunity to reflect on steps investors should consider whenever a financial intermediary or counterparty encounters financial difficulties. The issues clients face in such a case depend very much on the facts: for example, some intermediaries are execution-only brokers, some are prime brokers, others are derivatives counterparties. But we have found that there are a number of steps clients might take that can be effective in many if not all of these fact patterns. Here is a brief, representative list of steps you might want to consider when confronted by an intermediary in financial distress.

- *Who am I doing business with?* – Almost all large financial intermediaries have myriad affiliates, and you may well have exposure to many of them. The nature and number of those affiliates can have a substantial effect on your credit exposure. You should take the time to know the various affiliates you are dealing with, the lines of business you have with them, and how much. Bankruptcy and insolvency regimes in the US and foreign jurisdictions differ greatly, and you should keep in mind that the steps you may need to take, and your ultimate legal and financial position, can depend very much on the jurisdiction where you are required to bring your claim.
- *Where are the documents?* – Take the time to find and catalog all of the deal documents you have in place with the intermediary and its affiliates.
- *How do I contact the intermediary?* – Review the documentation carefully to determine where you need to send close-out or default notices, or other communications you might need to send quickly in the coming days or hours.
- *Think hard before sending money* – When an intermediary begins to teeter, this is not business as usual. You will obviously need to think hard about how to meet your contractual obligations to the intermediary, but you need to consider carefully the credit implications of sending/wiring any money or securities to the intermediary – including by way of mark-to-market collateral. And you will want to make certain you send/wire the money or securities to the right entity – because once the intermediary goes into bankruptcy, it can be difficult, if not impossible, to get back money or securities sent in error to the wrong affiliate.
- *DvP Settlement* – If you are required to settle a transaction with the intermediary, take all possible steps to effect settlement on a true delivery vs. payment ("DvP") basis. That means that you don't release money or securities to the intermediary until you know that you will receive securities or money in return. This is more easily done in some contexts than others, and you will need to work closely with your clearing broker or custodian, but a true "DvP" payment or delivery can reduce or eliminate much credit exposure. If possible, accelerate settlement periods to minimize the length of time you take settlement credit risk.
- *Overcollateralization/free credit balances* – Take whatever steps you can to move away from the intermediary any assets that don't have to be there, including any assets serving to overcollateralize your obligations to the intermediary, or any free credit balances. You will very likely end up as a general unsecured creditor for those assets in a bankruptcy.
- *Offset* – Common law and contractual rights of netting and offset generally work even after a bankruptcy filing. So you should take the time to determine the amount of your obligations to the financial intermediary and each of its affiliates (separately), and the offsetting obligations of the financial intermediary and each of its affiliates (separately) to you. If there is time, it may be possible to optimize your netting and offset position by transferring or assigning among your affiliates any rights or obligations to/from the financial intermediary and its affiliates, on the one hand, and you and your affiliates, on the other. (If you are an investment manager acting for managed accounts, your ability to move rights or obligations among accounts will, however, likely be limited.)

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- *Close-out may not be the best option* – You will want to think hard about whether closing out a transaction before the financial institution goes into bankruptcy proceedings is the best course. For example, if you close out a futures contract immediately before a bankruptcy, you may be an unsecured creditor for cash in the intermediary's proceeding; it might be worth taking the chance of leaving the contract open in the expectation that it will be assigned to another FCM with your collateral account. These determinations can obviously be highly subjective, and may involve choosing what is perceived to be the least of various evils.
- *Hedges* – Keep in mind that the insolvency of an intermediary with which you have a hedge on will effectively undermine the hedge and it may not be possible, or it may be prohibitively expensive, to replace the hedge. It is never too early to think about alternative hedging strategies.

All of these steps can be challenging and involve a detailed assessment of credit and legal risk, and you would be well advised to take financial and legal advice. We would, of course, be happy to assist you with any pre-insolvency planning so that you may optimize your position.

In the event you are confronted with a financial intermediary that has entered into U.S. bankruptcy proceedings, there are the basic distinctions that may apply when the distressed entity is a broker-dealer or clearing house:

Limitations on the Automatic Stay

The automatic stay triggered by a bankruptcy filing typically imposes various restrictions on actions that may be taken by a non-debtor regarding a debtor. Absent court-approved relief from the stay, lawsuits may not be commenced or continued, and contract counterparties are precluded from exercising various contract rights against a debtor, including the right to terminate a defaulted contract. These restrictions are frequently extremely burdensome on non-debtors. For example, when a contract does not mature for many years, the debtor may essentially be afforded the opportunity to cease making payments pending its decision whether to assume or reject the contract, while the counterparty is required to honor its contractual obligations. In appreciation of the burdens this inequality of power imposes on certain types of contract counterparties, the Bankruptcy Code exempts certain contractual relationships from these rules. These exceptions are referenced as "safe harbor" provisions.

In particular, exempted from the automatic stay are certain entities that have specific categories of financial contracts with a debtor: these safe harbor exemptions apply to "commodity contracts," "forward contracts," "securities contracts," "repurchase agreements," "swap agreements," and "master netting agreements." These, so-called, "safe harbor contracts" are not subject to the automatic stay, and as such, a party's contractual right "to cause the liquidation, termination, or acceleration of or to offset or net termination values, payment amounts, or other transfer obligations arising under or in connection with" a safe harbor contract "shall not be stayed, avoided, or otherwise limited by operation" of any other provision of the Bankruptcy Code. Moreover, swap counterparties are explicitly not precluded from exercising "any contractual right . . . to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with one or more such agreements." The benefit of these protections is clear: a counterparty is entitled to exercise its contractual right to close out its contract, calculate damages, and eliminate continuing exposure to the debtor under the contract.

Beneficiaries of these safe harbor provisions must satisfy two requirements. First, the applicable financial contract must fall within the Bankruptcy Code definitions of "commodity contracts," "forward contracts," "securities contracts," "repurchase agreements," "swap agreements," and "master netting agreements." Second, after determining that the financial contract is protected, the particular counterparty must qualify as one of the eligible types of parties; namely, a "financial institution," "financial participant," or "swap participant."

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As is often the case regarding complex legal rules, when considering whether a particular contract or particular party is eligible for the safe harbor protections, the defined terms do not exactly match their plain meaning. Careful review is, thus, necessary to confirm a party's eligibility to benefit from the safe harbor provisions. This caution is particularly compelled by the fact that violations of the automatic stay by a counterparty ineligible for safe harbor benefits may subject such counterparty to severe sanctions.

Claims Process

Particularly for parties eligible to take advantage of the safe harbor provisions, it is critical to be familiar with the steps necessary to exercise these rights. Such forethought mitigates the burden and risk of the claims process, and reduces the likelihood of subsequent disputes with the debtor.

For example, counterparties in recent bankruptcy cases discovered that they would have benefitted from understanding all the contractual provisions that govern termination before exercising their rights, including when calculating any close-out amounts, such as soliciting market quotations to value a terminated swap agreement. Each action taken and correspondence made should be well documented in anticipation of possible disputes with the debtor that may actually take place years later during the claims process.

Customer Status in a Broker-Dealer or FCM Bankruptcy:

Rights of a bankrupt's claimants, including their priority in any distributions from the bankruptcy estate, are governed by a series of rules, including both their contractual rights and rights granted by law. A unique and significant distinction between types of claimants is particularly applicable in the event of a bankruptcy filing by a broker-dealer or futures commission merchant. Certain claimants of these types of bankrupts may not be considered merely a creditor, but rather be categorized as having "customer" status. This "customer" status entitles the claimant to possible distribution priority, and applies to a party which had entrusted its securities, cash, or commodities positions to be held by the debtor. Since customers are entitled to the return of their securities, or some measure of their equivalent, ahead of the bankrupt's general creditors, members of the "customer" class generally receive a higher rate of recovery than general unsecured creditors. Whether a counterparty qualifies as a "customer" depends not only on contractual language, but also on nuances of the actual relationship with the bankrupt and the nature of their transactions. Disputes occasionally arise regarding a party's entitlement to "customer" status. Creditors asserting "customer" status are usually required to submit to the debtor customer claim and account details very soon after a bankruptcy filing. It is, therefore, prudent to review the nature of your relationship with the potential broker-dealer or FCM debtor in anticipation of its bankruptcy filing.

Exchange Traded Funds

Knight Capital currently serves as an authorized participant of certain ETFs, in some cases, the lead market maker. Although ETFs are unlikely to have significant credit exposure to their authorized participants, they may wish to enter into authorized participant agreements with other firms in order to reduce the possibility that a bankruptcy of existing authorized participants might disrupt trading in the ETFs' shares.

Looking Ahead

Recent examples of financial distress among market participants serve as a reminder that it is best to be prepared for such circumstances. All of the issues discussed in this alert should be considered when clients are entering into or renegotiating agreements with financial intermediaries and counterparties. We would be happy to assist you with a review of your existing agreements with such parties and with an analysis of ways to strengthen your existing practices and procedures in connection with your entry into new relationships.

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