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Systemic Risk & Chapter 11

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SYSTEMATIC RISK & CHAPTER 11

Stephen J. Lubben[*]

The systemic risk to the automotive industry and the overall U.S. economy are considerable, just as the bankruptcy of Lehman had a ripple effect throughout the financial industry . . . Based upon exhaustive analysis, these risks outweigh the benefits of a bankruptcy based approach to the Company's restructuring.[1]

The United States economy lost more than 650,000 jobs in February and the unemployment rate hit 8.1%, the highest rate since the early Reagan administration.[2] It would have seemed inconceivable six months ago that General Electric would be considered a risky investment, but as this article is being written, GE is trading in the CDS market[3] with "points upfront," typically an indication of a high near-term probability of default.[4] In early September 2008, just before

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[1] General Motors Corporation, *2009-2014 Restructuring Plan* 103 (Feb. 17, 2009).

[2] Peter S. Goodman & Jack Healy, *Job Losses Hint at Vast Remaking of Economy*, N.Y. Times, March 6, 2009, at A1.

[3] The credit default swap market. Under a CDS contract, the protection buyer agrees to make periodic payments to the protection seller. The protection seller agrees to pay the buyer if a "credit event" occurs with regard to a third-party (GE in the example in the text). 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] In mid-March S&P downgraded GE to AA+. GE had held a

Lehman Brothers entered bankruptcy, there were about 75 companies trading "upfront." By March 2009, the number was 260.[5]

In this context, chapter 11 is notable in its absence. Chapter 11 is thing that wrecked Lehman Brothers, and perhaps the credit markets.[6] And the thing that the Federal Reserve and Treasury worked so hard to keep AIG and Bear Stearns away from.[7] The thing that General Motors and Chrysler were working so hard to avoid.[8] Chapter 11 is something to be feared, not part of the solution.[9]

This apprehension of chapter 11 predates the recent financial crisis. Asset securitization, the première new financial vehicle of the last decade, represents a straightforward effort to exploit formalities to avoid chapter 11.[10] In a typical securitization transaction, income-

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AAA rating from both major rating agencies since 1967. Even at the reduced rating, this is indicative of less risk of default than implied by the CDS market.

[5] Information on the CDS market used in this paragraph comes from www.markit.com.

[6] http://www.iht.com/articles/2009/02/23/opinion/edkrugman.1-435823.php

[7] Andrew Ross Sorkin, *JP Morgan Pays $ 2 a Share for Bear Stearns*, N.Y. TIMES, Mar. 17, 2008, at A1; Joe Nocera, *Propping Up a House of Cards*, N.Y. TIMES, Feb. 28, 2009, at B1 (discussing AIG).

[8] Bernard Simon & John Reed, *GM Issues Warning on Cash and Sales,* Fin. Times., March 6, 2009, at 1. Chrysler filed its chapter 11 petition on April 30, 2009. Brian J. O'Connor, *Pain And Gain Await Chrysler In Bankruptcy Court*, Detroit Daily News, May 1, 2009.

[9] Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U.L. REV. – (2009).

[10] Stephen J. Lubben, *Beyond True Sales: Securitization and Chapter 11*, 1 N.Y.U. J.L. & BUS. 89 (2004); Steven L. Schwarcz, *Structured Finance: The New Way to Securitize Assets*, 11 CARDOZO L. REV. 607 (1990).

producing assets are sold to a newly created legal entity.[11] This entity's governing documents are designed with features that prevent a voluntary bankruptcy filing and the entity is limited in purpose to avoid creation of creditors who might support an involuntary filing.[12]

Similarly, credit derivatives originally developed as a kind of insurance against default, but speculative trading in these instruments was furthered by the belief by many investors that it was better to trade in "debt" that came unburdened by the others roles that came with traditional debt ownership, including potential obligations to work with a debtor toward a restructuring.[13] More broadly, in 2005 the derivatives industry obtained a broad exemption from the key provisions of chapter 11 primarily based on the dubious argument that chapter 11 represented a threat to the overall financial system.[14]

In a rather ironic twist then, both the alleged root sources of the current financial crisis – credit derivatives and asset securitization – and those that would rescue us for the crisis share a common skepticism of chapter 11. In this puzzling context, it bears asking if the fear of chapter 11 is warranted.

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[11] *See* Baher Azmy, *Squaring the Predatory Lending Circle: A Case for States As Laboratories of Experimentation*, 57 FLA. L. REV. 295, 315-16 (2005).

[12] Lubben, *Beyond True Sales, supra* note 10, at 93-95.

[13] Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 82 AMER. BANKR. L.J. 77 (2008); s*ee also* Anna Gelpern, *Domestic Bonds, Credit Derivatives, and the Next Transformation of Sovereign Deb*t, 83 CHI.-KENT L. REV. 147, 169 (2008).

[14] Frank R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 YALE J. REG. 92, 104 (2005).

In particular, what role does chapter 11 play in a time of widespread financial distress? Does it matter if the financial distress is focused in financial firms like Lehman and AIG, or traditional industrial firms like GM? And if chapter 11 has a role to play, what accounts for the suspicion of chapter 11 among non-legal professionals?

I begin to examine these questions by probing the fear of chapter 11, which is often bottomed on the speculation that if one firm in an industry were to enter chapter 11, then proximate firms would follow in a domino effect – that is, chapter 11 will create systemic risk.[15] The notion that chapter 11 could be the cause of an industry-wide cascade of failure is undermined by the lack of any actual examples of such an occurrence in the century-long history of American corporate reorganization. Particular industries have experienced waves of the financial distress – at present, the newspaper industry is experiencing one -- but this seems to be most often caused by the similar assets owned or the common business cycles faced by these firms, rather than any particular aspect of chapter 11.[16]

In short, I reject the foundational premise for much of the fear of utilizing chapter 11 in the present crisis. The start of the present financial crisis involved two problems: a lack of lending and a lack of

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[15] Systemic risk is the risk the failure of a firm will result in market-wide failures as a result of the firm's interconnectedness with other comparable firms in the market. *See* Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 196-97 (2008).

[16] Helwege, Jean, *Financial Firm Bankruptcy and Systemic Risk* (December 12, 2008). Available at SSRN: http://ssrn.com/abstract=1315316.

investment. Now the crisis appears to have evolved, with declining home prices, retirement account balances, and low consumer confidence stalling the economy; the initial alarm being replaced with protracted investor insecurity about the basic competence of key financial institutions and their executives. None of these problems are obviously exacerbated by chapter 11, and indeed chapter 11 has a role to play in dissipating panics through the automatic stay.[17]

Having cracked open the door for a potential role for chapter 11, I next directly examine the use of chapter 11 in times of systemic crisis. In particular, I examine the utility of chapter 11 with regard to the different types of debtors. There seems to be no reason why an industrial firm like GM should not use chapter 11 – these kinds of debtors were exactly the firms that Congress had in mind when it adopted the chapter in 1978. The belief that bankruptcy would mean GM goes "bust" reflects either a serious misunderstanding of chapter 11, or an intentional effort to create fear and panic about chapter 11 to support the case for a bailout.

Financial firms represent a more difficult task.[18] Because investment banks like Lehman Brothers are entirely dependent on their credit rating and reputation – to the extent those are different things – reorganization is unlikely to be an option. Nevertheless, chapter 11 provides an effective means of liquidating a larger corporation, and

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[17] 11 U.S.C. § 362.

[18] Ayotte, Kenneth and Skeel, David A., Bankruptcy or Bailouts? (March 2, 2009). U of Penn, Inst for Law & Econ Research Paper No. 09-11; Northwestern Law & Econ Research Paper No. 09-05. Available at SSRN: http://ssrn.com/abstract=1362639.

thus can play a role here too.[19] I thus argue that the Treasury Secretary's recent plan to create a new system for the liquidation or reorganization of financial firms represents an unnecessary duplication of existing structures.[20]

* * *

Beneath this analysis is an argument that Lehman's chapter 11 filing did not cause the current credit crisis, but rather Lehman's *failure* caused the crisis. That failure was likely to occur with or without chapter 11, unless the government prevented it or mitigated its consequences, as in the case of AIG. Chapter 11 has (or at least had) a role to play here, by providing a framework for government intervention that avoids the need for the kind of intervention we have recently been seeing on an *ad hoc* basis. The company in question enters chapter 11, which provides a kind of breathing space that prevents a "run on the bank," at which point the government can step in to save counterparties from their exposure to the debtor, if policymakers feel such a step is warranted.

The key caveat to all this comes back to the unbridled fear of chapter 11. Chapter 11 is avoided because key players argue that chapter 11 will make matters worse. And accepting this argument at face value, Congress has largely acquiesced in the creation of new

[19] Stephen J. Lubben, *Business Liquidation*, 81 AM. BANKR. L.J. 65 (2007).

[20] David Polk & Wardwell has produced an insightful analysis of this proposal: www.dpw.com/1485409/clientmemos/2009/03.30.09.resolution.authority.pdf

exceptions from chapter 11.[21] The "chancellor's umbrella" that once protected firms from financial storms has been so perforated that it barely serves its function anymore. [22] The brisk demise of Circuit City – rooted in large part in the landlord friendly 2005 amendments to §365(d)(4)[23] – is but the most obvious example of this phenomenon in action.

I conclude by arguing that the obsessive focus on bankruptcy avoidance in the last decade – the consequence of the fear of chapter 11 -- moved the financial industry's focus away from credit analysis. Once achieved, the apparent goal of avoiding any interaction with chapter 11 substituted for a real analysis of the risks of the underlying loan transaction. But avoiding chapter 11 is clearly not the same thing as avoiding default. Yet more reason why it may be time to reconsider the piecemeal erosion of chapter 11, and return to the more inclusive bankruptcy process that Congress enacted in 1978.

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[21] *See* H.R. Rep. 109-31(I), 1 (2005).

[22] *See generally* Richard Levin & Alesia Ranney-Marinelli, *The Creeping Repeal Of Chapter 11: The Significant Business Provisions Of The Bankruptcy Abuse Prevention And Consumer Protection Act Of 2005*, 79 AM. BANKR. L.J. 603 (2005).

[23] Under the current provision, retail debtors have an extremely short period of time to decide whether to assume (perform) or reject (breach) a commercial lease agreement. In a retail chapter 11 case, these decisions are central to the debtor's reorganization plan, yet must be made well before a plan is often sensibly negotiated. Before 2005, bankruptcy courts had the ability to extend to time for assumption or rejection until much latter in the case, at which point a debtor could make the decision in conjunction with its overall reorganization plans.

I. Systemic Risk and the Fear of Chapter 11

Avoidance of chapter 11 is often based in fears of systemic risk.[24] For example, as highlighted by the quote at the start of this paper, General Motors has recently justified its efforts to restructure outside of chapter 11 in terms of the systemic risks that would allegedly result from such a bankruptcy case.

When firms or creditors say that a particular chapter 11 case would create systemic risk, it is based on an argument that the putative debtor in question has become so intertwined with the economy that the debtor's failure will leave a hole in some relevant market, with collateral effects for all the non-debtor firm's whose future depends on the debtor. The GM quote at the outset of the paper, and the case of AIG – which was reportedly saved by the government to avoid the effects of AIG's default on the broader CDS market[25] – are recent examples of such a systemic risk argument.

But this is not really an argument about chapter 11. The systemic risk in both the GM and AIG examples is not a creation of chapter 11, but rather this risk was created at the point when these companies

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[24] Karen P. Ramdhanie, *Derivatives Contracts of Insolvent Companies: Preferential Treatment under the Bankruptcy Code of the United States and the Insolvency Laws of the United Kingdom*, 18 N.Y.L. SCH. J. INT'L & COMP. L. 269 (1999). *See also* H.R. Rep. No. 109-31, pt.1, at 3 (2005).

[25] http://blogs.reuters.com/felix-salmon/2009/04/24/are-cds-a-good-thing/

became "too big to fail."[26] A chapter 11 filing may represent the point when this risk is realized – or even the point at which the risk becomes understood and known to the markets, raising important questions regarding the efficiency of these markets – but chapter 11 does not create any new systemic risk in this instance.

Even the example of derivative contracts, and the putative need to avoid chapter 11 because of increased systemic risks, represents an effort to tar chapter 11 with the risks inherent in the current nature of the derivatives markets. Initially, note that the systemic risk argument only holds with regard to financial firms. Financial firms buy and sell derivative contracts, whereas, as I have argued elsewhere, non-financial firms do not present the same question of interlocking derivative contracts inasmuch they are only on the "buy side" of derivative transactions.[27] Manufacturing firms also do not have the same kind of horizontal relationships with their peers that financial firms do – GM does not have significant contracts with Toyota or Ford -- raising the question of whether a failure of a firm like GM can ever be said to involve systemic risk.

In this context, the failure of a real economy firm does not present the counterparty with the loss of protection needed to guard against losses in another security or balance a portfolio.[28] For this reason, the

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[26] As I argue *infra*, it seems doubtful that GM fits into the typical systemic risk story, inasmuch as it is not interconnected with its peer firms.

[27] Stephen J. Lubben, *Derivatives and Bankruptcy: The Flawed Case for Special Treatment*, -- U. PA. J. BUS. L. -- (forthcoming, available on SSRN).

[28] Lubben, *supra* note 13, at __.

recent amendments to the Bankruptcy Code are at the very least overbroad, inasmuch as they move all derivative contracts outside of the bankruptcy system.[29]

Table 1: Top Recipients of AIG Collateral Payments
Billions of US Dollars

Societe Generale	$4.10
Deutsche Bank	$2.60
Goldman Sachs	$2.50
Merrill Lynch	$1.80
Calyon	$1.10
Barclays	$0.90
UBS	$0.80
DZ Bank	$0.70
Wachovia	$0.70
Rabobank	$0.50
KFW	$0.50
JPMorgan	$0.40

Source: www.aig.com

In the instance of financial firms, the case of AIG offers a ready example of how the structure of derivatives trading – particular trading in credit derivatives – can create systemic risk, but even here there is little support for the notion that subjecting these firms to the Bankruptcy Code would create any additional systemic risk.

In its June 2008 Form 10-Q, AIG reported that "[a]pproximately $307 billion of the $441 billion in [credit default swaps written by

[29] Kenneth C. Kettering, *Securitization and its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L.REV. 1553, `648-49 (2008) ("It is not plausible to suppose that repo or derivatives transactions of small size or with a small debtor are apt to cause a cascade of insolvencies among the debtor's counterparties.").

AIG] were written to facilitate regulatory capital relief for financial institutions primarily in Europe."[30] Although there is some tension between this statement and the more recent disclosure that Goldman Sachs and Merrill Lynch were among the biggest recipients of AIG's more than $22 billion in collateral postings – presumably there is a fairly direct correlation between exposure to AIG and the amount of collateral received – these two sources of information provide a picture of the interlocking effects of credit default swaps.

In particular, if AIG were to have immediately ceased operations in the period after Lehman's collapse and filed under the Bankruptcy Code, the banks listed on Table 1 would have suffered losses or have been required to write down their assets in an amount at least equal to, and probably much greater than, the collateral payments listed thereon.[31] One could imagine that this may have precipitated a chain reaction of bankruptcy filings, rippling through the financial industry with obviously dire consequences.[32] Thus it is said that an AIG bankruptcy would have increased overall systemic risk.

This analysis confuses the effects of chapter 11 with the failure of the banks listed on Table 1 to engage in sound risk management procedures when dealing with a distressed counterparty.[33] Moreover,

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[30] American International Group, Inc. Form 10-Q for the quarter ended June 30, 2008, at 42.

[31] The figures on Table 1 do not include any collateral payments that AIG made before the government's intercession in its affairs.

[32] A similar argument about the effect of a GM bankruptcy on its suppliers supports the contention that GM's chapter 11 case would create systemic risk.

[33] *See* James A. Fanto, *The Role Of Financial Regulation In Private Financial Firms: Risk Management And The Limitations Of*

it implicitly assumes that avoidance of bankruptcy is the equivalent of avoidance of failure – but the secondary effects of AIG's failure were avoided not by avoiding a bankruptcy filing, but rather by the federal government's decision to fund AIG's continued operations.[34] The government could have achieved the same result by making direct payments to the banks on Table 1, in which case AIG's bankruptcy status would have been irrelevant.[35] Similarly, whether or not GM files for bankruptcy, the larger automotive industry will have to face the effects of GM's declining share of the new car market.

Indeed, one could observe that virtually any chapter 11 filing is apt to affect the financial health of non-debtor firms that do business with the debtor. What makes GM and AIG unique is their size, which would likely result in a proportionally larger number of secondary firms experiencing financial distress. But having witnessed the chapter 11 filings of Enron, Worldcom, Owens Corning, Kmart, United Airlines, Pan Am, TWA (three times), Refco, Drexal Burham

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The Market Model, 3 BROOK. J. CORP. FIN. & COM. L. 29, 43-45 (2008).

[34] Thus when AIG asserted, "An AIG failure could have similar consequences for global financial markets as that of the Lehman bankruptcy," the truth of the statement turned on the doubtful assumption that the federal government would be as passive in the case of AIG as it was in the case of Lehman. *AIG Risk & Bankruptcy Report*, draft of Feb. 26, 2009, at 17 (available at http://www.scribd.com/doc/13112282/Aig-Systemic-090309).

[35] One obvious political reason to avoid this approach, of course, is the presence of several foreign institutions on Table 1. Nevertheless, AIG collateral postings that benefited domestic banks can be seen as a hidden piece of the larger bailout of the financial industry – absent these collateral postings, the recipients would have required more direct aid from the government.

Lambert, and numerous other very large firms,[36] all of whom default on at least some of their obligations to other businesses, there is good reason to doubt that GM and AIG represent little more than an incremental extension of a process that seems to have worked reasonably well.

In short, the case for any sort of relationship between chapter 11 or the Bankruptcy, on the one hand, and systemic risk, on the other, is unconvincing. Rather, systemic risk may well result from poor risk management among firms, and regulatory failures that allow firms to become "too big to fail," but by the time chapter 11 comes into play, the conditions leading to the failure of the firm in question have already been created. And as I argue in the next section, chapter 11 may actually have a role to play in mitigating the effects of a large firm's failure.

II. Chapter 11 in Times of Systemic Crisis

Having dispatched the principal argument against chapter 11's role in a systemic financial crisis, the question remains – can chapter 11 play a positive role in resolving a crisis that involves not just a single debtor, but an entire network of firms?

At the outset, it is important to recognize the limitations of chapter 11 in this context. As noted, chapter 11 is inherently a case-by-case endeavor, with each case proceeding before distinct bankruptcy judges, perhaps in judicial districts spread across the country. And a

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[36] http://www.bankruptcydata.com/findabrtop.asp.

chapter 11 cases only arises after the onset of financial distress.[37] As such, chapter 11 is ill-suited to broader questions of policy, or *ex ante* prevention of crisis that are better achieved through capital requirements and financial regulation.[38] Moreover, the fractured nature of a series of bankruptcy cases within an industry makes it difficult to implement a coordinated policy response across multiple firms – although the use of chapter 11 to resolve the vexing issue of asbestos liability, with multiple firms following a template initially pioneered by the Johns Manville Company, shows that even this difficulty may not be a great as would appear at first blush.[39]

Nevertheless, it is fair to acknowledge at the outset that chapter 11's role in any systemic financial crisis will be only one part of an overall solution.

On some level, chapter 11 provides the same benefits to systemically important debtors that it provides to all debtors. Namely, the filing invokes the automatic stay, which stops all collection efforts, and the debtor obtains the ability to reshape its business by using Code provisions that allow for the rejection of contracts and the recovery of preferential and other suspect transactions.[40] Once the estate is

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[37] *See* Barbara J. Houser, *Chapter 11 as a Mass Tort Solution*, 31 LOY. L.A.L. REV. 451, 452 (1998).

[38] The point also holds for the Treasury's proposed structure for resolving financial distress among systemically significant financial firms: in the absence of *ex ante* regulation and monitoring, the system will be invoked only after a problem has become obvious. *See*, *supra* note 20.

[39] Kane v. Johns-Manville Corp., 843 F.2d 636 (2d Cir. 1988).

[40] Timothy D. Cedrone, *A Critical Analysis Of Sport Organization Bankruptcies In The United States And England: Does Bankruptcy*

remolded, the debtor benefits from the ability to bind all creditors to a plan, overcoming holdout issues, and the ability to discharge claims in exchange for proportional payment of claims.[41]

But in the context of systemic crisis, chapter 11 offers something more. First, the automatic stay, which is often criticized for delaying the exercise of non-bankruptcy rights,[42] can help contain financial distress in a sensitive industry by limiting the ability of creditors to disengage from the debtor. Socially inefficient breaches of agreements because of spite, a general fear of bankruptcy, or panic are precluded by the general prohibition on termination of contracts under "ipso facto" clauses and the automatic stay's general prohibition on attempts to take the debtor's property after the bankruptcy filing.[43]

More broadly, the imposition of the automatic stay can prevent the liquidation of the debtor's assets at firesale prices, which may have systemic effects on other, non-debtor firms.[44] For example, the quick liquidation of a systemically important debtor's assets could depress the value of comparable assets in the hands of competitor firms, potentially causing these firms to breach financial covenants in debt agreements, and thus resulting in further financial distress. The

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Law Explain The Disparity In Number Of Cases?, 18 SETON HALL J. SPORTS & ENT. L. 297, 310-12 (2008).

[41] 11 U.S.C. § 1141(a).

[42] Theodore Eisenberg, *The Undersecured Creditor in Reorganizations and the Nature of Security*, 38 VAND. L. REV. 931, 958-60 (1985); Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 188 (1989).

[43] 11 U.S.C. §365(e). *See* Lubben, *supra* note 27, at __.

[44] Edwards & Morrison, *supra* note 14, at ___.

chapter 11 process allows the debtor to avoid dismemberment by its creditors, while moving toward a rational solution for its financial distress.

Chapter 11 can play this role whether the debtor is reorganizing or liquidating. Chapter 11 is clearly better suited to reorganizing a "real economy" firm like GM. Financial firms like AIG and Lehman Brothers have traditionally employed a business model that allowed them to use their superior credit ratings to act as an intermediary between investors and security issuers. Once a financial firm's credit rating becomes less than stellar – and a chapter 11 filing is a sure way to kill a credit rating in a hurry – its very *raison d'être* evaporates. Nonetheless, chapter 11 can still provide a forum for a controlled liquidation, which is likely to result in much higher returns to creditors than a comparable chapter 7 proceeding.[45]

III. Back to 1978

One of the key limitations of using chapter 11 as part of any response to a systemic crisis is the growing numbers of creditors who are not subject to the normal rules of chapter 11. Principally this is a result of Congressional "tinkering" with chapter 11 since its enactment in 1978, a process that was greatly accelerated by the 2005 amendments to the Code.[46] But exceptions to chapter 11 have also been judicially created, and Congress' failure to address the difficult

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[45] *See* Lubben, *supra* note 19. *See also* John C. Anderson & Peter G. Wright, *Liquidating Plans of Reorganization*, 56 AM. BANKR. L.J. 29 (1982).

[46] Pub. L. No. 109-8, 119 Stat. 23 (2005).

issues presented in these instances has also expanded the number of creditors that are exempt from all or part of chapter 11.

As originally enacted in 1978,[47] the automatic stay had eight exceptions set forth in section 362, today it has approximately thirty-four.[48] In addition, several exceptions to the automatic stay have been added outside of section 362(b).[49] And while some of those exceptions are clearly only applicable in individual bankruptcy cases,[50] the vast bulk of the new exceptions come into play only in chapter 11 cases, as many of them involve various derivative contracts.

When enacted in 1978, section 362 contained a limited exception from the automatic stay for the setoff of certain commodity contracts.[51] That exception was expanded slightly in 1982,[52] and repo agreements achieved a similar exemption in 1984, inserted into section (b)(7), where commodities used to be, with commodity setoffs moving to section (b)(6).[53]

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[47] Bankruptcy Reform Act Of 1978, Pub. L. No. 95-598 (Nov. 6, 1978).

[48] The counting becomes a bit subjective with regard to provisions like § 362(b)(2), which now contains several subsections.

[49] *See, e.g.,* 11 U.S.C. §§ 362(h), 362(n).

[50] 11 U.S.C. § 362(b)(2)(E) (automatic stay not applicable to "the reporting of overdue support owed by a parent").

[51] The original section 362(b)(7) provided that the normal prohibition of post-bankruptcy setoff in section 362(a)(7) did not apply to "the setoff of any mutual debt and claim that are commodity futures contracts, forward commodity contracts, leverage transactions, options, warrants, rights to purchase or sell commodity futures contracts or securities, or options to purchase or sell commodities or securities."

[52] Pub. L. No. 97-222.

[53] Pub. L. No. 98-353, § 392. Repo agreements are essentially a

All of which laid the groundwork for "real" derivative contracts to gain special treatment under the Bankruptcy Code, beginning in 1990 with the addition of new section (b)(14) – latter to become (b)(17)[54] -- that took certain swap agreements out of the realm of the automatic stay.[55] This round of amendments was distinctive, inasmuch as Congress not only exempted the setoff of some swap transactions from the automatic stay, but also provided protection for these transactions from the debtor's avoiding powers[56] and an express exemption from section 365(e)(1), which normally prohibits termination of a contract solely because of the debtor's bankruptcy filing.[57]

The 2005 amendments completed the work of taking all derivative contracts out bankruptcy.[58] The definition of swap was extraordinarily expanded in 2005,[59] and expanded even further in 2006.[60] The current definition now includes not only swaps, but also any instrument currently used in the derivatives markets, all related agreements, such

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kind of secured loan, whereby one party sells securities to another party, at an amount less than the actual market value of the securities, with an agreement to buy back the securities at a fixed point the future for an amount equal to the sale price plus interest. In re Bevill, Bresler & Schulman Asset Management Corp., 67 B.R. 557, 567 (D.N.J. 1986).

[54] Bankruptcy Reform Act of 1994 Pub. L. No. 103-394, §501(d)(7)(B)(vii). Congress had inadvertently enacted two section (b)(14)s.

[55] Pub. L. No. 101-311, § 102(3).

[56] *Id.* at §103.

[57] *Id.* at §106 (adding §560 to the Bankruptcy Code).

[58] *See* Jonathon Keath Hance, *Derivatives At Bankruptcy: Lifesaving Knowledge For The Small Firm*, 65 WASH. & LEE L. REV. 711, 753 (2008).

[59] Pub. L. No. 109-8, § 907(a)(1)(E).

[60] Pub. L. No. 109-390, § 5 (2006).

as collateral documents, and any future instrument that might be developed in the derivatives market.[61] This stunningly broad definition supports several other new provisions in the Code that exempt swaps from the automatic stay, and all other stays, and prohibit any attempt to characterize a swap-related transaction as a preference or a fraudulent transfer – even in situations where the holder creates a setoff position after bankruptcy.[62] Indeed, because the new amendments deem swap participants to have always given "value" in connection with any transfer, even a swap transfer made with "actual intent to hinder, delay, or defraud"[63] creditors may be difficult to recover.[64]

Additionally, in 2005 the Bankruptcy Code for the first time expressly blessed derivative's industry trade group's model documents for derivative transactions. Under the ISDA forms, a wide variety of derivatives are documented under a single master agreement between

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[61] 11 U.S.C. §101(53B).

[62] 11 U.S.C. §§ 362(b)(27), 362(o), 546(g), 552(a)(2)(B)(ii) 553(a)(3)(C), 553(b)(1), 560, 561. There is an interesting, and perhaps unnoticed, drafting problem with the exemption written into §552(a)(2), in that the exemption arguably only applies to subpart (B), leaving post-bankruptcy transfers of swaps unprotected under §552(a)(2)(A). There is also a general question of what the exemption in subpart (B) really means, given that it refers to a setoff in a statutory provision that otherwise does not mention setoff. That is, it is arguable that the exception language is irrelevant to the provision in question, although the bankruptcy courts have been remarkably tolerate of Congress' drafting deficiency in interpreting the 2005 amendments to the Code. *E.g.*, In re DeSardi, 340 B.R. 790, 812-13 (Bankr. S.D. Texas 2006).

[63] 11 U.S.C. §548(a)(1)(A).

[64] *Compare* 11 U.S.C. §548(c), *with* 11 U.S.C. § 548(d)(2)(D).

two counter-parties.[65] Under bankruptcy law there is a debate whether such arrangements constitute one contract or many,[66] but for derivatives that debate is academic, as the 2005 amendments accept ISDA's argument that a derivatives master agreement and its subsidiary derivatives transactions constitute a single contract.[67]

Beyond derivatives, there are a host of other classes of creditors that have obtained at least partial immunity from chapter 11. In 2005 landlords obtained strict time limits on a debtor's ability to assume or reject a commercial lease under section 365.[68] Other counterparties have to wait until confirmation of a plan to find out if their contract will be assumed or rejected.[69]

In a large retail case where the debtor has myriad leases – Kmart had approximately 2,000 when it filed for chapter 11 – the new time limit places an unrealistic outside date on the debtor's reorganization efforts.[70] And DIP lenders are aware of this reality, and have begun setting loan terms that call for the termination of credit if a retail debtor does not adopt a plan within the time frame for assumption or

[65] Lubben, *supra* note 13, at n.65.

[66] *E.g.,* DB Structured Prods. v. Am. Home Mortg. Holdings, Inc. (In re Am. Home Mortg. Holdings, Inc.), 2009 Bankr. LEXIS 439 (Bankr. D. Del. 2009).

[67] 11 U.S.C. §§ 101(38A), 101(53B)(iv), 561.

[68] 11 U.S.C. §365(d)(4).

[69] 11 U.S.C. §365(d)(2).

[70] Debtors now have up to 210 days from the start of the bankruptcy case to assume or reject their nonresidential real property leases. If the debtor does not act within the time allotted by the statute, the lease is automatically rejected. In re Tubular Techs., LLC, 362 B.R. 243 (Bankr. D.S.C. 2006).

rejection of leases.[71] In this way, the limitations in newly amended section 365(d)(4) have become hard and fast time limitations on a retail chapter 11 case.

Other exemptions not only favor specific creditors, but also create liquidity issues for the debtor, further imperiling the chances for reorganization.[72] Utilities now have the ability to demand affirmative deposits upon bankruptcy; administrative priority no longer being sufficient under the Code.[73]

General trade creditors benefit from a host of exceptions from the normal rules. The revised "ordinary course of business" exception to the Code's preference rules protect a much broader range of transactions from being questioned and perhaps unwound post-bankruptcy[74] – allowing trade creditor substantially increased leverage against distressed companies.[75] Newly added sections of the Code

[71] *Debtors' Motion for Interim and Final Orders Pursuant to 11 U.S.C. §§ 105, 361, 362, 363 and 364 and Federal Rules of Bankruptcy Procedure 2002 and 4001 (I) Authorizing Debtors (A) to Obtain Postpetition Financing and (B) to Utilize Cash Collateral; (II) Granting Adequate Protection; and (III) Scheduling Interim and Final Hearings*, In re Circuit City Stores, Inc., Case No. 08-35653 (KRH) (Bankr. E.D. Va. Nov. 10, 2008).

[72] Levin and Ranney-Marinelli, *supra* note 22, at 605.

[73] 11 U.S.C. §366; Bertrand Pan & Jennifer Taylor, *Sustaining Power: Applying In Chapter 11 Post-BAPCPA*, 22 BANK. DEV. J. 371 (2006).

[74] Charles Jordan Tabb, *The Brave New World of Bankruptcy Preferences*, 13 AM. BANKR. INST. L. REV. 425, 440-45 (2005).

[75] 11 U.S.C. §547(c)(2). *Cf.* Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713, 775-76 (1985).

give large swaths of trade creditors administrative status[76] and enhanced reclamation rights – beyond what is provide under the state law and the UCC.[77]

These statutory provisions are further enhanced by the judicially created "necessity of payment" doctrine. This doctrine allows for the full and immediate payment of pre-petition claims of certain "critical" trade creditors, even if doing so arguably violates the Bankruptcy Code.[78] It was originally developed in railroad reorganization cases[79] – where, notably, the debtor did not have the option of liquidation[80] – and extended, somewhat debatably, to airlines in the early 1980s.[81] From that point courts have willingly allowed the payment of large masses of trade debt,[82] and even the leading circuit court opinion

[76] 11 U.S.C. §503(b)(9). Alan N. Resnick, *The Future of the Doctrine of Necessity and Critical-Vendor Payment in Chapter 11 Cases*, 47 B.C.L. REV. 183, 203-05 (2005).

[77] 11 U.S.C. §546(c); *compare* U.C.C. §2-702.

[78] *Cf.* Melissa Jacoby, *The Bankruptcy Code a Twenty-Five and the Next Generation of Lawmaking,* 78 AM. BANKR. L.J. 221, 237-38 (2004).

[79] Stephen J. Lubben, *Railroad Receiverships and Modern Bankruptcy Theory*, 89 CORNELL L. REV. 1420, ___ (2004). *See also* 11 U.S.C. §1171(b) (providing for such a special priority in railroad cases under current chapter 11).

[80] David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1325, 1355-57 (1998).

[81] In re Ionosphere Clubs, Inc., 98 B.R. 174 (Bankr. S.D.N.Y. 1989). Questionable because the analogy between early railroads and airlines is flawed.

[82] Joseph Gilday, *"Critical" Error: Why Essential Vendor Payments Violate the Bankruptcy Code*, 11 AM. BANKR. INST. L. REV. 411 (2003).

against the practice was so flip in its reasoning that it has failed to slow the growth of the exception outside of its home circuit.[83]

Another judicially created exception that Congress has failed to address – despite more than a decade of existence – is the tendency of DIP lenders to demand that a large portion of a DIP loan be used to pay off the lender's pre-petition claims against the estate.[84] Although the debtor often lacks any good alternatives in these situations,[85] and the lender often asserts that they are fully secured in any event, this sort of "rollup" of pre-petition debt is nonetheless a clear instance where a creditor avoids having to endure the normal chapter 11 process with regard to their pre-petition claim.

While some of these exceptions may have seemed reasonable in isolation, when taken together they represent serious challenges to the efficacy of chapter 11, especially when chapter 11 is to be used in times of a systemic crisis. For example, the derivative exemptions in the Code undoubtedly weighed against using chapter 11 to resolve AGI's financial distress – even though doing so may have saved billion of taxpayer dollars – because filing would have given each of AIG's counterparties an option to terminate their agreements with AIG.[86] Likewise, a GM chapter 11 filing is now tempered by the

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[83] In re Kmart Corp., 359 F.3d 866 (7th Cir. 2004) (asserting that that the "”doctrine of necessity' is just a fancy name for a power to depart from the Code”).

[84] *See* Scott Cousins, *Postpetition Financing of Dot-Coms*, 27 DEL. J. CORP. L. 759, 780-81, 800-801 (2002).

[85] In re Ames Dept. Stores, Inc., 115 B.R. 34, 39-40 (Bankr. S.D.N.Y. 1990).

[86] http://blogs.wsj.com/bankruptcy/2009/03/18/bankruptcy-for-aig-think-again/

reality that the cash requirements that faced by a debtor post-filing have increased tremendously since the 2005 amendments, further complicating an already complex chapter 11 case. More broadly, the debtor's ability to resolve its financial distress under chapter 11 is limited by the degree to which particular groups of creditors are not subject to payment and discharge under a chapter 11 plan.

In light of this, it is time for Congress to systemically evaluate chapter 11 and consider the extent to which chapter 11 would benefit from a return to its simpler form, as enacted in 1978. Certainly debtors would benefit from a more inclusive process, and it is not clear that creditors benefit from the status quo. Of course, in considering these changes Congress should also consider the extent to which court created exceptions to chapter 11 – like the necessity of payment doctrine, and other "first day" related procedures – should be codified or prohibited. Doing so might not only improve the utility of chapter 11, it might also partially reduce the incentive for very large cases to concentrate in jurisdictions that are receptive to these maneuvers.[87]

IV. Conclusion

The last decade saw the growth of what I term "chapter 11 anxiety." This fear drove moves to both avoid chapter 11 by structural manipulations – such as asset securitization – and through legislative change, such as the derivative "safe harbors." While it is still early for

[87] Stephen J. Lubben, *Delaware's Irrelevance*, 16 AM. BANKR. INST. L. REV. 267 (2008); *see also* Kenneth Ayotte & David A. Skeel, Jr., *An Efficiency-Based Explanation for Current Corporate Reorganization Practice*, 73 U. CHI. L. REV. 425 (2006).

a historical account of the current crisis, it does seem as though these moves to avoid chapter 11 and bankruptcy exacerbated the general lack of risk adversity in the financial community.

Once achieved, the apparent goal of avoiding any interaction with chapter 11 substituted for a real analysis of the risks of the underlying debt transaction. But avoiding chapter 11 is clearly not the same thing as avoiding default, and it may be that too many risk management strategies were overly content with a "bankruptcy proof" investment.

In this short paper I have argued that the fear of chapter 11 is largely misguided, and too often reflective of outdated notions of chapter 11. Whether this reflects a true lack of understanding, particularly among non-legal professionals, or a deliberate attempt to disparage chapter 11 to achieve special treatment from Congress, the time has come to examine the role chapter 11 can play in times of systemic crisis.