Financial Statements

By C. Scott Pryor

A Fable of Financial Contracts: A Guide for the Perplexed

Editor’s Note: For another article on forward contracts, read On the Edge on page 28.

Flush from the profits of his bumper 2010 cotton harvest, Farmer Rex, principal shareholder of Farmer Rex Inc. (FRI), decided to hedge against the risk of falling prices in 2011. Early in February, he contacted Sussex Cotton Gin and agreed to sell 500,000 pounds from his unplanted 2011 cotton crop for 80¢ per pound for delivery in October.

Even though it was an ordinary bilateral agreement, this contract was also a financial contract, a “forward contract” in particular. Sussex paid FRI up front for his yet-to-be-grown cotton, which created a prepaid forward contract. Prepayment turned out to be a boon to FRI in this case because the price of cotton fell over the course of 2011. FRI also entered into a second forward contract with Sussex that was not prepaid. The agreed-upon price was a bit higher than the prepaid forward contract because Sussex kept the purchase price for the growing season.

Of course, Farmer Rex ran several risks when FRI entered into these forward contracts: What if his crop suffers from a boll weevil infestation or a sustained drought and FRI cannot deliver? What if FRI delivers under the second contract and Sussex does not pay? Sussex also runs risks: What if cotton prices fall dramatically and it is bound to “overpay” FRI for the cotton? What if cotton prices unexpectedly rise and FRI sells on the open market and breaches its contracts with Sussex? Each party has the standard legal remedies provided by Article 2 of the Uniform Commercial Code (UCC), but anyone who has litigated a sales case knows that it can be brutish, nasty and long.

Might FRI and Sussex Use Financial Contracts to Hedge These Risks?

How did Farmer Rex protect FRI against the risk that it might not be able to grow 500,000 pounds of cotton? FRI purchased an option to buy 100,000 pounds from JuliaDreyfus for 78¢ per pound, slightly less than Sussex had agreed to pay him. An option is another financial contract, and a derivative to boot. The value of an option derives from the value of the underlying contract. For example, FRI’s option to buy 100,000 pounds of cotton would be worth $4,000 if the market price of cotton on the option date was 82¢ per pound ($82,000 [market price] minus $78,000 [option price]).

Next, Farmer Rex hedged FRI’s risk of not getting paid by Sussex with a credit default swap (CDS) purchased from BJH Inc. In return for a payment, BJH promised to pay FRI whatever Sussex

3. 11 U.S.C. § 101(25) (2012). If Sussex had been a futures commission merchant, then this financial contract would have been a “commodity contract,” id. § 761(4), because it would have been traded on an exchange (hence, the category of “exchange-traded financial contracts). The contract between FRI and Sussex was between only them; thus, it was an over-the-counter (OTC) financial contract.

4. 11 U.C.C. 2-703 through 2-710 for FRI, and U.C.C. 2-711 through 2-716 for Sussex.
5. Not LouisDreyfus. Farmer Rex did not purchase an option for all 500,000 pounds of the cotton due to Sussex because he was confident that he could grow at least 400,000 pounds. He could, of course, have purchased an option to buy more pounds than he contracted to deliver to Sussex, but that would be speculation rather than hedging.
6. Why wouldn’t Farmer Rex simply bank on pocketing the difference between the option and his contract price (i.e., engage in arbitrage) and take the summer off? Because he expects to grow his cotton for less than the option price.
7. Peltz v. Welch, Carson, Anderson & Stowe II LP (In re Bridge Info. Sys. Inc.), 311 B.R. 781, 791 (Bankr. E.D. Mo. 2004) (“[T]he value of a call option is derivative of the value of the underlying stock.”). Farmer Rex could have purchased standard forms of crop insurance from an insurance company with mandated reserves to pay claims. Options and other derivatives often function as insurance, although there are no reserves to reduce the risk of nonpayment by the counterparty. Interestingly, option counterparties sometimes buy insurance to cover their risks, thus making them the economic equivalent of brokers. See, e.g., PXRE Corp. v. Terra Nova Ins. Co., 76 F.App’x 485, No. 02-3426, 2003 WL 22253054, at *485 (3d Cir. 2003).
(the “reference entity”) failed to pay for the cotton (failure to pay, along with actions such as bankruptcy, are examples of a “credit event”).

What about Sussex? How did it protect itself from the risk of nonperformance by FRI and the risk of a declining market price? Sussex also purchased an option to buy cotton. Sussex purchased its option through a “futures commission merchant” that does business on one of the federally regulated commodities exchanges. The counterparty to all exchange-traded derivatives is the exchange itself, which virtually eliminates the risk of nonperformance by the counterparty.

Sussex, in turn, contracted to sell cotton to an international buyer, a Korean firm that manufactures shirts and has a firm policy of accepting only Korean won. Sussex is concerned that the value of the won may fall relative to the dollar and hedges that risk by purchasing a currency swap from BJH. A currency swap is another derivative because its value derives from changes in the relative values of two currencies. For a purchase price, BJH agrees to pay Sussex any shortfall between today’s dollar-to-won exchange rate and the rate as of the sale date. In fact, Sussex is so convinced that the won will fall relative to the dollar that it buys another $1 million of currency swaps from BJH as a speculative investment. Conversely, BJH’s analysts believe that the dollar will fall, so it sells $10 billion of currency swaps to many investors. BJH collects millions for selling the currency swaps with the hope that it will not have to pay out a cent. Of course, if the won falls, BJH will be in a heap of trouble.

Sussex also has a large line of credit with a regional bank. Historically, the bank would have spread the risk of Sussex’s default by syndicating the loan among a number of participants. More recently, the bank (and its participants) “lay off” risk with credit default swaps with hedge funds of their own.

More Risk and More Hedges

In the above scenario, the bank entered into a CDS for its loan to the bank with a hedge fund named The Haag Fund. Unknown to the bank, Haag also entered into a total return equity swap (TRS) with BJH, economically “shorting” the stock of Sussex. In its TRS, Haag agreed to pay BJH an amount equivalent to any dividends that might be paid on Sussex’s stock plus any appreciation its market value. Haag agreed to make these payments on various “refixing dates” specified in the TRS. In return, BJH agreed to pay Haag amounts equal to interest on what it would have to cost to buy the stock of Sussex minus any depreciation in the market value of that stock. In short, Haag was betting that Sussex’s stock would go down while BJH was betting it would go up. Even though neither Haag nor BJH actually owned any of the stock of Sussex, their relative financial positions would rise or fall as if they did. Of course, because of its CDS with the bank, Haag has the potential to influence the direction Sussex’s stock will go.

Haag has sources of funding in addition to capital. One of them is a repurchase agreement (a “repo”) with BJH. In its repo, Haag agreed to buy a $10 million U.S. Treasury bill from BJH one year hence for $10.4 million. Simultaneously, however, Haag sold to BJH a $10 million T-bill for its face amount. The repo has all the appearance of a one-year $10 million loan at 4 percent interest. However, notwithstanding UCC Article 9, a repo is not treated as if it were a secured loan.

The sale of unsecured commercial paper is another source of working capital for several of our parties. FRI was not in a position to sell commercial paper but had borrowed money to pay the Mac brothers, the former owners of FRI. Farmer Rex had bought the Mac brothers’ stock in 2009 with a little cash of his own and the balance from a loan from a small local bank (an old-fashioned leveraged buyout). Although its cash flow remained positive until 2012, the debt

About the Resident Scholar

Prof. C. Scott Pryor will serve as the Robert M. Zinman ABI Resident Scholar for the spring 2013 semester. He teaches courses on bankruptcy law, contracts, international business transactions, international comparative law, sales law and secured transactions. Prof. Pryor has written and lectured extensively on bankruptcy, contract law and Article 9 of the Uniform Commercial Code. He will be based in ABI’s Alexandria, Va., office, assisting ABI with its educational programming and in its role as the authoritative source of bankruptcy information for Congress, the media and the public.

Prof. Pryor has been a professor at Regent University School of Law since 1998, and was a Fullbright Scholar to National Law School-Jodhpur (India) in 2009. Additionally, he was a visiting professor at Campbell University School of Law (Raleigh, N.C.) from 2010-11, and a visiting professor at Handong International Law School (Pohang, Korea) in 2006. Prior to joining the staff at Regent University, he was a shareholder at Howard, Solochek & Weber (Milwaukee) from 1983-95. Prof. Pryor received a B.A. from Dordt College in 1976, a J.D. from the University of Wisconsin in 1980 and an M.A. from The Reformed Theological Seminary in 1997.

18 U.C.C. § 9-109(a) (“Except as otherwise provided in subsections (c) and (d), this article applies to: (1) a transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract.”).
20 The Investment Company Act of 1940, 15 U.S.C. § 80a-2 (2012). (“Short-term paper” [or commercial paper] means any note, draft, bill of exchange or banker’s acceptance payable on demand or having a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof payable on demand or having a maturity likewise limited, and such other classes of securities, of a commercial rather than an investment character, as the Commission may designate by rules and regulations.”). Because of its small size, FRI is exempt from securities registration even though FRI’s commercial paper had a maturity of more than 270 days from date of issuance.
to the local bank, assumed liabilities from the buyout and new debt left FRI insolvent. Nevertheless, in 2012, Farmer Rex decided to have FRI prepay its debt to its local bank for what had been paid to the Mac brothers with the profits from FRI’s bumper 2010 cotton crop. Surprisingly, the Bankruptcy Code identifies such an expenditure as a “settlement payment,” another example of a financial contract.

Financial Contracts in Bankruptcy

Now our fable takes a darker turn. Assume that each of the leading figures files for bankruptcy. How does the Bankruptcy Code treat financial contracts like forward contracts, options, CDSs, currency swaps, total return equity swaps, repos, redemptions of commercial paper and settlement payments? In other words, how do §§ 362 (automatic stay), 365 (executory contracts), 547 (preferences) and 548 (fraudulent conveyances) apply to financial contracts?

In short, hardly at all. Forward contracts are unaffected by bankruptcy.22 The automatic statutory stay does not apply, and the nondebtor party may terminate the contract. *Ipso facto* clauses are fine if the nondebtor counterparty holds one of a large class of financial contracts.23 The same freedom for counterparties applies to commodity contracts.24 Swaps are also free from the strictures of the Bankruptcy Code,25 as are repos.26 Even redemptions of unsecured commercial paper within 90 days of bankruptcy generally cannot be avoided as preferences or attacked as fraudulent conveyances.27 Most surprisingly, even whether FRI’s prepayment of its debt to its local bank is protected from avoidance is a close question.28

How can it be that provisions fundamental to the underlying purpose of bankruptcy law—treating similarly situated creditors alike and maximizing collective recoveries for unsecured creditors—are irrelevant when it comes to certain contracts and select creditors? The story of how the “safe harbors” for financial contracts came to be is long. From humble beginnings with the original 1978 Bankruptcy Code to the most recent expansions with the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA),29 financial contracts have enjoyed an ever-growing immunity from the strictures of bankruptcy law. Over nearly 30 years, the scope of what counts as a financial contract has increased and the range of protected parties has expanded.30 Congress has become convinced that the liquidity of the financial system depends on freedom from the constraints of bankruptcy.31 While it is unlikely that financial contracts’ safe harbors will expand further, their current breadth makes knowing about their intersection with bankruptcy important to everyone.


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21 11 U.S.C. § 741(b) (2012) ("A preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment or any other similar payment commonly used in the securities trade.").

22 See id § 559.


24 See, e.g., In re MBS Mgmt. Serv. Inc., 432 B.R. 570, 577 (Bankr. E.D. La. 2010) (holding that “forward contracts include contracts for the sale or purchase of a commodity between an industry participant and forward contract merchant”); aff’d, In re MBS Mgmt. Serv. Inc., --- F.3d ---, No. 11-30553, 2012 WL 3125167, at *1 (5th Cir. 2012).


26 id. § 559.

27 Id. § 546(e). “Generally” is an important word when it comes to preferences and fraudulent conveyances, e.g., Grubert v. Mooney (In re MacMenamin’s Grill Ltd.), 450 B.R. 414 (Bankr. S.D.N.Y. 2011) (holding that “settlement payments” in connection with purchase of stock of “mom-and-pop” corporation were not protected from avoidance by Bankruptcy Code § 546(e)(1). But see Off. Comm. of Unsec’d Cred’s of Quebecor World (USA) Inc. v. Amer. United Life Ins. Co. (In re Quebecor World (USA) Inc.), 453 B.R. 201 (Bankr. S.D.N.Y. 2011) (holding that exemption of “settlement payments” from avoidance should be broadly applied).

28 See id.

