Transaction Simplicity

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David Skeel and Thomas Jackson come at the important question of derivatives in bankruptcy by wondering why the Bankruptcy Code was largely left out of Dodd-Frank.[1] On one level, it is an odd question: recent experience notwithstanding, the vast bulk of derivative users that find themselves in bankruptcy are not financial institutions, and financial institutions were the focus of Dodd-Frank.

Dodd-Frank itself draws a distinction between financial institutions and real economy companies with regard to derivatives: financial institutions being subjected to extra capital requirements, clearing and exchanging trading mandates with regard to derivatives, while "end users" are largely exempt.[2] This reflects the reality that while financial institutions use derivatives for myriad purposes, end users are almost exclusively hedgers, engaging in derivative trades as an ancillary part of their business.[3] And while their derivatives portfolios can undoubtedly be quite large in absolute terms, the amount of derivatives held by financial institutions is another thing altogether.[4] For example, the OCC reported in June of this year that Goldman Sachs had the fifth largest derivatives portfolio in the United States, with a total notional amount of more than $50 trillion, and the two largest derivatives traders (JP Morgan Chase and Bank of America) held portfolios of more than $70 trillion each.[5]

Of course, understanding this distinction immediately calls into question the entire foundation for all of the Code's special treatment of derivatives and repos. If a non-financial institution derivatives or repo user files for bankruptcy and the filing perturbs the financial markets, it seems more likely that this is the result of a failure

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[1] David A. Skeel, Jr. & Thomas H. Jackson, *Transaction Consistency and the New Finance in Bankruptcy*, 112 COLUM. L. REV. 152, 153-54 (2012) [hereinafter, "Skeel & Jackson"].

[2] 7 U.S.C. §§ 1a, 2, 6s. The distinction is especially clear in 7 U.S.C. § 2(h)(7). For a helpful discussion of central clearing of derivatives, see Anupam Chander & Randall Costa, *Clearing Credit Default Swaps: A Case Study in Global Legal Convergence*, 10 CHI. J. INT'L L. 639, 651 (2010).

[3] *See* Sarah Pei Woo, *Regulatory Bankruptcy: How Bank Regulation Causes Fire Sales*, 99 GEO. L.J. 1615, 1623 (2011); *see also* Erik F. Gerding, *Credit Derivatives, Leverage, and Financial Regulation's Missing Macroeconomic Dimension*, 8 BERKELEY BUS. L.J. 29, 37 (2011); Christine Cuccia, *Informational Asymmetry and OTC Transactions: Understanding the Need to Regulate Derivatives*, 22 DEL. J. CORP. L. 197, 207 (1997).

[4] Laurin C. Ariail, *The Impact of Dodd-Frank on End-Users Hedging Commercial Risk in over-the-Counter Derivatives Markets*, 15 N.C. BANKING INST. 175, 190 (2011).

[5] These numbers are gross notional amounts.

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of risk management at financial institutions than any systemic risk created by the bankruptcy. After all, a financial institutions' exposure to an "end user" is a one-way affair, and the actions of a single client should never threaten the viability of the bank. Nonetheless, systemic risk remains the primary justification for the inclusion of the "safe harbors" for financial contracts in the Bankruptcy Code.[6]

Skeel and Jackson thus correctly identify the real motivation for special treatment of derivatives and repos under the Bankruptcy Code: subsidy.[7] Taking these agreements out of the normal bankruptcy process means that counterparties do not have to incur the cost of the collective process used in this country to resolve financial distress.[8] While chapter 11 is generally assumed to be socially efficient, exemption from chapter 11 allows counterparties to make a socially inefficient but individualistically valuable decision.[9] In short, the special treatment of derivatives and repo agreements under the Bankruptcy Code is a subsidy to the financial industry, and its time it was recognized as such.[10]

Whether the subsidy is a good thing is unclear.[11] One the one hand, evasion of the bankruptcy system has obvious costs for unsubsidized creditors and other stakeholders like employees. Namely, the bankruptcy process is less useful to these creditors, and they bear more of the bankruptcy system's cost if subsidized creditors are allowed to opt out. On the other hand, the loss of the subsidy would increase the costs of hedging, resulting in either increased cost or risk to corporations from

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[6] Kenneth Ayotte, David A. Skeel, Jr., *Bankruptcy or Bailouts?*, 35 J. CORP. L. 469, 494 (2010); Bryan G. Faubus, *Narrowing the Bankruptcy Safe Harbor for Derivatives to Combat Systemic Risk*, 59 DUKE L.J. 801, 825 (2010).
[7] Skeel & Jackson, *supra* note 1, at 155.
[8] *See* Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1567-68 (2008) (making a similar point with regard to asset securitization).
[9] In re Nat'l Gas Distributors, LLC, 556 F.3d 247, 259 (4th Cir. 2009).
[10] Michael S. Knoll, *Put-Call Parity and the Law*, 24 CARDOZO L. REV. 61, 62 (2002).
[11] *See* Colleen M. Baker, *Regulating the Invisible: The Case of Over-the-Counter Derivatives*, 85 NOTRE DAME L. REV. 1287, 1303 (2010).

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unviable hedges,[12] which itself has positive cost.[13] How these two costs balance out – and the net cost of the safe harbors – is unclear, and perhaps unknowable.[14]

Skeel and Jackson spend the bulk of their essay arguing for a complete rethink of derivatives and repos in bankruptcy, a project that they put under the general heading of "transactional consistency." In short, they argue that repos should be treated as secured financing, save for where the repo is based on cash-like collateral.[15] Swaps should be treated as regular contracts, insurance contracts, or financing, depending on their true purpose.[16]

I am largely sympathetic to the project, having argued myself that straight repeal of the "safe harbors" is often little more than an unrealistic thought exercise.[17] But I also worry that Skeel and Jackson have a bit too much faith in their new categories. To some degree they have replaced one set of exceptions with another. I thus use this short response essay to outline these concerns and suggest a simpler solution to the issue.

I embrace the basic Skeel and Jackson premise that like agreements should be treated alike under the Bankruptcy Code. But I depart from them insomuch as they engage in a resorting of agreements: repos would be treated one way under their proposals, swaps another.[18] As the recent efforts to draft the content of the Volcker rule have shown, translating financial transactions into legislative rules is no easy task.[19] Moreover, we should never doubt the creativity at work in financial institutions. Skeel and Jackson address swaps throughout their article, but what of the various combinations of forwards, options, linear certificates, structured notes, correlation products and whatnot that can achieve the same ends?

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[12] This does assume that the derivatives market is price competitive and subsidies pass through financial institutions to end users. There are reasons to doubt this currently holds, although market features introduced by Dodd-Frank – like exchange trading – might make it so in the future. *Cf.* Aaron Unterman, *Innovative Destruction-Structured Finance and Credit Market Reform in the Bubble Era,* 5 HASTINGS BUS. L.J. 53, 94 (2009).

[13] *See* Peter H. Huang & Michael S. Knoll, *Corporate Finance, Corporate Law and Finance Theory,* 74 S. CAL. L. REV. 175, 185-86 (2000); *see also* David B. Spence, *Can Law Manage Competitive Energy Markets?,* 93 CORNELL L. REV. 765, 805 (2008).

[14] *See* Kristin N. Johnson, *Things Fall Apart: Regulating the Credit Default Swap Commons*, 82 U. COLO. L. REV. 167, 205 (2011).

[15] Skeel & Jackson, *supra* note 1, at 179.

[16] Skeel & Jackson, *supra* note 1, at 180-81.

[17] *See generally* Stephen J. Lubben, *The Bankruptcy Code Without Safe Harbors*, 84 AM. BANKR. L.J. 123 (2010).

[18] *E.g.,* Skeel & Jackson, *supra* note 1, at 199 (summarizing their proposal).

[19] http://thehill.com/blogs/on-the-money/banking-financial-institutions/214395-sec-head-indicates-slow-going-on-volcker-rule

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And their basic project is still largely based on two financial institutions as counterparties, which may reflect the bulk of the derivatives and repo markets, but plays a relatively small part in chapter 11, and is apt to get even smaller with the creation of the new Orderly Liquidation Authority.[20]

I therefore conclude by arguing that two simple changes would better address the pressing problems of the special treatment of derivatives in bankruptcy. First, opening the door to judicial recharacterization of putative derivatives and repos that are really just disguised versions of other transactions would solve much of the problem associated with the overbroad safe harbors. A supply contract that is rewritten as a swap should be treated as a supply contract, and the bankruptcy court should have the power to do just that. This is a simpler version of transactional consistency.

And the Bankruptcy Code should be harmonized with Dodd-Frank. This is the simpler, immediate solution to Skeel and Jackson's concerns about financial institutions in bankruptcy, and if we are to take the financial regulators at their word, we must anticipate that a few financial institutions will be resolved under chapter 11. If chapter 11 is the complement to OLA, there should be consistency amongst the two proceedings.

These are not perfect solutions, but rather first steps. They are, however, steps that should be easily achievable.

I. The Problem of Derivatives in Bankruptcy

Derivatives and bankruptcy interact in strange ways, creating strange laws.[21] But one of the most fundamental problems is that discussions of "derivatives" in this context sweep up the rather distinct issue of repurchase agreements, which are

[20] *See* Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 488 (2011).
[21] Given the space constraints of this short essay, I assume the reader is familiar with the treatment of derivatives and repos under the Bankruptcy Code, particularly post 2005. If not, good reading on the topic includes Stephen J. Lubben, *Repeal the Safe Harbors*, 18 AM. BANKR. INST. L. REV. 319 (2010); Mark J. Roe, *The Derivatives Market's Payment Priorities As Financial Crisis Accelerator*, 63 STAN. L. REV. 539 (2011); Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019 (2007); Michael Simkovic, *Secret Liens and the Financial Crisis of 2008*, 83 AM. BANKR. L.J. 253 (2009). For something even more concise, see http://rortybomb.wordpress.com/2010/05/06/an-interview-about-the-end-user-exemption-with-stephen-lubben/

treated the same as traditional derivatives under the Bankruptcy Code but are otherwise quite distinct.[22]

Derivatives are at heart contracts.[23] Repos, however, are financing.[24]

Contracts are subject to the debtor's special power to assume (perform) or reject (breach).[25] Financing, on the other hand, is considered to be among the special class of agreements, like personal service contracts, that are exempt from this normal rule.[26]

By the time of bankruptcy, financing has typically transformed itself into debt. The corporate debtor that enters chapter 11 with untapped sources of liquidity is a rare bird indeed.

Skeel and Jackson spend a good bit of time grappling with these issues, before ultimately coming to some sensible conclusions with regard to swaps.[27] But there are some bigger issues that loom here, and some non-problems that also cloud the Skeel-Jackson analysis.

The basic issue is that contracts of all sorts are subject to default. If an entire class of contracts is subject to rumors or fears of default, that type of contract is subject to a run.[28] Once a class of contract or debt instrument becomes subject to a run, it ceases to have value in the market, and we then term it "illiquid." Often this is a temporary condition, but it can also be self-reinforcing.

Based on these simple truths, and a semi-plausible argument that derivatives were especially likely to be subjected to runs and illiquidity, the derivatives industry persuaded Congress to enact a series of "safe harbors" for derivatives.[29] In

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[22] *See* Eleanor Heard Gilbane, *Testing the Bankruptcy Code Safe Harbors in the Current Financial Crisis*, 18 AM. BANKR. INST. L. REV. 241, 268 (2010).
[23] Stephen J. Lubben, *Derivatives and Bankruptcy: The Flawed Case for Special Treatment*, 12 U. PA. J. BUS. L. 61, 68-73 (2009).
[24] Granite Partners L.P. v. Bear, Sterns & Co., 17 F. Supp. 2d 275, 301 (S.D.N.Y. 1998).
[25] 11 U.S.C. § 365.
[26] 11 U.S.C. § 365(c).
[27] Although their conclusion that a ISDA master agreement and all subsidiary documents must constitute a single agreement, even in the absence of the safe harbors, is not nearly as clear as they make it out to be. *See* Rhett G. Campbell, *Energy Future and Forward Contracts, Safe Harbors and the Bankruptcy Code*, 78 AM. BANKR. L.J. 1, 44 (2004).
[28] *See* Charles K. Whitehead, *Reframing Financial Regulation*, 90 B.U. L. REV. 1, 23 (2010).
[29] Thomas J. Giblin, *Financial Markets in Bankruptcy Court: How Much Uncertainty Remains After BAPCPA?*, 2009 COLUM. BUS. L. REV. 284, 289 (2009); Shmuel Vasser, *Derivatives in Bankruptcy*, 60 BUS. LAW. 1507, 1511 (2005).

particular, financial institutions have large gross exposures to derivatives and would like to be assured that their net exposures are what really matter.[30]

Actually the argument began with the Federal Reserve and the concern over the failure of a few repo dealers shortly after the enactment of the current Code in 1978.[31] The swaps dealers, and their allies in Treasury and the FDIC simply used the preexisting repo safe harbors to gain special treatment for derivatives too.[32] Thus, repo and derivatives became linked together in the world of bankruptcy.

The end result is that both repos and derivatives are exempt from the normal rules of bankruptcy: there is no automatic stay, there are no avoidance actions, and the debtor does not get to decide whether to assume or reject contracts that are still executory upon bankruptcy.[33] After 2005 the definitions of the relevant repos and derivatives were expanded, resolving every possible doubt in the prior definitions in an industry favorable way, so that now anything that even "sort of" looks like a covered transaction can be arguably included within the safe harbors.[34]

Although I might put the emphasis in different spots – and doubt that the safe harbors really had much role to play in Lehman's infamous "repo 105" – Skeel and Jackson correctly identify many of the pernicious effects.

Because of the subsidy given to repo and derivatives, the debtor's cost of capital will be lower if it can finance itself with either of these two classes of instruments.[35] The safe harbors thus encourage overuse, especially since most of the bad effects of overuse are likely to occur far in the future, in a state of failure that managers will understandably discount. This overuse become extreme in cases where "normal" contracts become recast as either type of financial contract.

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[30] http://www.isda.org/researchnotes/pdf/Netting-ISDAResearchNotes-1-2010.pdf

[31] Bevill, Bresler & Schulman Asset Management Corp. v. Spencer S & L Ass'n. (In re Bevill, Bresler & Schulman Asset Mgt. Corp.), 878 F.2d 742, 745-50 (3d Cir. 1989).

[32] Timothy P.W. Sullivan, *Swapped Disincentives: Will Clearinghouses Mitigate the Unintended Effects of the Bankruptcy Code's Swap Exemptions?*, 80 FORDHAM L. REV. 1491, 1510 (2011).

[33] For example, with regard to swaps see sections 362(b)(17) (exemption from automatic stay), 546(g) (exemption from certain avoiding powers), and 560 (preserving rights of termination including under an ipso facto clause, close-out netting and swap enforcement) of the Bankruptcy Code.

[34] John J. Chung, *From Feudal Land Contracts to Financial Derivatives: The Treatment of Status Through Specific Relief*, 29 REV. BANKING & FIN. L. 107, 133 (2009); Stephen J. Lubben, *Systemic Risk & Chapter 11*, 82 TEMP. L. REV. 433, 443 (2009).

[35] I am implicitly assuming that Modigliani & Miller overstated their case, and that the debtor can avoid paying more to subordinated creditors. *See* John D. Ayer, *The Role of Finance Theory in Shaping Bankruptcy Policy*, 3 AM. BANKR. INST. L. REV. 53, 60 (1995).

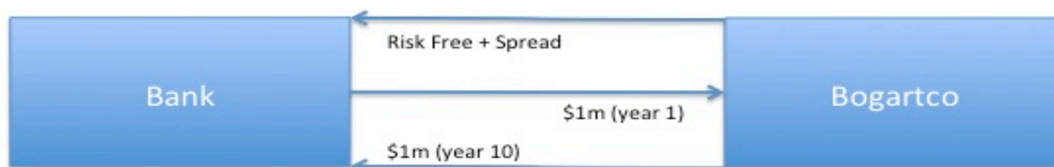
And while Dodd-Frank has created a new bankruptcy system for financial institutions, it did not replace the Bankruptcy Code in all instances.[36] Indeed, FDIC indicates that chapter 11 remains the primary framework for resolving financial distress in these institutions. In this light, we then need to worry about the ways in which the safe harbors create runs in repos and derivatives markets, given the extensive involvement of most financial institutions.

It is these two problems, and my proposed solutions, that are the most pressing issues with regard to financial contracts in bankruptcy. They animate the remainder of this short paper.

II. The Problem of Pretend Derivatives

Whatever position one might have regarding the special treatment of financial contracts under the current Bankruptcy Code, it seems unquestionably problematic that the definitions of things like "swap" was left so open-ended that it could potentially cover relatively mundane contracts.

Consider, for example, a hypothetical debtor: Bogartco, a leading manufacturer of trenchcoats and fedoras. Bogartco enters a transaction with a bank whereby the bank gives Bogartco $1 million and Bogartco promises to repay that sum in ten years. In the interim, Bogartco promises to make periodic interest payments to the bank. To secure its performance, Bogartco agrees to provide the bank with a lien on its property, plant, and equipment (PP&E). The cash flows would look like this:



This is rather clearly a secured loan. But what if the original deal was modified as follows:

[36] Hollace T. Cohen, *Orderly Liquidation Authority: A New Insolvency Regime to Address Systemic Risk*, 45 U. RICH. L. REV. 1143, 1151 (2011).

And replace the security interest with "margin," represented by the grant of an interest in Bogartco's PP&E.

Note that the economics of the transaction have not changed – the additional risk free rate payments cancel each other out. Nonetheless, there is an argument that the second transaction is a swap[37] – especially if memorialized under the ISDA form documents used to document derivatives trades.[38]

If the payments were made in different currencies the transaction would easily fit within the safe harbors, as currency swaps are some of the few transactions to involve the exchange of principal.[39] Bogartco could then be obligated by the bank to hedge the currency risk in the transaction with another safe harbored instrument.

A similar, if somewhat lesser, situation exists with regard to the definition of "repurchase agreement" under the Code.[40] Essentially any loan collateralized by certificates of deposit, bankers' acceptances, US or other OECD government securities, mortgage loans or interests in the same, including MBS, with less than a one year term fits within the safe harbor. In an extreme case, the debtor could grant a security interest in a large portion of its cash – in the form of a CD – which essentially exposes the lender to no risk so long as fully collateralized, yet the loan will still be exempt from the automatic stay.[41]

These provisions thus exclude legitimate financial contracts – things we would think really are swaps, forwards, and repos – from the scope of the Bankruptcy Code. But they also exclude pretend financial contracts from the Code, to such a degree that there might not be much left of the debtor to reorganize once enough contracts get rewritten to take advantage of the expansion of the safe harbors in 2005.[42]

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[37] 11 U.S.C. § 101(53B)(A)(ii).
[38] *See* In re Enron Corp., 328 B.R. 58, 70 (Bankr. S.D.N.Y. 2005).
[39] *See* Jennifer A. Frederick, *Not Just for Widows & Orphans Anymore: The Inadequacy of the Current Suitability Rules for the Derivatives Market*, 64 FORDHAM L. REV. 97, 99 n.8 (1995).
[40] 11 U.S.C. § 101(47).
[41] 11 U.S.C. § 362(b)(7).
[42] The definitions were also expanded in 2006, but for ease I collapse the two changes to the Code and refer to the "2005 changes" throughout. Seth Grosshandler & Kate A. Sawyer, *The Financial Netting Improvements Act of 2006 Clarifies the*

While Skeel and Jackson would argue for a broad rethink of the special treatment of derivatives generally, and I have undeniably done the same in the past too, it seems time to admit that such a broad approach leads to a dead-end. Namely, derivatives have become integrated into the American economy, so that even a mid-cap manufacturing company will have a portfolio of interest rate and currency swaps to hedge its loans and foreign operations. Removing the bankruptcy subsidy to these contracts will result in higher prices for the hedge.

Maybe the higher prices are outweighed by the net social benefits of not subsidizing derivatives. However, maybe they are not, and the true answer is essentially an unanswerable empirical question.

But it seems unquestionable that efforts to sneak "regular" contracts into the financial contracts provisions in the Code are pernicious, and could eventually destroy the benefits of chapter 11. As such, I argue in the conclusion for an increase in bankruptcy court's powers to police the line between true financial contracts and pretend financial contracts.

But I first explain the other issue in need of immediate attention: the impossibility of financial institutions in a bankruptcy case under the Bankruptcy Code.

III. Dodd-Frank's Partial Solution to Orderly Liquidation

Dodd-Frank's Title II creates a new Orderly Liquidation Authority that potentially replaces chapter 11 as the resolution tool for bank holding companies and their non-regulated subsidiaries.[43] It only potentially displaces chapter 11 because chapter 11 remains in place unless financial regulators decide to invoke OLA,[44] through a intricate process that culminates with the D.C. District court having 24 hours to say "no" under very controlled circumstances.[45]

In essence, OLA expands the FDIC's bank receivership powers to cover a greater part of the financial institution.[46] This allows the FDIC to conduct a purchase and assumption transaction with regard to non-depository bank parts of the institution, or transfer the institution to a newly created "bridge bank."[47] The latter allows the FDIC to split the good assets from the bad, in a process that is very much like that

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Bankruptcy Protections and Promotes Netting for Qualifying Derivative Transactions, 124 BANKING L.J. 523, 525 (2007).

[43] 12 U.S.C. §§ 5381-94. *See also* Stephen J. Lubben, *Resolution, Orderly and Otherwise: B of A in OLA*, – U. CIN. L. REV. – (forthcoming 2012)

[44] 12 USCS § 5382(c)(1); *see* 12 USC §§ 5388, 5383(b)(2).

[45] 12 USC § 5382; *see also* 12 USC § 5383.

[46] 12 USCS § 5384(b).

[47] 12 USC § 5390.

used in "363 sales" under chapter 11, widely publicized by the automotive chapter 11 cases.[48]

Importantly, FDIC is granted a one-day stay on counterparties' ability to terminate their derivative contracts.[49] This obviously facilitates the sale of the debtor financial institution in a way that is lacking under the Bankruptcy Code, where there are no restraints on counterparties ability to terminate derivatives contracts.[50] Similarly, under Dodd-Frank FDIC has an ability to nullify *ipso facto* clauses in financial contracts between subsidiaries and counterparties that are triggered solely because of the parent company's OLA filing.[51]

In short, under OLA the debtor's derivatives book can remain intact; under chapter 11 it will be pulled to pieces. Nonetheless, FDIC and Treasury have asserted that bankruptcy remains the preferred solution for financial distress in financial institutions. OLA is only to be used when the debtor's distress threatens to cause systemic problems.

The reason for the disparity is puzzling, especially if one focuses on situations where there has been no performance default on the debtor's financial contracts. Why particularly should a systemic crisis provide an occasion for the preservation of going concern value, whereas such value is destroyed in all other situations?

Moreover, the potential disruption in the derivatives markets caused by the chapter 11 case of a financial institution could itself necessitate invoking OLA. If the regulatory community is serious about making chapter 11 the primary tool for resolving financial distress in this area, that would itself seem like another reason to achieve some degree of parity with regard to financial contracts.

For the "end users" of financial contracts, the unequal treatment of financial contracts is all the more stark, since by and large these debtors will never be eligible to reorganize under OLA.[52] The airline that has hedged its fuel needs might rightly wonder why it must loose its hedges upon bankruptcy, whereas its counterparty, a major financial institution, can demand the airline's continued performance after

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[48] Stephen J. Lubben, *No Big Deal: The GM and Chrysler Cases in Context*, 83 AM. BANKR. L. J. 531 (2009). *See also* Stephanie Ben-Ishai & Stephen J. Lubben, *Sales or Plans: A Comparative Account of the "New" Corporate Reorganization*, 56 MCGILL L.J. 591 (2011).
[49] 12 U.S.C. § 5390(c)(10)(B)(i).
[50] 12 C.F.R. pt. 380.
[51] 12 U.S.C. § 5390(c)(16). On March 20, 2012, FDIC issued its Notice of Proposed Rulemaking setting forth the proposed rule (the "Proposed Rule") to implement this section.
[52] I use the term "reorganize" intentionally, despite OLA's claimed model of "liquidation only." A recapitalized financial institution has been reorganized, whatever the language of the statue.

the FDIC takes over the bank as receiver. This exposes the one-way direction of the safe harbors, especially after the advent of Dodd-Frank.[53]

IV. Conclusion: Simple Solutions

In an ideal world, the treatment of derivatives under the Bankruptcy Code, SIPA, OLA, and other insolvency statutes would be entirely reconsidered, and these various insolvency systems would be further integrated.[54] The legitimate concerns that support the safe harbors in all of these statutes could be addressed in a far more narrowly tailored way.[55] But given the larger, difficult empirical questions I identified at the outset of this paper, this discussion is not apt to be easy or quick.

But in the interim, the key problems identified herein could be addressed. First, the problem of pretend financial contracts could be addressed by a little faith in judicial discretion – admittedly something Congress showed little regard for in 2005.[56]

Nonetheless, in virtually every other context the bankruptcy judge is empowered to recast a transaction to reflect its true nature.[57] This principal has a long history.[58]

If the bankruptcy court had such a power with regard to putative financial contracts, it would give the court the ability to police the boundaries between the legitimate goals of the safe harbors and their potential, particularly post 2005, to swallow the

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[53] Stephen J. Lubben, *Financial Institutions in Bankruptcy*, 34 SEATTLE U. L. REV. 1259, 1261 (2011).
[54] Brett McDonnell, *Don't Panic! Defending Cowardly Interventions During and After A Financial Crisis*, 116 PENN ST. L. REV. 1, 51 (2011).
[55] *See* Lubben, *supra* note 17.
[56] Lauren E. Tribble, *Judicial Discretion and the Bankruptcy Abuse Prevention Act*, 57 DUKE L.J. 789, 804 (2007).
[57] In re SubMicron Sys. Corp., 432 F.3d 448, 454-56 (3d Cir. 2006); International Trade Admin. v. Rensselaer Polytechnic Inst. (In re Rensselaer Polytechnic Inst.), 936 F.2d 744 (2d Cir. 1991); Roth Steel Tube Co. v. Comm'r of Internal Revenue, 800 F.2d 625, 630 (6th Cir. 1986); In re BH S & B Holdings LLC, 420 B.R. 112, 157 (Bankr. S.D.N.Y. 2009) aff'd as modified, 807 F. Supp. 2d 199 (S.D.N.Y. 2011); In re Commercial Loan Corp., 316 B.R. 690, 700 (Bankr. N.D. Ill. 2004). *See* Robert D. Aicher & William J. Fellerhoff, *Characterization of A Transfer of Receivables As A Sale or A Secured Loan Upon Bankruptcy of the Transferor*, 65 AM. BANKR. L.J. 181, 183 (1991) (noting the various legal context in which recharacterization issues can arise); Michael Simkovic*, Secret Liens and the Financial Crisis of 2008*, 83 AM. BANKR. L.J. 253, 281 (2009).
[58] Home Bond Co. v. McChesney, 239 U.S. 568, 575 (1916). James M. Wilton & Stephen Moeller-Sally, *Debt Recharacterization Under State Law*, 62 BUS. LAW. 1257, 1268 (2007).

whole of the Bankruptcy Code.[59] In essence, this would amount to an antievasion rule, such as are common in many other corporate statutes[60] – including recently enacted provisions of Dodd-Frank.[61] In this case, the court's ability to recharacterize would work as a prohibition on evasion of the Bankruptcy Code.

The great bugaboo of a rouge bankruptcy judge would undoubtedly be raised against such move. But financial contracts are most apt to be an issue in large chapter 11 cases, the kind that are most likely to be filed in front of experienced bankruptcy judges.[62] It seems farfetched to assume these judges would not "get it."

Similarly, regardless of the type of debtor, it seems that if financial institutions are allowed twenty-four hours to save their financial contracts, real economy companies should also have this option. Moreover, if financial institutions are to ever use chapter 11 as their resolution tool, such a change is quite obviously necessary.

Thus, the Bankruptcy Code should be amended to allow debtors one day to assume or reject their swaps and other derivatives before counterparties can terminate those contracts. If the debtor assumes a swap, only performance related defaults would justify termination going forward.

Two practical changes that would go a long way toward addressing the very serious issue of derivatives in bankruptcy.

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[59] *Cf.* Shu-Yi Oei, *Context Matters: The Recharacterization of Leases in Bankruptcy and Tax Law,* 82 AM. BANKR. L.J. 635, 655 (2008).
[60] *E.g.,* Section 30(b) of the Securities Exchange Act of 1934.
[61] *E.g.,* 12 U.S.C. §§ 1851(e), 5323(c).
[62] Troy A. McKenzie, *Judicial Independence, Autonomy, and the Bankruptcy Courts*, 62 STAN. L. REV. 747, 781 (2010).