

Repeal the Safe Harbors

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It is often said that banks are not subject to the ordinary bankruptcy regime because bankruptcy is a negative cash flow event for banks.¹ While traditional companies that file bankruptcy gain the benefits associated with halting their debt payments, banks would experience a rapid departure of customers, reducing their cheapest source of funding. That is, there would be a run on the bank.

No doubt this is true for depository banks. But if a run on the bank is a bad thing, which undoubtedly it is, why would we want to expand the number of firms that are subjected to a run? That is what the immense expansion of the derivative safe harbor provisions did in 2005.²

Consider the case of AIG. By and large, AIG was a profitable insurance and leasing company. But its financial products division in London had decided to sell as many credit default swaps as it possibly could, without worrying too much about any sort of

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¹ See Stephanie Ben-Ishai, *Bank Bankruptcy in Canada: A Comparative Perspective*, 25 *Bank. & Fin. L. Rev.* 59, 64 (2009).

² As noted in the legislative history, these changes were “derived from recommendations issued by the President's Working Group on Financial Markets and revisions espoused by the financial industry.” H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 20, 44, 127-134 (2005). As explained in Part 1, the “safe harbors” are various provisions of the Bankruptcy Code that operate to exempt derivatives from the normal operation of the Bankruptcy Code. Throughout this paper I assume the reader is generally familiar with derivatives. For background on derivatives, see FRANKLIN ALLEN, RICHARD A. BREASLEY & STEWART C. MYERS, *CORPORATE FINANCE* 727 (8th ed. 2006); Frank Partnoy, *The Shifting Contours of Global Derivatives Regulation*, 22 *U. Pa. J. Int'l Econ. L.* 421, 424-28 (2001); and the sources cited, *infra* note 2.

risk management of those swaps.³ In essence, the financial products division became like a giant insurance company writing policies without any reserves to pay claims.

Once it became clear that the financial products division would have to have to pay out on those CDS contracts – many were written as “credit enhancements” on mortgage backed securities – AIG’s counterparties requested assurance that AIG would be able to meet its obligations. Specifically, as AIG’s credit rating fell, due in part to the increased risk of a large payout on the swaps, its counterparties had a contractual right to demand that AIG post cash or other assets as collateral to back up the swaps. This converted the previously unsecured claims on the swaps into secured claims.

It also became self-reinforcing – as AIG posted more collateral, it began to develop liquidity problems, which lead to the threat of further downgrades and collateral calls. There was no end in sight, save for the complete self-liquidation of AIG.⁴ In short, a run on AIG had commenced.⁵

For a normal firm in this kind of downward spiral, the obvious answer would have been a chapter 11 petition. The imposition of the automatic stay would have stopped the efforts to grab AIG’s assets, and it might have been possible to retrieve the posted collateral as a “preference.”⁶

AIG had no such option, especially after 2005.⁷ Because the contracts at issue were swap agreements, and subject to the “safe harbor” exceptions in the Bankruptcy Code, the

³ See Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 82 Am. Bankr. L.J. 77 (2008), for a fuller description of credit default swaps. See also Stephen J. Lubben, *Credit Derivatives and the Resolution Of Financial Distress*, in THE CREDIT DERIVATIVES HANDBOOK (Greg N. Gregoriou & Paul U. Ali eds., McGraw-Hill 2008).

⁴ By August 2008, AIG had posted \$16.5 billion in collateral on swaps.

⁵ Bear Sterns presents a similar story. Michael C. Macchiarola, *Beware Of Risk Everywhere: An Important Lesson From The Current Credit Crisis*, 5 Hastings Bus. L.J. 267, 301(2009).

⁶ 11 U.S.C. §§362, 547.

⁷ Cf. Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U.L. Rev. – (2009).

counterparties could have continued to take collateral and previously posted collateral was irretrievable.⁸

Moreover, as Lehman Brothers has shown, even if the debtor has a more balanced derivative portfolio – with a mix of derivatives that are valuable to the debtor and value to the debtor’s counterparties – the safe harbor provisions allow another kind of run on the bank. In particular, those parties who have collateralized swaps can terminate the swap, as in AIG, those parties who owe money to the debtor can find a countervailing swap and “net” the two out, and those parties who simply owe money to the debtor can attempt to withhold performance on the swap. All of which destroys going concern value in the debtor – either by taking assets out of the estate or stopping cashflows that would otherwise benefit the debtor.

Before the current crisis, it was often argued that the safe harbors were required to protect the financial system from the threat posed by the Bankruptcy Code.⁹ Since those putative benefits do not seem to have materialized, and the financial system has not been harmed by its involvement in Lehman’s domestic bankruptcy case, it is time to reexamine the need for the safe harbors. Indeed, because the existence of the safe harbors makes chapter 11 very nearly unworkable for financial companies like AIG and Lehman, I urge their complete repeal.¹⁰

⁸ See Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 Yale J. Reg. 91 (2005) (“The Code contains numerous provisions affording special treatment to financial derivatives contracts No other counterparty or creditor of the debtor has such freedom; to the contrary, the automatic stay prohibits them from undertaking any act that threatens the debtor’s assets.”).

⁹ *See, infra* part 1.

¹⁰ To be sure, chapter 11 in its traditional sense, was an unlikely option. But the firms might have benefited from a GM/Chrysler style reorganization, which would have allowed a quick separation of the good from the troublesome parts of the firms. *See, infra* part 4. It appears that such a plan was contemplated for AIG, but rejected by AIG’s management, before the Lehman bankruptcy case. *See* James B. Stewart, *Eight Days*, New Yorker, Sept. 21, 2009, at 58, 69 (“Flowers proposed that this firm and Allianz buy A.I.G. . . . They would acquire the assets of the subsidiaries, but would need to be insulated from the liabilities of the parent.”).

This is even truer with regard to non-financial debtors, who make up the vast bulk of chapter 11 debtors. In this context, the safe harbors have already been shown to be little more than windfall gifts to the financial industry and avenues for abuse.¹¹ Utility companies are arguing that their supply contracts are protected “forwards,” and routine corporate transactions are being recast to make them “bankruptcy proof.”

In the first part of the paper I provide a concise overview of the safe harbor provisions in the Bankruptcy Code. Part two introduces the reasons given in support of these provisions. In the third part of the paper I critique this reasoning and make the broader argument that derivatives should be treated like any other contract in bankruptcy, and thus the safe harbors should be repealed. And in the final part of the paper I suggest how chapter 11 could be modified, following the repeal of the safe harbors, to accommodate the bankruptcy of a financial firm.

Before commencing, it should be noted that in arguing for repeal of the safe harbors, I do not advocate pulling out sections of the Bankruptcy Code and leaving the Code otherwise the same. Derivative contracts are somewhat unique. The volatility, interconnectedness and sheer magnitude of the sums of money involved make financial firms unique. As part of the repeal that I suggest, the Code would have to adapt to these realities. For example, adequate protection becomes a crucial issue in this context, where the collateral in question may be subject to great volatility. As I discuss further in Part 4, it may be that derivative contracts should be permitted to retain pre-existing “mark to market” collateral arrangements despite the automatic stay. Other changes are also clearly in order.

Ultimately my argument is motivated by a belief that the automatic stay would reduce systemic risks in more cases than it would exacerbate it. Presently, the safe harbors encourage a rush to sell derivatives, and buy replacement derivatives, upon a firm’s financial distress. It seems manifestly implausible that this situation reduces systemic

¹¹ *Hutson v. E.I. du Pont de Nemours & Co. (In re Nat'l Gas Distribs., LLC)*, 556 F.3d 247 (4th Cir. 2009).

risk. If instead the automatic stay applied, the ripples of panic and market disruption that are currently generated would be at least moderated by the pause that a bankruptcy filing would bring, perhaps creating enough space for a distressed firm to transfer its business to a new, more stable owner. In short, systemic risk would be reduced.

1. The Safe Harbors

The term “safe harbors” is a kind of shorthand for a variety of provisions in the Bankruptcy Code that reflect the “well-established Congressional intent to protect the derivatives markets from the disruptive effect of bankruptcy proceedings.”¹² These provisions excuse several broad classes of derivative contracts from fundamental provisions of the Bankruptcy Code.¹³

For example, the Bankruptcy Code prohibits the termination of most contracts simply because the debtor has filed a bankruptcy petition.¹⁴ Not so with derivative contracts.¹⁵

¹² Brief And Memorandum Of Law Of Amicus Curiae In Support Of Various Derivatives Counterparties' Objections To The Debtors' Motion For Establishment Of The Deadline For Filing Proofs Of Claim, Approval Of The Form And Manner Of Notice Thereof And Approval Of The Proof Of Claim Form, In re Lehman Brothers Holdings, Inc., 08-13555 (JMP) (Bankr. S.D.N.Y. June 12, 2009).

¹³ In particular, “securities contracts,” “forward contracts,” “commodity contracts,” “repurchase agreements,” “swap agreements” and “master netting agreements.” 11 U.S.C. §§101, 741(7), 761(4). Some of the definitions are sufficiently broad that they may overlap with other definitions – compare, for example, the definitions of “forward contract” and “swap.” 11 U.S.C. § 101(53B) (definition of “swap agreement,” which includes several types of forward agreements).

¹⁴ 11 U.S.C. §365(e)(1); *see also* 11 U.S.C. §541(c).

¹⁵ To gain the protections of the safe harbor, one has to be among the protected classes. In re Mirant Corp., 310 B.R. 548 (Bankr. N.D. Tex. 2004). But the classes are defined with extreme breadth after 2005. For example, to be protected under “swap agreements” with the debtor, the counterparty must be a “swap participant” or a “financial participant.” “Swap participant” is defined in the Bankruptcy Code as an “entity” (which includes individuals as well as corporations) that at any time before the filing of the petition has an outstanding swap agreement with the debtor. That would seem to cover anyone who would want to assert the applicability of the safe harbors. *See* 11 U.S.C. §101.

Instead, the non-debtor party has an option to declare the bankruptcy filing an event that will terminate the derivative.¹⁶

Termination in and of itself might be of little use, since the debtor might still be unable to “settle up” on the contract. But the safe harbors also provide for exceptions from the automatic stay¹⁷ – the statutory injunction that normally stops creditors from undertaking any further efforts to collect on their debt, which then compels creditor participation in the collective process that is bankruptcy.¹⁸

If a derivative transaction has been collateralized – that is, the debtor’s ability to pay is backed up by other assets– the exemption from the automatic stay means that the non-debtor party to a derivative contract can take the collateral.¹⁹ This makes derivative counterparties entirely unlike other secured creditors, who have to get court permission to foreclose on their collateral.²⁰

The exemption from the automatic stay also facilitates the “setting off” of derivative contracts. For regular creditors, if they owe the debtor money and the debtor owes them money, these two mutual obligations create a kind of secured claim that, with court permission, can be netted against each other.²¹ Derivative counterparties do not have to get court permission to setoff in this way, and it appears that they may not even have to have a right to setoff before the bankruptcy case.²² That is, it appears that the 2005

¹⁶ 11 U.S.C. §§ 555, 559, 560, 561; *see also* Am. Home Mortg. Inv. Corp. v. Lehman Bros. (In re Am. Home Mortg. Holdings, Inc.), 388 B.R. 69, 78 (Bankr. D. Del. 2008).

¹⁷ 11 U.S.C. §§362(b)(17), (b)(27); *see also* 11 U.S.C. §§362(b)(6), (b)(7), (o).

¹⁸ 11 U.S.C. §362(a).

¹⁹ Assuming the collateral has not been “rehypothecated.” Rehypothecation means that the posted collateral is used as collateral in a new transaction by the party demanding collateral in the first transaction. For example, a counterparty could have collateral posted with Lehman, Lehman could have then used it to borrow for its own purposes, and then the collateral would not be held by Lehman at the time of its bankruptcy – rendering the right to collect the collateral despite the automatic stay worthless.

²⁰ *See* 11 U.S.C. §362(d).

²¹ §§362(a)(7), 553. *See* Citizens Bank of Md. v. Strumpf, 516 U.S. 16, 18 (1995).

²² 11 U.S.C. §553(a).

amendments were designed to allow derivative parties to concoct a setoff after the bankruptcy – although the drafting of the statutory provision in question leaves this subject to some debate.²³ Derivative counterparties can setoff any of the specified “safe harbor” contracts against each other, no matter when the contracts were entered into or what their subject matter.²⁴

Finally, derivatives are exempt from the avoidance provisions of the Bankruptcy Code.²⁵ In a typical bankruptcy case these provisions ensure creditor equality, but especially since 2005, creditor equality has been partially repealed. Normally if a creditor receives a payment on the eve of bankruptcy that allows that creditor to receive more than they would in the bankruptcy case, this “preference” must go back into the estate and the once favored creditor must be treated like everyone else.²⁶ Not so for derivatives; such a preference is not recoverable.²⁷

Similarly, under state law and the Bankruptcy Code, if the debtor sells its assets for insufficient value, that transaction may be undone as a constructive fraudulent transfer.²⁸ This principle holds even if the non-debtor party acted in good faith – getting too good of a deal is a problem if the seller files for bankruptcy shortly thereafter.²⁹ And if the debtor

²³ The way the exemption was drafted, it does not appear to apply to §553(b)(2)(A), which covers transfers after the petition date. Stephen J. Lubben, *Chapter 11 and Systemic Risk*, 82 Temp. L. Rev. –, n.63 (forthcoming 2009).

²⁴ 11 U.S.C. 560; *see also* 11 U.S.C. § 101(38B). In essence, the statute converts derivative counterparties’ setoff rights into recoupment rights, without the requirement that the underlying obligations arise out of the same transaction or occurrence. *Cf.* *Malinowski v. New York State Dep’t of Labor (In re Malinowski)*, 156 F.3d 131, 133 (2d Cir. 1998); *Wells Fargo Bank, N.A. v. Am. Home Mortg. Holdings, Inc. (In re Am. Home Mortg. Holdings, Inc.)*, 401 B.R. 653, 655-56 (D. Del. 2009).

²⁵ 11 U.S.C. §546.

²⁶ 11 U.S.C. §547.

²⁷ 11 U.S.C. §546(g), (j); *see also* 11 U.S.C. §560 (“the termination, liquidation, or acceleration of one or more swap agreements shall not be stayed, avoided, or otherwise limited by operation of any provision of this title”); *accord* 11 U.S.C. §§555, 556, 559, 561.

²⁸ 11 U.S.C. §548; *see also* Uniform Fraudulent Transfer Act (state level model law).

²⁹ 11 U.S.C. §548(a)(1)(B).

transfers its assets with the actual intent to harm creditors, that is an “actual” fraudulent transfer that is not only avoidable but also sometimes a criminal offense.³⁰

Derivatives cannot be the subject of a constructive fraudulent transfer action and the 2005 amendments also impeded the ability to bring an actual fraudulent transfer action, although this latter change may have been inadvertent.³¹

Taken collectively, these “safe harbors” give the non-debtor party to a derivative contract an option to terminate upon the debtor’s bankruptcy filing.³² There is no obligation to terminate.

Moreover, termination does not equal payment. For example, a party that terminates a swap that is “in the money” from that party’s perspective (i.e., the debtor owes the non-debtor party) will simply generate an unsecured claim absent an ability to seize collateral or offset the claim against some other liability to the debtor.³³ In short, the safe harbors are most likely to benefit large financial institutions, as these institutions are more likely to have either demanded pre-bankruptcy collateral, and have retained control over that collateral, or have a variety of derivative positions with a single debtor.

³⁰ 11 U.S.C. §548(a)(1)(A); Cal. Penal Code §531 (any person who is a party to a fraudulent conveyance made or contrived with intent to deceive and defraud others, or to defeat, hinder or delay creditors, is guilty of a misdemeanor punishment by imprisonment in a county jail not exceeding 6 months, or by fine not exceeding \$1,000, or by both).

³¹ 11 U.S.C. §§546(g), 546(j), 548(d)(2), 560, 561. Although §546 leaves open the ability to bring an actual fraudulent transfer action under §548, §548(d)(2) provides that derivative-related transfers are always for “value,” and §548(c) provides that a party “has a lien on or may retain any interest transferred or may enforce any obligation incurred, . . . to the extent that such transferee or obligee gave value,” thus limiting the debtor or trustee’s ability to fully unwind the transaction, and narrowing the cases in which even an actual fraudulent transfer claim will be useful.

³² In a recent ruling in *Lehman Brothers*, Judge Peck determined that it is indeed an option, with an expiration date. A counterparty that waited 11 months to terminate had waived its rights. In re *Lehman Brothers Holdings, Inc.*, 08-13555 (Bankr. S.D.N.Y. Sept. 17, 2009).

³³ 5-561 *Collier on Bankruptcy* ¶ 561.04.

2. *Arguments for Safe Harbors*

The chief derivatives industry trade group, the International Swaps and Derivatives Association (ISDA), generally argues for the safe harbors as a necessary means to protect the ability to “net” derivatives upon a bankruptcy filing and thus avoid systemic risk.³⁴ As will be seen in the next section, the safe harbors actually go far beyond what is required to achieve this goal, and do not evidently advance this ambition, but it bears setting forth ISDA’s argument more fully before examining its weaknesses. To ensure that I faithfully represent the main arguments, I quote liberally from ISDA documents found on their web page.³⁵

ISDA frequently quotes from Congressional testimony and statements made at the time of the enactment of the safe harbors to support their application in specific cases.³⁶ For example, in a recent amicus brief, ISDA quoted the 1999 statements of David H. Jones, Senior Deputy General Counsel to the Federal Deposit Insurance Corporation, where he explained to the Senate Banking Committee that

The series of "netting" amendments to the Bankruptcy Code . . . over the past two decades were designed to further the policy goal of minimizing the systemic risks potentially arising from certain interrelated financial activities and markets. Systemic risk has been defined as the risk that a disruption -- at a firm, in a market segment, to a settlement system, etc. -- can cause widespread difficulties at other firms, in other market segments or in the financial system as a whole. Netting

³⁴ As explained by ISDA, “Close-out netting applies to the occurrence of any or all of the following: the termination, liquidation and/or acceleration of any payment/delivery obligations. When invoked, close-out netting facilitates the calculation of a close-out (market/liquidation/replacement) value; the conversion of calculated values into a single currency; and the determination of the net balance of the values.” ISDA Research Notes, No. 2, 2009, at page 7, n.2. Available at <http://www.isda.org/researchnotes/pdf/ISDA-Research-Notes2.pdf>

³⁵ www.isda.org

³⁶ There may be some circularity here, if ISDA provided the testimony or helped craft the congressional statements.

helps reduce this risk by reducing the number and size of payments necessary to complete transactions.³⁷

Specially, ISDA argues that close-out netting, that is, the termination of a parcel of related derivative trades upon a debtor's bankruptcy filing, "reduces the risk of a large insolvency have a "domino" effect on the solvency of other market participants who have dealt with the insolvent."³⁸ ISDA argues that netting reduces credit risk of individual firms, and systemic risk to the entire economy. The two forms of risk reduction are interrelated, in that by "reducing credit risk at each node in the network of relationships between market participants, close-out netting also has an important beneficial effect on systemic risk."³⁹

ISDA has also argued that derivatives need special treatment to avoid "cherry picking." As asserted in connection with recent changes to the Canadian insolvency laws

This "cherry-picking" of transactions would undermine the netting arrangements between the parties. Where a master agreement (or master agreement with respect to more than one master agreement) is in place, the master agreement and all individual transactions under it form a single agreement.⁴⁰

³⁷ Brief And Memorandum Of Law Of The International Swaps And Derivatives Association, As Amicus Curiae, In Support Of Defendant's Motion (A) To Dismiss Trustee's Complaint For Failure To State A Claim Under Federal Rule Of Bankruptcy Procedure 7012, Or, In The Alternative, (B) For Summary Judgment Under Federal Rule Of Bankruptcy Procedure 7056, *Hutson v. Smithfield Packing Co. (In re Nat'l Gas Distrib. LLC)*, 06-00267-8-ATS (Bankr. E.D.N.C. Apr. 3, 2007), at 8-9.

³⁸ Memorandum On The Implementation Of Netting Legislation, A Guide for Legislators and Other Policy-Makers , at 4 (March 2006). Available at <http://www.isda.org/docproj/pdf/Memo-Model-Netting-Act.pdf>

³⁹ Letter dated Dec. 13, 2004, from Robert G. Pickel, ISDA Executive Director and Chief Executive Officer to Davida Lachman-Messer, Deputy Attorney General (Israel) and Yoav Lehman, Bank of Israel, at p. 2. Available at <http://www.isda.org/speeches/pdf/IsraelLetterDec13-04.pdf>

⁴⁰ Submission of the International Swaps and Derivatives Association, Review of Bill C-12 to the Senate Standing Committee on Banking Trade and Commerce, at p. 5-6 (Feb. 26, 2008). Available at http://www.isda.org/c_and_a/pdf/ISDALtrBillc12.pdf

In another document, this time dealing with Russia, ISDA further explains that

The primary concern with this “cherry picking” is that the inability to terminate and net the transactions increases the risk of a chain of interrelated defaults, that is, systemic risk.⁴¹

In short, the imposition of the automatic stay, and the subsequent inability to offset a series of derivative contracts is said to create systematic risk. Systematic risk is further exacerbated by “cherry picking,” in that the ability to assume and reject contracts under section 365 will lead to the termination of only those derivative contracts under which the non-debtor is obliged to pay its counterparty, the debtor.

3. A Critique of the Arguments (and the argument for repeal)

As has been widely recognized,

Staying collection actions helps preserve firm value. A firm's most important assets include its web of contractual relationships , , , [accordingly, U.S. bankruptcy] law allow[s] a debtor to preserve most contractual relationships during the reorganization process.⁴²

Thus, if the goals of chapter 11 are to be achieved, deviations from this basic rule should be justified by well-built arguments. ISDA’s argument does not meet this standard.

First, consider the sweeping generality of the argument for the safe harbors, which at times appears to be little more than a claim that other firms will experience distress when a debtor files for bankruptcy protection. Yes, but that is true for all types of firms and

⁴¹ ISDA Research Notes, No. 2, *supra* note 34, at 7.

⁴² Theodore Eisenberg & Stefan Sundgren, *Is Chapter 11 Too Favorable to Debtors? Evidence from Abroad*, 82 Cornell L. Rev. 1532, 1537 (1997).

creditors, and in all types of insolvency systems. For example, when a manufacturing firm enters chapter 11, its suppliers and dealers are likely to experience financial distress in turn.⁴³ But when the same manufacturing firm experiences financial distress outside of bankruptcy, its suppliers and dealers are also likely to suffer.

The reality of collateral financial distress does not itself justify an exception from the automatic stay, or the rules regarding contracts or avoidance actions, because such an exception would utterly wreck chapter 11. Chapter 11 is designed around the notion of shared sacrifice and collective recovery – whereas granting exceptions to the process, even in cases of hardship, undermines those twin goals.

Similarly, while part of the “cherry picking” argument amounts to little more than a repeat of the broader systemic risk argument, the argument also asserts that such risk will be enhanced if the debtor is allowed to keep its “good” derivatives while rejecting its “bad” contracts, as section 365 normally allows. Of course, all the safe harbors do is turn around the normal rule and allow the non-debtor engage in “cherry picking” of its own.⁴⁴ The connection with reduced systemic risk is doubtful.

But what of the argument that the individual ripples of financial distress will ultimately aggregate in a manner that causes systemic risk or crisis? It is undoubtedly true that financial firms have an added amount of horizontal contracts with their peer firms. Lehman Brothers and Goldman Sachs dealt with each other in a way that would be foreign to GM and Ford. These bilateral connections do increase the risk that a single firm’s failure could trigger an industry-wide collapse.

⁴³ Philippe Jorion & Gaiyan Zhang, *Credit Contagion from Counterparty Risk*, 64 J. Fin. 2053, 2055 (2009) (“The ongoing business of the trade creditor can be impaired by the bankruptcy of its borrower because this is often a major customer.”).

⁴⁴ Shmuel Vasser, *Derivatives in Bankruptcy*, 60 Bus. Law. 1507, 1542 (2005). (noting that “only the non-debtor counterparty obtains the upside of a derivative in a bankruptcy, not the debtor”).

But even accepting this argument for the moment, it does not justify the current breadth of the safe harbors, which are not limited to financial firms and are drafted so broadly that almost any supply contract is protected.⁴⁵ The airline that files under chapter 11 immediately finds its portfolio of fuel hedges terminated, even though its bankruptcy should not have any systemic effects.

And even among financial firms, an exception from the normal rules of bankruptcy does nothing to protect firms from their counterparties' collapse. The safe harbors did nothing to protect the derivative markets from AIG's collapse – the U.S. Treasury's largesse prevented the systemic collapse, and that generosity could have happened within the context of a bankruptcy case.⁴⁶ Much of ISDA's argument for the safe harbors seems to confuse avoidance of bankruptcy with avoidance of default.

What is lacking in the argument is any specific explication of how the Bankruptcy Code, as distinct from the general issue of counterparty risk, increases systemic risk.⁴⁷ In particular, how would it increase systemic risk to require derivative counterparties to seek court approval to terminate a swap or setoff several obligations, as other contractual parties must?⁴⁸

⁴⁵ See Stephen J. Lubben, *Derivatives and Bankruptcy: The Flawed Case for Special Treatment*, 12 U. Pa. J. Bus. L. -- (forthcoming 2009, available on SSRN).

⁴⁶ <http://www.washingtonpost.com/wp-dyn/content/article/2009/10/27/AR2009102703963.html?hpid=topnews>

⁴⁷ Bliss, Robert R. and Kaufman, George G., *Derivatives and Systemic Risk: Netting, Collateral, and Closeout* (May 10, 2005). FRB of Chicago Working Paper No. 2005-03. Available at SSRN: <http://ssrn.com/abstract=730648>. As the authors note,

Market participants tend to be more concerned with their own welfare in normal day-to-day business environments than with possibilities of adverse externalities in the form of systemic failures of markets. Netting, close-out, and collateral serve the needs of market participants even when there is no systemic threat: They facilitate market risk and counterparty credit risk management; and they permit expansion of dealer activities, enhancing the depth and liquidity of the derivatives markets.

⁴⁸ If the issue were simply potential delay, certainly strict time limits for hearing such motions would make more sense than a complete exception from the normal

Indeed, some of the safe harbors plainly worsen systemic risk. For example, with no threat of having the transaction reversed as a preference, derivative counterparties have every incentive to setoff contracts and seize collateral upon the first hint of financial distress. In short, this particular safe harbor provision encourages a run on the bank.⁴⁹

Moreover, the safe harbors do little to protect the non-debtor from the consequences of the debtor's default. A party who is "in the money" on a derivative contract with a debtor is allowed to terminate the contract – and assert an unsecured claim. The only potential benefit is the ability thwart the debtor's assignment of the derivative. A party that is "out of the money" on a derivative with the debtor also has an option to terminate the contract, although termination should not be confused with a power to "undo" the contract. The non-debtor party will still have to pay the debtor in this state of affairs.

Indeed, the safe harbors only benefit parties in two respects. First, a party that has entered into multiple derivative contracts with a single debtor can net these contracts against each other. Second, a party that has demanded collateral to support a derivative transaction, and who has control over that collateral, is truly exempt from the bankruptcy

rules. It is equally true that many of the claims about delay in chapter 11 are uncorroborated. Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 Mich. L. Rev. 603, 607-08, 626 (2009) (reporting from a study of 1,422 chapter 11 cases that "[t]he median time spent in Chapter 11 is about eleven months"). And the evidence suggests that the early criticisms of chapter 11 have not been born out by the long-term evidence. Lemmon, Michael L., Ma, Yung-Yu and Tashjian, Elizabeth, *Survival of the Fittest? Financial and Economic Distress and Restructuring Outcomes in Chapter 11* (January 1, 2009). Available at SSRN: <http://ssrn.com/abstract=1325562>.

⁴⁹ If stopping preference actions is an important part of controlling systemic risk, one wonders why ISDA has done nothing to address §5(b) of the Uniform Fraudulent Transfer Act, which also allows recovery of preferences made to insiders under state law. One banker on the board is sufficient to make the bank an "insider" for purposes of this statute, UFTA §1(7) (definition of "insider"), and the statute of limitations is much longer under the UFTA than §547 of the Bankruptcy Code.

process, at least to the extent of the collateral.⁵⁰ They can take the collateral in satisfaction of their claim.

Both benefits are most likely to accrue to large financial institutions: who else is apt to have a large number of derivative trades with a single debtor, and the ability to compel that debtor to post collateral?⁵¹ Even then, these benefits are only useful if the non-debtor party is, on a net basis, “in the money” with respect to the debtor, otherwise the safe harbors will simply hasten the liquidation of the debtor’s derivative portfolio.

Ultimately then, the argument for the safe harbors is quite simple: the safe harbors reduce systemic risk by giving large financial institutions special treatment.

This argument only holds, if at all, with regard to derivative transactions among financial institutions, and thus supports only a much narrower version of the existing safe harbors.⁵² It also only holds if we believe that the special interrelations among financial firms, combined with some special volatility of derivatives, necessitates altering the Bankruptcy Code to prevent a systemic crisis.⁵³ There is little actual evidence to support even this narrow claim.⁵⁴

⁵⁰ Financial firms apparently exchange “mark to market” collateral on a daily basis, but larger investment banks, at least before Lehman’s bankruptcy filing, often required the posting of additional collateral when dealing with a smaller entity like a hedge fund. For non-financial firms using derivatives for hedging, any collateral posted will be held by the selling financial institution.

⁵¹ To be sure, the collateral point may change either as a result of experiences in the Lehman case or newly enacted regulations.

⁵² Edwards & Morrison, *supra* note 8, at 98 (“[T]he Code encompasses far too many transactions. Fear of systemic risk is warranted only in cases involving the insolvency of a major financial market participant, with whom other firms have entered derivatives contracts of massive value and volume. Yet the Code offers special treatment to derivatives no matter how large or small the counterparty.”).

⁵³ See Vasser, *supra* note 44, at 1511 (noting that in enacting the safe harbors, “Congress also focused on the unique nature of the financial markets and their volatility.”).

⁵⁴ See Edward R. Morrison & Joerg Riegel, *Financial Contracts And The New Bankruptcy Code: Insulating Markets From Bankrupt Debtors And Bankruptcy Judges*,

For example, why are ISDA and its supporters at the Federal Reserve and the FDIC so certain that liquidation of a debtor's derivative portfolio reduces systemic risk or is otherwise socially optimal? It seems more likely that sale of a large financial institution's derivative portfolio as a whole would both maximize the value of the estate and reduce systemic risk by avoiding the rush to "close out" myriad positions upon a bankruptcy filing.⁵⁵

And is the Bankruptcy Code the proper place to address the interlocking nature of financial firms? Indeed, the safe harbors would seem to encourage excessive risk taking in this regard, by promoting the belief that firms need not worry about default. And while systemic risk may well result from poor risk management among financial firms, and regulatory failures that allow firms to become "too big to fail," by the time chapter 11 comes into play, the conditions leading to the failure of the firm, and the risk to its competitors, have already been created. Viewed in this light, the safe harbors make allowances for earlier risk management and regulatory failures.

4. Outlines of an Alternative System

For the foregoing reasons, I urge the repeal of the safe harbors.⁵⁶ But once the safe harbors are repealed, how should the distressed financial institution resolve its situation?

13 Am. Bankr. Inst. L. Rev. 641, n.15 (2005) (Arguing that the systemic risk argument in favor of the safe harbors, "appears to have little empirical support.").

⁵⁵ Lubben, Systemic Risk, *supra* note 23; *see also* Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. Cin. L. Rev. 1019, 1049 (2007) ("The first thing to note is that the standard explanation for the special treatment is not particularly compelling. It is far from clear that the exception reduces systemic risk; it may even increase this risk because it eliminates a possible curb on counter-parties' rush to close out their contracts in the event of a wave of failures.").

⁵⁶ The one exception I might make is for traditional, very short-term repo agreements. These are short term loans, often overnight, with small profit margins that may be unable to support the consequences of a sudden bankruptcy and the imposition of the automatic stay. To the extent these short, overnight loans are important sources of liquidity in the financial markets, they warrant special

In this section I offer a brief sketch of my thoughts on how this question should be addressed.

One answer is to erect a new structure, as the Administration has suggested through its proposed Orderly Resolution Regime (ORR).⁵⁷ There is an element of reinventing the wheel here, as chapter 11 itself is an “orderly resolution regime” for myriad corporations every year. A distinct system would also start from scratch, whereas a modified chapter 11 system could draw on the existing skill and knowledge of chapter 11 practitioners and courts. This could be especially important given that a distinct ORR would be infrequently utilized.

The defenders of the ORR suggest several reasons why a bankruptcy system would not work, including

First, corporate bankruptcy is focused almost exclusively on the interests of creditors of the firm, with little concern for “third party” effects such as systemic risk. Second, the restrictions on the claims of creditors inherent in bankruptcy will likely result in counterparties (and employees) refusing to do business with a financial institution either in or approaching bankruptcy. Third, court proceedings are likely to move slowly, as opposed to administrative proceedings like an ORR. Finally, whereas the ORR would permit the government to intervene in various ways before the firm “fails,” traditional corporate bankruptcy would not.⁵⁸

treatment. I would, however, correct the current definition of repurchase agreements, which covers transactions where the collateral can be returned within a year. 11 U.S.C. §101(47). Such a transaction evidences a degree of risk taking and exposure to the debtor that is inconsistent with a traditional repo arrangement.

⁵⁷ <http://www.washingtonpost.com/wp-dyn/content/article/2009/10/26/AR2009102603260.html?hpid=topnews>

⁵⁸ H. Rodgin Cohen and Morris Goldstein, *The Case for an Orderly Resolution Regime for Systemically-Important Financial Institutions*, Pew Financial Reform Projects Briefing Paper # 13 (Oct. 21, 2009). Available at www.pewfr.org/task_force_reports_detail?id=0027

The key difficulty with this analysis is that it assumes chapter 11 is as it always must be, while the very idea of modifying chapter 11 to accommodate financial firms presupposes change. For example, the financial institution’s regulator should have the ability to initiate a bankruptcy proceeding. And that bankruptcy proceeding should have the ability to address all aspects of the institution – whether it be a bank holding company, hedge fund, or insurance company.

Given the difficulty that financial firms would have pursuing a traditional reorganization, and the potential effects that a bankruptcy case of uncertain duration might have on the financial markets, it would make sense to provide such firms with a limited period in which to reorganize. For example, a financial debtor might have 90 days to achieve a reorganization or sale, after which the case would be dismissed or converted to a chapter 7 liquidation, with no automatic stay for financial contracts. If the particular circumstances dictated that even 90 days was too disruptive to the market, creditors or regulators would have the ability to move to convert or dismiss at an earlier point. And creditors would retain their individual rights to move to lift the automatic stay.

Because financial contracts and the collateral that supports them are likely more volatile than traditional assets, the Bankruptcy Code’s adequate protection provisions, which protect secured creditors during a bankruptcy process, become even more important.⁵⁹ I suggest that preexisting “mark to market” collateral arrangements should presumptively be allowed to continue post-petition, and that the debtor should have the burden of seeking court approval or counterparty consent to alter these arrangements if they are no longer appropriate.⁶⁰ Given the new reality that secured post-petition lenders often have a claim on all of the debtors assets, combined with a super-priority administrative claim,⁶¹ it will be necessary to provide greater protection to financial creditors than

⁵⁹ 11 U.S.C. §§ 361, 362(d), 363(c)(2).

⁶⁰ *Cf.* §363(c)(2).

⁶¹ 11 U.S.C. §364(c)(1).

current section 507(b) provides⁶² – perhaps in the form of a carveout of the DIP lender’s collateral.⁶³

The argument against using bankruptcy “court proceedings” because they are too slow repeats in a new mode the old canard about chapter 11 being a source of great delay, despite abundant evidence to the contrary,⁶⁴ and ignores the experience in Lehman, GM, and Chrysler, among other cases that are indicative of the “new and improved” chapter 11.⁶⁵ And the notion that pre-default creditors would behave differently if the looming procedure were called by a different name is just odd. This again seems to confuse the source of the problem: a firm’s inability to meet its obligations is distinct from whatever procedure is used to address the problems.

In short, it seems that with a limited amount of tuning, chapter 11 could be easily adapted to the plight of financial firms after the safe harbors were repealed. And this initial analysis suggests that a newly created proceeding is unnecessary. This also has the benefit of utilizing a well-understood structure, with pre-existing traditions and standards.

Conclusion

Normally if you are a secured creditor in a bankruptcy case, you have to get court approval to take the collateral, even if it is in your possession.⁶⁶ That same rule holds if you have the right to setoff countervailing obligations.

⁶² At present, section 507(b) provides for a priority administrative claim for a creditor who was given “adequate protection,” that turned out to be inadequate, but this claim is subordinate to claims under §364(c)(1) and secured claims.

⁶³ Richard B. Levin, *Almost All You Ever Wanted to Know About Carve Out*, 76 Am. Bankr. L.J. 445 (2002).

⁶⁴ See, *supra* note 48. Complaints about long, drawn-out chapter 11 cases are a prime example of what Paul Krugman has termed zombie fallacies — ideas that you kill repeatedly, but refuse to die.

⁶⁵ Stephen J. Lubben, *No Big Deal: The GM and Chrysler Cases in Context*, 83 Am. Bankr. L.J. – (2009). Available at <http://ssrn.com/abstract=1467862>

⁶⁶ 11 U.S.C. §541 (the estate is comprised of all the debtor’s property, “wherever located and by whomever held”).

If you want to avoid that, you have to set up either an escrow or securitization structure that will keep the collateral out of the bankruptcy estate.⁶⁷ The safe harbors in the Bankruptcy Code give the derivatives industry a kind of "free pass." They get treated as though they established an escrow or securitization, without actually doing it.

The core policy question is whether this is justified, or whether derivative counterparties should be treated like everybody else. The argument in favor of special treatment is a vague contention that special treatment reduces systemic risk.

The argument in favor of normal treatment is that it will maximize the value of the debtor's estate and reduce systemic risk by removing the perceived need to buy and sell myriad derivative contracts shortly after the debtor's collapse.

In this short paper I have argued that ISDA's argument for the safe harbors is shallow and uncorroborated. This is a position that other leading scholars have also embraced.⁶⁸ Given recent events, it seems appropriate to reexamine the arguments.

I thus submit the safe harbors should be repealed. Stopping the run on the bank seems distinctly preferable to facilitating the run.

⁶⁷ See Edward J. Janger, *The Death of Secured Lending*, 25 *Cardozo L. Rev.* 1759 (2004).

⁶⁸ Edwards & Morrison, *supra* note 8, at 103-04 (arguing that excluding derivatives from the bankruptcy process increases the risks of contagion in the financial system); Partnoy & Skeel, Jr., *supra* note 55, at 1049 (terming ISDA's argument "unpersuasive").