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# **Bankruptcy Boundary Games**

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## BANKRUPTCY BOUNDARY GAMES

David A. Skeel, Jr.<sup>1</sup>

### Introduction

A century ago, securities law and corporate reorganization were flip sides of the same coin. When a company sold stock and bonds to the public, an investment bank—usually J.P. Morgan or another of a small handful of dominant banks—underwrote the issuance, with the help of its Wall Street lawyers.<sup>2</sup> If the company later defaulted, the same Wall Street bank stepped in, formed a committee to represent the investors who held the bonds or stock it had underwritten, and negotiated with the company’s managers on their behalf. Equity receivership, as corporate reorganization was known then, was simply one facet of corporate and securities law.

The legislative reforms of the New Deal drove a sharp wedge between these two previously connected areas of law. The most important blow was struck by the Chandler Act of 1938, which quite consciously ended the old equity receivership practice.<sup>3</sup> In

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<sup>1</sup> S. Samuel Arsht Professor, University of Pennsylvania Law School. Thanks to David Gunther and Daniel Rubin for helpful research assistance, and the the University of Pennsylvania Law School for generous summer support.

<sup>2</sup> The historical details in this paragraph and the next are treated at greater length in DAVID A. SKEEL, JR., *DEBT’S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA* (2001).

<sup>3</sup> Corporate reorganization had been codified in 1933 (railroad reorganization) and 1934 (reorganization of other large corporations), but the earlier reforms largely preserved existing practice.

addition to displacing a debtor's managers, the Chandler Act prohibited the Wall Street banks and lawyers that had represented a debtor prior to bankruptcy from participating in the bankruptcy case. Within a few years, Wall Street corporate reorganization practice had largely disappeared. Almost the only source of continuity between securities law and bankruptcy practice was the Securities and Exchange Commission (SEC), which was given a prominent role in corporate reorganization by the Chandler Act.

During this same era, Congress also passed the two securities acts, which put securities law on a federal footing and laid the groundwork for what quickly became an immensely complicated area of law.<sup>4</sup> The ever increasing complexity of securities law further reinforced its separation from the (similarly complex) bankruptcy process.

As with other points of separation between bankruptcy and related regulatory regimes,<sup>5</sup> the isolation of bankruptcy from securities law has created boundary issues in places where they overlap. The drafters of the Bankruptcy Code could respond to the overlapping domains in any of three ways: by overriding the securities law in order to promote bankruptcy principles, by allowing both sets of rules to apply, or by deferring to the securities laws. One can find evidence of each of the three approaches. First, with some issues, such as the securities law rules dealing with offerings of corporate securities, the drafters have concluded that bankruptcy law adequately addresses the

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<sup>4</sup> The Securities Act of 1933 was one of the laws enacted during Franklin D. Roosevelt's first hundred days; the Securities and Exchange Act of 1934, which established the SEC, followed a year later. *See, e.g.,* JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* (1982).

<sup>5</sup> For a detailed analysis of another boundary, the separation between bankruptcy and state corporate law, see David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 *TEX. L. REV.* 471 (1994).

concerns that animate the securities laws. When it issues new stock or debt in connection with a reorganization plan, the debtor is excused from complying with the requirements of the 1933 Act.<sup>6</sup>

Perhaps the best illustration of the second stance, coexistence, is the antifraud provisions of the securities laws. Although bankruptcy has a welter of bankruptcy-specific antifraud laws,<sup>7</sup> it does not displace securities law antifraud provisions such as section 10(b) and Rule 10b-5, which prohibit insider trading and misdisclosure. In consequence, the securities law provisions intersect with the bankruptcy framework in sometimes awkward fashion.<sup>8</sup>

This article is concerned with the last of the three responses. With another set of issues, Congress has concluded that ordinary bankruptcy principles should give way in an area of overlap between bankruptcy and securities law. The normal operations of bankruptcy law for corporate debtors are called off in order to effectuate other important principles, such as the smooth functioning of the securities markets.

In the first three parts of this Article, I take up three of these issues in turn: the exclusion of brokerage firms from Chapter 11; the protection of settlement payments

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<sup>6</sup> 11 U.S.C. sec. 1145(a).

<sup>7</sup> See, e.g., Leah Lorber & Bruce A. Markell, *Bankruptcy Crimes and the Federal Sentencing Guidelines*, 7 FED. SENTENCING REP. 49 (1994)(describing bankruptcy crime provisions).

<sup>8</sup> A particular issue is the application of Rule 10b-5 to the members of creditors committees. Institutions that actively trade are wary of serving on the committee for fear that privileged information they receive as a committee member would expose them to insider trading liability if they bought or sold securities of the debtor during the case. The standard prophylactics are the use of a “Chinese Wall” and, more recently, so-called “Big Boy” letters. See, e.g., Daniel Sullivan, *Comment, Big Boys and Chinese Walls*, 75 U. CHI. L. REV. 533 (2008).

from avoidance as preferences or fraudulent conveyances; and the exemption of derivatives from the automatic stay and other basic bankruptcy provisions. I begin each part by discussing the provision and the concern it was designed to address. I then identify and assess important unintended consequences of the provisions. Both Drexel Burnham and Lehman Brothers evaded the brokerage exclusion, for instance, when these investment banks filed for bankruptcy; and the settlement provision has been invoked in several high profile contexts that do not fit neatly within the core cases for which it was designed. The application of the special derivatives provisions has also raised even more questions, once again most prominently in the Lehman bankruptcy.

In the final part of the Article and in a brief conclusion, I explore the implications of the awkward interaction between bankruptcy and securities law. I begin by speculating about how bankruptcy courts will handle each of these issues if Congress does not alter the current rules. I then consider how Congress might intervene in these areas to address some of the problems that have arisen. I focus most extensively on the most complex of the issues, bankruptcy's special protections for derivatives and other financial contracts. After surveying possible alternatives to the existing framework, I propose and defend two strategies for reform: under the first and more novel, the stay would apply in cases involving systemically important firms but not in other cases; and the second would simply remove the existing exemptions, imposing the stay in all cases. I argue that the choice between the two approaches depends on the overall structure of financial services regulation.

The frictions between bankruptcy and securities law have increased with the growth in financial innovation in the past several decades. But the wall of separation between these two areas is rapidly eroding at the same time. If the erosion translates to less deference to the securities industry and more careful oversight of the bankruptcy-securities law intersection by Congress, it may, I conclude, justify cautious optimism about the future integration of these long estranged bodies of law.

## **I. The Brokerage Exclusion from Chapter 11**

From its original enactment in 1978, the Bankruptcy Code has excluded brokerages from Chapter 11, based on a concern for the protection of customer accounts and a perception that the rules governing customer accounts would make a Chapter 11 reorganization prohibitively complex.<sup>9</sup> The drafters of the provisions seem to have contemplated that troubled brokerages would be liquidated in Chapter 7, and that the liquidation would be coordinated with the insurance scheme for brokerage customers established by the Securities Investor Protection Act of 1970.<sup>10</sup>

With the benefit of twenty-twenty hindsight, we can see that the brokerage exclusion was designed with the brokerages of the 1960s particularly in view<sup>11</sup>—brokerages that were set up as partnerships and generally provided brokerage and

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<sup>9</sup> 11 U.S.C. sec. 109(d). The Bankruptcy Code includes special provisions for the protection of customer accounts in Chapter 7 in 11 U.S.C. sec. 741-767.

<sup>10</sup> For an overview of the background and structure of the SIPA, see Hugh L. Sowards & James S. Mofsky, *The Securities Investor Protection Act of 1970*, 26 BUS. L. 1271 (1971).

<sup>11</sup> *See generally id.* at 1271-72 (describing SIPA as a response to the brokerage failures of the late 1960s and early 1970s).

advisory services. The investment banking business had not yet been transformed by investment bank IPOs and the shift to proprietary trading as a major source of investment bank profits.<sup>12</sup> Unlike their 1960s predecessors, most current investment banks have a complex capital structure consisting of multiple (sometimes hundreds or thousands of) entities.

The two major investment banking failures since the implementation of the exclusion have shown that, at least in the current environment, the special rules are quite easily evaded. When Drexel Burnham filed for bankruptcy in 1990, it filed a Chapter 11 petition for its holding company, and kept its brokerage subsidiary out of bankruptcy until it had time to move all of the customer accounts. Lehman Brothers used roughly the same strategy, putting its holding company in Chapter 11 and forgoing bankruptcy for its brokerage subsidiaries.<sup>13</sup>

Lehman added a clever twist to the strategy earlier used by Drexel. Lehman's principal objective when it filed for bankruptcy was to quickly complete a sale of its brokerage operations to Barclays. There was one small problem with the sale, however. The power of the debtor to propose, and of the bankruptcy court to approve, sales free and clear of existing liabilities only extends to property of the bankruptcy estate.<sup>14</sup>

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<sup>12</sup> Morrison and Wilhelm explain the shift to proprietary trading as a response to technological change that diminished the value of the tacit knowledge that traditionally had been banks' stock in trade. This and the need for capital made the traditional partnership structure less attractive than shifting to corporate form. ALAN D. MORRISON & WILLIAM J. WILHELM JR., *INVESTMENT BANKING: INSTITUTIONS, POLITICS, AND LAW* (2007).

<sup>13</sup> The Drexel and Lehman bankruptcies are discussed in more detail in Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts?* (unpublished manuscript, 2009).

<sup>14</sup> 11 U.S.C. sec. 363(b)(1) ("trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, *property of the estate*") (emphasis added).

Because the brokerage subsidiary had not filed for bankruptcy, its assets were not part of Lehman's bankruptcy estate and thus technically were not subject to the bankruptcy court's power to authorize a sale.

To square the circle, Lehman coordinated with the SEC to set up a SIPC proceeding for its North American brokerage operations simultaneously with the sale of the assets to Barclays.<sup>15</sup> The brokerage entered liquidation just soon enough to whitewash the assets on their way to Barclays. Objectors challenged this maneuver at the hearing on Lehman's sale, arguing that the brokerage was never property of the bankrupt entities' estates and thus that the bankruptcy court lacked the power to authorize a sale. But the court overruled the objections and permitted the sale to go through.<sup>16</sup>

The Lehman sale was a tribute to bankruptcy lawyers' ingenuity in circumventing a framework that may once have made sense, but is anachronistic in the current investment banking environment. The sale to Barclays clearly was in the best interests of Lehman and its creditors, as the value to Lehman of the brokerage operations would have vanished otherwise.<sup>17</sup> If the bankruptcy laws permitted an investment bank to file for Chapter 11, the fancy footwork used to make the sale possible would not have been necessary. The brokerage exclusion might be justified, despite this effect, if its original

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<sup>15</sup> Lehman's bankruptcy filing and the early sales are described in Ben Hallman, *A Moment's Notice*, AMER. LAWYER, Dec. 2008, at 85.

<sup>16</sup> Email Correspondence from Martin Bienenstock to David Skeel (June 2009)(describing the objection and the court's dismissal).

<sup>17</sup> Whether value in an absolute sense would have disappeared is not quite as clear. If the brokerage operations had independent franchise value as a unit, that value might have been undermined by delay. But if the value was simply a function of human capital of individual employees, the principal effect of delay might have been distributive, with Lehman losing their value and another bank gaining it without compensating Lehman.



rationale—that Chapter 11 would be a quagmire, while Chapter 7 meant an orderly unwinding—held true. But the Drexel and Lehman experience suggests that investment banks are likely to be sold rather than reorganized in Chapter 11, and that Chapter 11 is an effective venue for achieving this.<sup>18</sup> In each case, the Chapter 11 proceeded in two steps: an effort to rapidly sell assets whose value was time sensitive, followed by a more leisurely disposition of the firm’s other assets.<sup>19</sup>

In Part IV, we will consider the obvious implications of this experience.<sup>20</sup> For present purposes, the principal point is that the brokerage exclusion has functioned quite differently than its drafters seem to have envisioned. Congress imagined that when investment banks filed for bankruptcy, they would be liquidated under the watchful eye of a bankruptcy trustee. Both Drexel Burnham and Lehman sidestepped the trustee and used Chapter 11 rather than Chapter 7. This sharp disconnect between ostensible purpose and actual use is, as we shall see, a recurring pattern in the securities-oriented provisions in the bankruptcy laws.

## **II. The Special Protection for Securities Settlements**

In 1982, Congress added a special provision to the Bankruptcy Code in order to protect the payments made by or to brokers in connection with margin calls or settlement

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<sup>18</sup> Although Drexel was eventually reorganized, most of its assets were sold prior to confirmation of the reorganization plan and the reorganized firm was a far smaller entity. *See, e.g.,* Ayotte & Skeel, *supra* note 13, at 12 (noting that the reorganized company, New Street Capital, would manage \$450 million of Drexel’s junk bonds).

<sup>19</sup> *See, e.g., id.* at 9-15 (discussing the two cases).

<sup>20</sup> *See* Part IV(B)(1), *infra* (recommending removal of the brokerage exclusion).

payments from challenge as preferences or fraudulent conveyances in connection with the bankruptcy of a company whose securities are being traded.<sup>21</sup> The intuition is that these are ordinary brokerage operations, not preferences or fraudulent conveyances, and that the possibility of avoidance in the event of a bankruptcy could seriously interfere with the internal functioning of the securities markets. “If a firm or a clearing organization had to return margin payments received from a debtor when he had already transmitted those funds to others in the clearing chain,” a witness at the principal congressional hearing testified, “its finances could be seriously undermined to the point where it might also be driven into bankruptcy.” “[W]hen these moneys flow through the clearing chain,” he continued, “they are disbursed in many different directions, and there really is no way of tracing where they have gone. Any other firm in the chain would stand to have its own capital exposed if there were an attempt to recover these moneys.”<sup>22</sup>

Although the warning about ripple effect bankruptcies was no doubt exaggerated, the justification for protecting ordinary settlement operations is compelling. Payments to or from a broker to complete a trade, and for which the broker is simply a middleman, are not the kinds of transactions the preference and fraudulent conveyance laws are designed to police. But Congress did not explicitly limit the protection to this context. The provision simply states that a settlement payment made by or to one of a long list of

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<sup>21</sup> Originally enacted as 11 U.S.C. sec. 546(d), the protection is now 11 U.S.C. sec. 546(e). Section 546(e) states that: “Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment ... or settlement payment ... made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.”

<sup>22</sup> Hearing Before the Subcommittee on Monopolies and Commercial Law of the Committee on the Judiciary on Bankruptcy of Commodity and Securities Brokers, 97<sup>th</sup> Cong. 1<sup>st</sup> Sess. 165 (July 23, 1981)(statement of Edmund R. Schroeder, Attorney, Barrett Smith Schapiro Simon & Armstrong).

market participants is protected. Although settlement payment is a defined term, the definition is almost comically circular, repeating the term “settlement payment” six times.<sup>23</sup> As a result, the settlement payment protection can be seen—particularly if one is willing to squint—as applying to issues well outside the context for which it was ostensibly drafted. Two important examples illustrate the extent to which this potential has indeed materialized.

The first is leveraged buyouts. When a number of the LBO’s of the 1980s quickly failed, bankruptcy courts were faced with the question whether the financing of an LBO should be seen as a fraudulent conveyance, given that the company took on substantial debt in connection with the transaction but did not retain the proceeds of the loan.<sup>24</sup> If they—or some of them—were indeed fraudulent conveyances, the next question was who could be held responsible. In several prominent cases, courts held that the public shareholders of the debtor could not be forced to disgorge the money they received for their stock.<sup>25</sup> The courts based this conclusion in important part on bankruptcy’s settlement provision.

Several other cases have questioned this interpretation, refusing to apply the settlement protection to protect payments to shareholders in an LBO if the broker or other institution never had a beneficial interest in the payments. In *Matter of Mumford*, the

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<sup>23</sup> According to 11 U.S.C. sec. 101(51A), “‘settlement payment’ means ... a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, a net settlement payment, or any other similar payment commonly used in the forward contract trade.”

<sup>24</sup> One of the best analyses of the fraudulent conveyance issue is Douglas G. Baird, *Fraudulent Conveyances, Agency Costs, and Leveraged Buyouts*, 20 J. LEG. STUD. 1 (1991).

<sup>25</sup> In re Kaiser Steel Corp., 952 F.2d 1230 (10<sup>th</sup> Cir. 1991); *Lowenschuss v. Resorts Int’l, Inc.* (In re Resorts Int’l, Inc.), 181 F.3d 505 (3d Cir. 1999).

Eleventh Circuit held that the “involvement of the financial institution was not sufficient to invoke the safe harbor because the bank was nothing more than an intermediary or conduit. Funds were deposited with the bank and when the bank received the shares from the selling shareholders, it sent funds to them in exchange. The bank never acquired a beneficial interest in either the funds or the shares.”<sup>26</sup>

The second battleground involving the settlement provision was Enron. Shortly before filing for bankruptcy in late 2001, Enron bought significant amounts of its commercial paper at prices well above the prevailing market prices in an effort to protect its credit rating. It also purchased more than 300,000 shares of its own stock from a swap counterparty and bought the notes of a collateralized loan obligation (CLO) facility, again at above market rates, to satisfy obligations under those arrangements. As debtor in possession in its bankruptcy case, Enron later challenged all of these purchases, arguing that the commercial paper transactions were in essence preferential payments of its commercial paper obligations, and that the stock and note transactions were constructively fraudulent, since Enron paid appreciably more than the prevailing market value.<sup>27</sup> In each case, the defendants argued that the purchases were settlement payments and was therefore could not be avoided.

With the commercial paper case especially, the peculiar dynamics of Enron’s plight—its purchase of the paper in a desperate effort to fend off a catastrophic ratings

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<sup>26</sup> *Munford v. Valuation Research Corp. (Matter of Munford)*, 98 F.3d 604, 610 (9<sup>th</sup> Cir. 1996).

<sup>27</sup> *Enron Corp. v. Bear Stearns International Ltd (In re Enron Corp.)*, 323 Bankr. 857 (Bankr. S.D.N.Y. 2005); *Enron Corp. v. J.P. Morgan Securities (In re Enron Corp.)*, 325 Bankr. 671 (Bankr. S.D.N.Y. 2005); *Enron Corp. v. International Finance Corp. (In re Enron Corp.)*, 341 Bankr. 451 (Bankr. S.D.N.Y. 2006).

downgrade—created a difficult tension between the settlement payment provision and bankruptcy’s preference and fraudulent conveyance provisions. In form, the transactions were simply purchases of commercial paper, which look like new market transactions rather than payments to an existing creditor that would implicate the preference provision. But their effect was to pay existing Enron creditors who would otherwise hold ordinary unsecured claims.

The bankruptcy judge finessed this tension, as well as the uneasy fit between the cases and the core context for which the settlement payment safe harbor was designed, by asking whether the payments were of a type that is “common within the securities trade.”<sup>28</sup> If so, he concluded, the payments would qualify as settlement payments and come within the safe harbor. Although he concluded that the CLO note purchases clearly qualified and dismissed Enron’s action in that case, the judge refused to dismiss Enron’s avoidance actions with respect to its commercial paper and stock purchases.<sup>29</sup> In each case, the status of the payments was a factual issue that could only be resolved at trial.

The Enron decisions further illustrate the uncertainty as to just how far the settlement safe harbor sweeps. Not only was the bankruptcy court unable to resolve two of the three cases prior to trial, but he introduced what arguably is a third approach to limning the boundaries of the settlement payment safe harbor. The judge’s concern for

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<sup>28</sup> See, e.g., *Enron Corp. v. J.P. Morgan*, 325 Bankr. at 677.

<sup>29</sup> *Enron Corp. v. Bear Stearns International Ltd*, 323 B.R. at 879 (holding that Enron’s purchase of its own stock was not protected if it violated Oregon law); *Enron Corp. v. J.P. Morgan*, 325 B.R. at 687 (holding that the question whether commercial paper purchases are protected by section 546(e) “is a factual issue requiring a trial”); *Enron Corp. v. International Finance Corp.*, 341 B.R. at 459 (holding that Enron’s purchase of notes qualified as settlement payment).

what is “common with in the securities trade” is narrower than the sweeping protection afforded in several of the LBO cases, but potentially broader than the “mere conduit” approach used in other LBO cases.

In both the LBO and the Enron cases, as with the brokerage exclusion from Chapter 11, developments in the securities markets after the provisions were adopted have given rise to unintended consequences. Courts seem to be wrestling with the tension between the broad language of the safe harbor, which weighs in favor of protection, and the fact that the defendants in the cases are far removed from the core purpose of the harbor, protecting middlemen in the securities settlement system.

### **III. The Special Treatment of Derivatives in Bankruptcy**

A final example of bankruptcy’s effort to accommodate securities law is the special protection afforded derivatives and other financial contracts in bankruptcy. The earliest version of these provisions in the Bankruptcy Code was enacted as part of the original 1978 legislation, and exempted commodities and forward contracts from the automatic stay. Additional exclusions have been added at regular intervals, most recently with the 2005 amendments to the Code.<sup>30</sup>

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<sup>30</sup> In 1982, Congress added the settlement protection discussed in the last part, as well as a protection for margin payment; in 1984, Congress provided special exemptions for repurchase transactions. In 1990, Congress exempted swap transactions; and in 2005, Congress expanded the protections for repos and for netting. For a brief overview, see Edward R. Morrison & Joerg Riegel, *Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankruptcy Debtors and Bankruptcy Judges*, 13 AM. BANKR. INST. L. REV. 641, 644 (2005).

The amendments have been championed by the principal industry lobbying organization, the International Swaps & Derivatives Association (ISDA), as well as by the U.S. Federal Reserve and Treasury. If derivatives are not completely protected from the automatic stay, these groups argued, a bankruptcy involving a firm with significant derivatives exposure could snarl the financial system. The “right to terminate or close-out financial market contracts,” as the Fed put it in a 1999 submission to Congress, “is important to the stability of financial market participants ... and reduces the likelihood that a single insolvency will trigger other insolvencies due to the nondefaulting counterparties’ inability to control their market risk. The right to terminate or close-out protects [financial institutions] on an individual basis, and by protecting both the supervised and unsupervised market participants, protects the markets from systemic problems of ‘domino failures.’”<sup>31</sup> (As will already be evident, the testimony is replete with warnings about “domino effect” and “ripple effect” failures unless financial contracts and securities transactions are protected from core bankruptcy provisions.)

Most bankruptcy lawyers and judges have little familiarity with the securities markets. As a result, they largely deferred to the testimony of bank regulators and the securities industry each time Congress considered new expansions of the derivatives protections. The testimony of Bruce Bernstein, a prominent bankruptcy lawyer speaking on behalf of the National Bankruptcy Conference on a proposal to expand protection for repurchase transactions is particularly striking in this regard. Bernstein was skeptical of

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<sup>31</sup> Hearing Before the Senate Committee on Banking, Housing, and Urban Affairs, 106<sup>th</sup> Cong., 1<sup>st</sup> Sess. 56 (March 25, 1999)(prepared statement of Oliver Ireland, Associate General Counsel, Board of Governors of the Federal Reserve System).

the need to expand the special treatment of these transactions. “My experience [in another area, secured lending], he said, “has been that markets do have a way of adjusting to shocks or interpretations of relationships that do not necessarily go the way the market thinks they should have gone initially.”<sup>32</sup> But he disclaimed any expertise on the implications of the treatment of derivatives, saying both that “I really am not expert enough, nor is my crystal ball clear enough, to be able to respond in any certain way,”<sup>33</sup> and that the “broad, economic policy arguments of these well-informed and highly respected institutions [the Fed and the Public Securities Association] ... are, quite frankly, beyond the scope of the NBC’s expertise and its normal areas of inquiry.”<sup>34</sup> Fifteen years later, National Bankruptcy Conference representatives did question the necessity of still further expansion of the protections, but by then the die had long since been set and the testimony had little impact.<sup>35</sup>

As with each of the issues we have considered, the derivatives protections have given rise to unintended consequences. But with derivatives and other financial contracts, the consequences stem less from subsequent market developments than from the provisions

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<sup>32</sup> Hearing Before the Subcommittee on Monopolies and Commercial Law of the House Committee on the Judiciary on H.R. 2852 and H.R. 3418, 98<sup>th</sup> Cong., 2d Sess. 73 (May 2, 1984)(testimony of H. Bruce Bernstein, Sidley & Austin, on behalf of National Bankruptcy Conference)[hereinafter 1984 House Hearing].

<sup>33</sup> *Id.*

<sup>34</sup> *Id.* at 66.

<sup>35</sup> See Bankruptcy Reform Act of 1999 (Part III): Hearing on H.R. 833 Before the Subcomm. on Commercial and Administrative Law of the House Comm. on the Judiciary, 106<sup>th</sup> Cong., 1<sup>st</sup> Sess. 360 (1999)(statement of Professor Randal Picker on behalf of National Bankruptcy Conference), available at [http://commdocs.house.gov/committees/judiciary/hju63847.000/hju63847\\_OF.htm](http://commdocs.house.gov/committees/judiciary/hju63847.000/hju63847_OF.htm) (“There is no indication that the absence of such cross-product netting features has led to widespread difficulties or systemic disruptions in the financial markets for such products. In addition, master netting could deprive a debtor of much-needed cash collateral”); Bankruptcy Reform Act of 1999 (Part II): Hearing on H.R. 833 Before the Subcomm. on Commercial and Administrative Law of the House Comm. on the Judiciary, 106<sup>th</sup> Cong., 1<sup>st</sup> Sess 246-57 (1999)(statement of Professor Kenneth Klee on behalf of National Bankruptcy Conference), available at [http://commdocs.house.gov/committees/judiciary/hju63847.000/hju63847\\_OF.htm](http://commdocs.house.gov/committees/judiciary/hju63847.000/hju63847_OF.htm) (same).



themselves. Whereas the provisions originally sought to protect particular parties, they now extend to the entire market for derivatives and other financial contracts.<sup>36</sup>

Counterparties to a debtor that files for bankruptcy are exempt from the automatic stay, are permitted to invoke any termination clause, and are protected from bankruptcy's preference and fraudulent conveyance provisions.<sup>37</sup>

Prior to the recent financial crisis, several commentators pointed out that permitting counterparties to terminate is at least as likely to create systematic problems—by inviting runs in the event of financial distress—as to counteract them.<sup>38</sup> Regulators' response to the recent crisis seems to confirm these criticisms. The decision to bail out Bear Stearns, rather than to allow it to file for bankruptcy, stemmed at least in part from the perceived consequences of default and termination for the repo and derivatives markets. “Fears of so-called counterparty risk arising from credit default swaps on the books of Bear Stearns,” according to a widely read column in the *New York Times*, “were central to the investment bank's unraveling in March [2008] and the rescue engineered by the Federal Reserve Bank of New York and JPMorgan Chase.”<sup>39</sup> The onset of AIG's financial distress six months later triggered a simultaneous wave of collateral demands that forced the government to choose between a massive bailout and allowing it to file for

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<sup>36</sup> I borrow this characterization from an insightful article by Morrison & Riegel. Morrison & Riegel, *supra* note 30.

<sup>37</sup> *See, e.g.*, 11 U.S.C. sec. 362(b)(7)(exempting repos from stay); sec. 559 (exempting repos invalidation of ipso facto clauses); sec. 546(f)(exempting repos from avoidance).

<sup>38</sup> Key early articles questioning the rationale for the systemic risk rationale include Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 YALE J. REG. 92, 94 (2005); Shmuel Vasser, *Derivatives in Bankruptcy*, 60 BUS. L. 1507, 1541-42 (2005); Robert R. Bliss & George G. Kaufman, *Derivatives and Systemic Risk: Netting, Collateral, and Closeout*, 2 J. FIN. STAB. 55, 67-68 (2006). *See also* Ayotte & Skeel, *supra* note 13; David A. Skeel, Jr., *Governance in the Ruins*, 122 HARV. L. REV. 696, 738-740 (2008); Frank Partnoy & David Skeel, *The Promise & Perils of Credit Derivatives*, U. CINN. L. REV. (2007).

<sup>39</sup> *See, e.g.*, Gretchen Morgenson, *A Window in a Smoky Market*, N.Y. TIMES, July 6, 2008.

bankruptcy.<sup>40</sup> Largely because of the perceived effect on the credit default swap market, the government opted for a bailout whose cost is estimated at \$180 to \$200 billion as of this writing.<sup>41</sup> Whether an AIG default would indeed have cascaded through the financial system, as regulators feared, is subject to vigorous debate, but regulators clearly did not trust counterparties' exemption from the bankruptcy stay to neutralize potential systemic effects.

The experience of Lehman, the one major derivatives player that was allowed to file for bankruptcy, suggests that bankruptcy professionals may respond by creatively interpreting the exclusions to reduce counterparties' ability to exit. Although counterparties of trades with Lehman affiliates that had not themselves filed for bankruptcy should have been able to terminate their contracts and retrieve the collateral securing them, Lehman argued that the collateral—which consisted of various financial assets-- had been commingled with the holding company's general accounts and therefore were subject to the automatic stay. Based on this claim, Lehman retained control of the assets.<sup>42</sup>

At least with major players in the derivatives markets, the recent stress test of the special exclusion of derivatives and other financial contracts from core provisions of the Bankruptcy Code raises serious questions about the wisdom of the exclusions.

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<sup>40</sup> See, e.g., William K. Sjoström, Jr., *The AIG Bailout* at 16 (unpublished manuscript, March 10, 2009), available at <http://ssrn.com/abstract=1346552> (“as CDO values tanked, AIG was obligated to post more and more cash collateral” on its credit default swaps).

<sup>41</sup> *Id.* at 28-29.

<sup>42</sup> See, e.g., *Events of Default: Is the Bankruptcy Provision Guttled?*, WESTLAW BUS. CURRENTS EXTRA, available at <http://www3.gsonline.com/FORMS/BankruptcyEvents.asp?cid-cibwqa0011jn> (describing suits by Evergreen Solar, Bank of America, Nomura Global and Freddie Mac to retrieve their financial asset collateral).

#### **IV. Implications of the Boundary Games**

With each of the issues we have considered, Congress has concluded that, as between the securities markets and the normal operations of the bankruptcy laws, bankruptcy should give way and the markets should prevail. In each case, the special protection has proven problematic. Debtors have sidestepped the requirement that broker-dealers file for Chapter 7 rather than Chapter 11; the settlement protection has been the subject of increasing uncertainty; and the special treatment of derivatives was a problem rather than a solution during the recent crisis.

This part considers some of the implications of these unintended consequences. I begin by speculating about implications in the absence of any legislative intervention. I then consider how Congress might alter the existing rules to more effectively manage the boundary between bankruptcy and the securities markets.

##### **A. Managing the Growing Tensions**

The increasing friction at the boundary between bankruptcy and the securities markets is not accidental. Each of the special protections affected relatively few cases when it was first enacted. But with the transformation of investment banking and the explosion of financial innovation of the last several decades, the securities markets,

traditional corporate enterprise, and bankruptcy have become increasingly intertwined. Despite the recent financial crisis, this tendency will surely continue.

The exclusion of investment banks from Chapter 11 has been rendered largely but not completely irrelevant by the shift in banks' corporate structure and their use of Chapter 11 for the holding company and non-brokerage affiliates. As we have seen, the principal limitations of the strategy stem from the limits on the ability of the brokerage itself, because it is not in bankruptcy, to take advantage of provisions such as section 363. Given the benefits to both the debtor and its creditors, courts are likely to continue authorizing sales of brokerage assets.

With the settlement safe harbor and derivatives exemptions, the provisions are now drafted so broadly that the market transactions may continue to prevail over the automatic stay and other core bankruptcy provisions. Several commentators have recently defended the breadth of the provisions, predicting that they will reduce uncertainty by curbing bankruptcy judges' discretion to protect some transactions but not others.<sup>43</sup>

This prognosis may well be right. Certainly it accords with the general strategy of insulating these markets from ordinary bankruptcy rules. But the breadth of the provisions will magnify the frictions they cause, as the provisions increasingly crop up in contexts in which they were not intended to apply and seem to interfere with the bankruptcy process. The friction will be further magnified by increasing questions as to

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<sup>43</sup> Morrison & Riegel, *supra* note 30.

whether the special derivatives protections are justified, and by the widespread use of derivatives by ordinary businesses. Indeed, after agonizing whether a small business debtor's commodity contract with a natural gas supplier should be characterized as a swap and thus exempt from bankruptcy's avoidance provisions, a bankruptcy judge recently refused to construe the exemptions broadly. "Because the contract is not clearly within the definition of swap agreement," he concluded, "the court will not upset the priority scheme of the Bankruptcy Code by affording the transfers under the contract the protections afforded to swap agreements and swap participants."<sup>44</sup> I suspect other courts also will increasingly nibble at the edges of the provisions.

If this prediction is correct, it raises two possible concerns. The first is the costs of uncertainty.<sup>45</sup> When bankruptcy courts have raised questions about financial innovations that were thought to be insulated from bankruptcy, the decisions have often had an immediate, negative market impact.<sup>46</sup> If bankruptcy courts do not effectively distinguish between cases where the special protections are or are not warranted, the uncertainty costs could be still higher.

The second concern is not entirely distinct from the first, but has a different focus. The bankruptcy rules are designed to effectively resolve the financial distress of a particular debtor, and bankruptcy judges' decision making tends to reflect this orientation. This generally works well, but it may prove problematic if a decision that

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<sup>44</sup> In re Natural Gas Distributors, LLC, 369 B.R. 884, (Bankr. E.D.N.C. 2007).

<sup>45</sup> See Morrison & Riegel *supra* note 30.

<sup>46</sup> A decision in the LTV bankruptcy suggesting that an asset securitization would not qualify as a true sale temporarily jolted the securitization market in the 1990s.

maximizes the value of the debtor’s assets could have costly spillover effects on parties outside the bankruptcy. As we have seen, concerns about spillover effects—especially systemic risk—are a recurrent theme in the legislative history of the special protections for financial contracts.<sup>47</sup> If bankruptcy judges do not fully take spillover effects into account, and if the risk of these effects is real, courts’ exercise of judicial discretion could benefit the debtor and its creditors while inflicting broader damage on the markets.

Overall, the first of the concerns—uncertainty—seems more serious than the risk that bankruptcy judges will fail to pay sufficient heed to possible spillover effects. Bankruptcy judges’ exercise of discretion is as likely to curb spillover effects as to cause them, and the risk of serious spillover effects in the vast majority of cases is limited.

## **B. Legislative Reform**

Bankruptcy judges and professionals have adapted to many to the problematic effects of the boundary rules we have been considering. But the adaptations are invariably imperfect. How, if at all, might Congress better shape the rules in each area?

### *1. The Brokerage Exclusion from Chapter 11*

As we have seen, the parties have responded to the brokerage exclusion by working around it, but the solution—putting affiliates but not the brokerage in bankruptcy—is an imperfect proxy for Chapter 11. Technically, the brokerage cannot take advantage of benefits such as section 363. Although the exclusion once could be

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<sup>47</sup> See *supra* note 31 and accompanying text.

justified, it no longer serves any real purpose. Congress could appreciably simplify the bankruptcy process for investment banks by simply deleting the brokerage exclusion, and allowing brokerages to use Chapter 11.

## *2. The Safe Harbor for Settlement Payments*

The simplest solutions to the uncertainties created by the safe harbor for settlement payments would be either to explicitly limit the safe harbor to its original habitat—protecting securities middlemen in market transactions—or to broadly protect every transaction that takes place through the settlement system.<sup>48</sup> But neither of these bright line approaches is particularly attractive. If only securities professionals were protected, ordinary market investors could find themselves subject to fraudulent conveyance or preference challenge, due to breadth of the bankruptcy avoidance provisions.<sup>49</sup> Explicitly protecting all of these transactions, on the other hand, would shelter the recipients of problematic transfers due to the happenstance of a connection to the financial markets. So many transactions now take place on markets that blanket protection of financial market transactions could insulate a large number of transactions that do not warrant protection.

The current provision provides an escape valve, in that it does not protect transfers that amount to actual fraud. But, unless fraud is defined elastically, the fraud

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<sup>48</sup> Interestingly, if Congress eliminated the safe harbor altogether, securities middleman might well be protected by courts from preference or fraudulent conveyance attack. To the extent the middleman is simply a conduit for settlement payments, she is not really the recipient of a transfer.

<sup>49</sup> The preference and constructive fraud provisions use a strict liability approach that does not take motive or knowledge into account—this is the principal source of their breath. 11 U.S.C. sec. 547(b); sec. 548(a)(1)(B).

exception is not broad enough to police potentially problematic transactions.<sup>50</sup> One strategy for legislatively achieving a more workable middle ground might be to amend the safe harbor to provide differing levels of protection for market middleman and other participants in the market. Lawmakers could provide blanket protection for market middlemen, absent fraud, while protecting investors and other participants unless they knew or should have known that they were the beneficiary of a preference or fraudulent conveyance. As bankruptcy oldtimers will recognize, this standard is derived from the requirements for avoiding a preference under the old Bankruptcy Act.<sup>51</sup>

Consider how this rule might function in a leveraged buyout case. In many of these cases, insiders and large shareholders negotiated the terms of the buyout. If the debtor later filed for bankruptcy and the trustee challenged the LBO as fraudulent, any brokers who handled the payments would be protected. The old shareholders also would be protected unless the trustee could show that they knew or should have known the transaction could be avoidable as a fraudulent transfer. The trustee might well be able to make this showing with respect to the insiders. Most ordinary investors, on the other hand, would be protected.

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<sup>50</sup> An example of elastic interpretation of the fraud under sec. 546(e) is *Gredd v. Bear Stearns Sec. Corp.* (In re Manhattan Inv. Fund Ltd.), 359 Bankr. 510 (Bankr. S.D.N.Y. 2007). The court concluded that the debtor, a hedge fund, had functioned as a Ponzi scheme, and thus that any transactions with the fund were potentially fraudulent. The court concluded that settlement payments to Bear Stearns, its prime broker, could therefore be challenged as fraudulent conveyances. For an extensive critique of *In re Manhattan Inv. Fund Ltd.*, see Peter S. Kim, *Navigating the Safe Harbors: Two Bright Line Rules to Assist Courts in Applying the Stockbroker Defense and the Good Faith Defense*, 2008 COLUM. BUS. L. REV. 657, 676-79 (2008).

<sup>51</sup> Under former section 60, the trustee was required to show that the recipient of an alleged preferential transfer knew or should have known the debtor was insolvent at the time of the transfer. This requirement was criticized as making it too difficult to avoid preferences.



The chief shortcoming of this approach is the difficulty of determining when the recipient knew or should have known she was the recipient of a potentially avoidable transfer. But, given the cost of pursuing an avoidance action, a trustee or debtor in possession would rarely pursue these avoidance actions unless there were significant money at stake and a strong case that the recipient was aware that the payment she received was problematic.

### *3. Imposing a Stay on Derivatives and Other Financial Contracts*

Lawmakers might plausibly take any of three general tacks were they to reform the current exemption of derivatives from the automatic stay and other key bankruptcy protections: 1) exempt some financial contracts from the automatic stay but not others; 2) apply the stay in the bankruptcy of some kinds of firms but not others; or 3) apply the stay to all financial contracts, thus ending their special treatment.

Briefly consider the intuitions underlying each of the three approaches. With respect to the first, the case for exempting some products is stronger than for others. Subjecting repos to the automatic stay might significantly interfere with the repo market, since repo loans are extended on a very short term basis. The case for exempting credit default swaps, on the other hand, is weaker.<sup>52</sup> Under this approach, Congress would revisit each of the exemptions and remove the least compelling. In a sense, it would

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<sup>52</sup> Proponents of special treatment of swaps emphasized the standard systemic risk concern that preventing counterparties from terminating could cause “ripple effect” failures. They also argued that a party that depended on a swap for hedging purposes might have difficulty replacing the hedge and would run the risk of ending up with a duplicative hedge if the debtor later assumed its contract. These dangers can be minimized if the counterparty limits its exposure to any given debtor, the debtor often would be able to sell a duplicative head to someone else, and the uncertainty could be reduced under a rule that required the debtor to make prompt decisions on assumption, much as bank regulators do in a bank insolvency.

reverse the historic pattern of continuously expanding the special treatment of derivatives, and winnow down the protected list.

The second approach would distinguish among types of debtors, rather than focus on particular products. One commentator has recently argued, for instance, that the automatic stay should apply if the debtor is not a financial institution, but counterparties should retain their exemption with financial institution debtors.<sup>53</sup> A derivative may be important to a nonfinancial debtor's going concern value, the reasoning goes, and should be protected. A second proposal, which I have developed briefly elsewhere, would draw a very different line, distinguishing between systemically important and ordinary financial institutions.<sup>54</sup> Under this proposal, the stay would apply only to systemically important institutions. This proposal draws on the experience of the recent financial crisis, which seems to confirm concerns that the absence of a stay could magnify the systemic effects of a large financial institution's default.<sup>55</sup>

The final approach would reverse the special protections altogether, based on a view that the arguments for exempting the derivatives markets from bankruptcy no longer seem compelling. Exempting derivatives counterparties from the stay reduces their incentive to monitor the debtor and does not seem to provide a bulwark against systemic risk.

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<sup>53</sup> Stephen J. Lubben, *Derivatives and Bankruptcy: The Flawed Case for Special Treatment* (unpublished manuscript, 2009), available at <http://ssrn.com/abstract=1265070>.

<sup>54</sup> David Skeel, *Give Bankruptcy a Chance*, WEEKLY STANDARD, June 29, 2009.

<sup>55</sup> See *supra* notes 40-41 and accompanying text.

While each of these approaches has drawbacks, each also seems preferable to the existing framework. Let me briefly expand on the two that seem most compelling, the stay for systemically important institutions and the blanket stay.<sup>56</sup> The proposal for a stay on systemically important institutions might proceed in two steps.<sup>57</sup> First, the Federal Reserve would be instructed to designate the financial institutions it deems to be systemically important. As the regulator most concerned with systemic risk, and having conducted “stress tests” of the leading banks in early 2008, the Fed is the logical choice to determine which institutions are systemically important, and to do so in advance. Second, if a systemically important institution filed for bankruptcy, its derivatives and other financial contracts would be subject to the automatic stay.<sup>58</sup>

The bankruptcy-plus-stay proposal would reduce the danger that an institution would dismember itself prior to bankruptcy in response to collateral calls, as AIG threatened to do, as well as the threat that mass cancellation of contracts and collateral sales would drive down asset prices and increase the damage to other institutions. The proposal might also curb the perceived need for bailouts, give counterparties and creditors an incentive to monitor, and encourage the managers of a systemically

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<sup>56</sup> Lubben’s proposal for a stay on nonfinancial derivatives is compelling as far as it goes, but is subject to two limitations. First and most obvious, it does not address the need for a stay in insolvencies involving nonbank financial institutions. Second, it could be circumvented. A financial institution that wished to evade the stay could interpose another financial institution between itself and the debtor.

<sup>57</sup> For another, somewhat analogous proposal for singling out systemically important institutions, see Lee C. Buchheit & David A. Skeel, Jr., *Some Bankruptcies are Worth It*, N.Y. TIMES, May 19, 2009, at A23. Under this approach, lawmakers would provide for a transition period prior to bankruptcy during which the institution could attempt to raise money or arrange for a sale of its assets.

<sup>58</sup> In order to make the stay fully effective, Congress also would need to reverse the brokerage exclusion from Chapter 11, as discussed in Part IV(A), *supra*. Otherwise, the stay would not protect any derivatives or other financial contracts held by the brokerage entity.

important institution an incentive to plan for the possibility of bankruptcy, rather than trying to portray bankruptcy as a looming catastrophe in order to secure rescue funding.<sup>59</sup>

The most obvious concern with the proposal stems from its singling out of institutions that are systemically important. The special treatment could reward institutions that were given the “systemically important” designation, and thus perpetuate a status—call it the Fannie Mae effect—that should be avoided at all costs.<sup>60</sup> In practice, however, the proposal seems as likely to discourage as to invite firms to become “too big to fail.” Because the counterparties of a designated firm would be subject to the stay if the firm filed for bankruptcy, the proposal would increase counterparties’ incentive to deal with non-designated institutions if they wished to avoid the possibility of a stay in the event their counterparty encountered financial distress. The incentive to deal with non-designated institutions could help to erode the dominance of the derivatives industry by a handful of financial institutions.

The other strategy—a blanket stay on derivatives and other financial instruments—avoids the line drawing concerns created by approaches that apply the stay to some firms but not to others. The chief objections to the stay, as we have seen, stem from the consequences of preventing counterparties from exiting their contracts.<sup>61</sup> The value of the contracts and of any collateral, the reasoning goes, is extremely volatile. Counterparties could be seriously damaged by the uncertainty as to whether the debtor

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<sup>59</sup> See, e.g., Ayotte & Skeel, *supra* note 13; Skeel, *supra* note 54.

<sup>60</sup> See, e.g., Peter J. Wallison, *Too Big to Fail, or Succeed*, WALL ST. J., June 18, 2009.

<sup>61</sup> See *supra* note 31 and accompanying text.

will assume or reject their contract, and the cost of rehedging contracts that the debtor rejects could be devastating if the contract is substantial.

Although these are legitimate concerns, they must be weighed against the very substantial benefits of the stay. The prospect of a stay would give counterparties an incentive both to carefully monitor the debtor, and to avoid overexposing themselves to a single counterparty. Moreover, the costs of the stay could be reduced by setting tight deadlines on the debtor's decision whether to assume or reject the contract.

As between the limited and blanket stay, the determination as to which is preferable depends importantly on the shape of financial regulation more generally. So long as a group of nonbank financial institutions have been singled out, either implicitly or explicitly, the case for a stay that targets systemically important institutions is particularly strong. The financial reforms recently proposed by the Obama administration would have precisely this effect.<sup>62</sup> A blanket stay, on the other hand, may be more compelling under a framework that does not single out systemically important firms. It has the virtue of simplicity, and do not introduce the boundary issues that would arise with a distinction between systemically important and other institutions. Both approaches are, as I have emphasized, preferable to the current exemption the bankruptcy stay.

## CONCLUSION

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<sup>62</sup> The administration released a lengthy white paper outlining its financial reform proposals in June 2009. U.S. Department of the Treasury, *Financial Regulatory Reform: A New Foundation* (June 17, 2009), available at [http://www.financialstability.gov/docs/regs/FinalReport\\_web.pdf](http://www.financialstability.gov/docs/regs/FinalReport_web.pdf)

The securities market exclusions from core provisions of the bankruptcy laws have an awkward history. In each case, lawmakers swept with a broad brush, giving a wide berth to the operations of the securities markets, and they did so at a time when the special treatment was quite uncontroversial. Nearly everyone was happy to leave the markets alone. With the rapid evolution of the markets in the past several decades, however, the provisions are no longer on the periphery of the bankruptcy process, and they have given rise to a steady series of unintended consequences. Debtors have sidestepped the brokerage exclusion from Chapter 11, the settlement safe harbor has been invoked in contexts well outside the transactions it was originally designed to protect, and the exemption from the stay for derivatives and other financial contracts performed much differently than advertised when Bear Stearns, Lehman Brothers and then AIG failed.

In addition to speculating about the future of these provisions as bankruptcy judges continue to apply them under new or unanticipated conditions, I outlined possible legislative responses to each. The case for reversing the exclusion of brokerages Chapter 11 seems straightforward and compelling. It also seems clear that Congress should reverse course on its relentless expansion of special protections for financial contracts, although here the best strategy is debatable. The case for a legislative rewrite is weakest for the settlement safe harbor, although still plausible.

Overall, the bankruptcy courts have done a relatively good job of handling the fallout from the sweeping protection of securities markets. Perhaps more importantly,

there are grounds for encouragement going forward. The penchant for broad exclusions has been tied in important respects to the sharp line between securities law and bankruptcy dating back to the New Deal. Largely unfamiliar with the securities markets, bankruptcy lawyers and judges generally simply accepted the doomsday claims of banking regulators and securities industry interest groups like ISDA who insisted that Armageddon would ensue in the absence of special protections. But the line between securities markets and bankruptcy is rapidly eroding. This, and the harsh light the recent financial crisis has cast on the earlier claims about the virtues of unregulated derivatives markets, make it likely that these issues will be addressed in a more balanced, and better integrated, fashion in the future.