

## The Bankruptcy Code Without Safe Harbors

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In prior work I have argued that the derivative “safe harbors” in the Bankruptcy Code should be either repealed,<sup>1</sup> or at least greatly reduced in scope.<sup>2</sup> This argument is based on the mismatch between the safe harbors and their stated goal – reducing systemic risk.<sup>3</sup> Indeed, the safe harbors are likely to increase systemic risk by fostering a run on the bank.<sup>4</sup> Moreover, after 2005 the safe harbors are so broad that they are likely to seriously distort creditor behavior, resulting in socially wasteful efforts to reshuffle transactions in order to fit within these exceptions to the Bankruptcy Code.<sup>5</sup>

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<sup>1</sup> Stephen J. Lubben, *Repeal the Safe Harbors*, 18 A.B.I. L. Rev. – (2010).

<sup>2</sup> Stephen J. Lubben, *Derivatives and Bankruptcy: The Flawed Case for Special Treatment*, 12 U. Pa. J. Bus. L. 61 (2009); see also Bryan G Faubus, Note, *Narrowing the Bankruptcy Safe Harbor For Derivatives To Combat Systemic Risk*, 59 Duke L.J. 801 (2010).

<sup>3</sup> See Stephen J. Lubben, *Chapter 11 and Systemic Risk*, 82 Temp. L. Rev. 433 (2009).

<sup>4</sup> Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. Cin. L. Rev. 1019, 1049 (2007) (“The first thing to note is that the standard explanation for the special treatment is not particularly compelling. It is far from clear that the exception reduces systemic risk; it may even increase this risk because it eliminates a possible curb on counter-parties’ rush to close out their contracts in the event of a wave of failures.”).

<sup>5</sup> For example, one CLE outline advises:

Parties should always structure their transactions as Safe Harbor Contracts to take advantage of the so-called “safe harbor” provisions of the Bankruptcy Code, even if the counterparty is a foreign company that might file its main insolvency proceeding in another country. Similarly, parties should seriously consider structuring their Safe Harbor Contracts to enable maximum use of netting and setoff rights under the Bankruptcy Code, including the implementation of master netting agreements.

Arnold Gulkowitz & Brian E. Goldberg, *Looking For Light At The End Of The Tunnel-- Navigating The Subprime Mortgage Derivatives Market In Bankruptcy*, 1688 PLI/Corp 535 (2007). See also *Huston v. E.I. du Pont de Nemours And Co., Inc.* (In re National Gas Distributors, LLC), 556 F.3d 247 (4th Cir. 2009), and my discussion of warehouse loans in Part II, *infra*.

But upon repeal of the safe harbors, what happens next? Is it sufficient to remove the safe harbors from the Bankruptcy Code, or must the Code be further adapted to reflect the prevalence of derivatives throughout the economy? And if repeal is not enough, what kinds of issues should the Bankruptcy Code legitimately accommodate, and what issues are simply disguised versions of the general plea of all creditors to be excused from the normal consequences of default?

This short paper examines these and other related questions, and begins to sketch a roadmap for reforming the Code's handling of financial contracts.

In Part I, I begin with a review of the safe harbors, and the arguments against their inclusion in the Bankruptcy Code. Part II then starts afresh on the intersection of bankruptcy and derivatives. I examine the legitimate issues that arise from the growth of derivatives since the Code was first enacted in 1978. I also discuss those putative issues that are, upon further reflection, not real concerns.

For example, I explain how the volatility of derivatives makes them unsuited to the normal "adequate protection" rules in the Bankruptcy Code, inasmuch as a non-debtor counterparty might be compelled to file an adequate protection motion almost every day a case was pending. On the other hand, I submit that the derivatives industry's concerns about avoidance actions – like preference and fraudulent transfer actions – are largely overblown, with a few limited exceptions.

In Part III, I outline the ways in which the Bankruptcy Code might facilitate the legitimate concerns raised in Part II. Ideally these changes would be enacted as part of a broader legislative move to repeal the safe harbors. But more importantly, Part III demonstrates that the safe harbors are neither the only nor the best way to address the reality that derivatives have become a substantial part of modern corporate finance.

## I. Derivatives and the Safe Harbors

Derivatives are a kind of second order contract, deriving its value from other primary assets.<sup>6</sup> For example, a credit default swap (CDS) provides the buyer with a payout if some underlying debt – issued by the "reference entity" – defaults.<sup>7</sup> The

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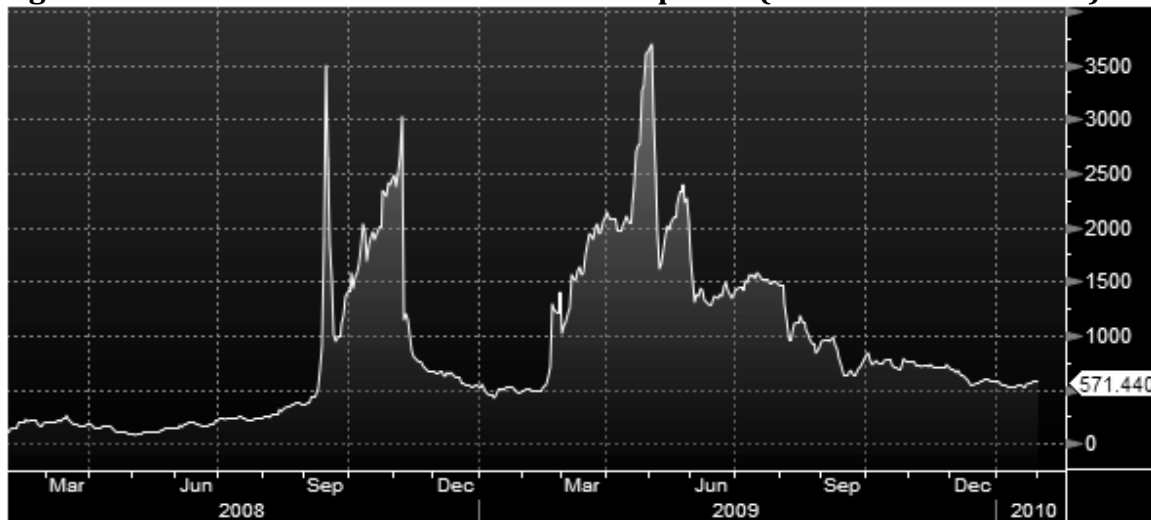
<sup>6</sup> CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, 562 F. Supp. 2d 511, 519 (S.D.N.Y. 2008). See also Mark A. Guinn & William L. Harvey, *Taking OTC Derivative Contracts as Collateral*, 57 Bus. Law. 1127, 1128 (2002).

<sup>7</sup> Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 Am. Bankr. L.J. 405, 410–11 (2007); see also Douglas G. Baird & Robert K. Rasmussen, *Anti-Bankruptcy*, 119 Yale L.J. 648, 683 (2010).

value of the CDS is entirely dependent on the properties of the underlying reference obligations.<sup>8</sup>

Likewise, a total return swap involves a contract that transfers all of the economic aspects of a particular investment contract, without transferring legal ownership.<sup>9</sup> The value of the swap will depend on the underlying investment instrument, perhaps subject to some further adjustment to reflect the credit-risk of the party selling the total return swap and its ability to perform on the swap.<sup>10</sup> This latter risk is known as “counterparty risk.”

**Figure 1: AIG Five-Year CDS Prices - in basis points (Feb. 2008 - Feb. 2010)**



Source: Bloomberg LP

The term “derivatives” also includes less mystifying instruments. For example, well-known derivative products include futures, options, and forwards.<sup>11</sup> Derivatives of any sort can be used either as a hedge (i.e., insurance) or for speculation.<sup>12</sup> A railroad can use derivatives to lock in the price of diesel fuel for the coming year, while the same derivatives can be used by investors to bet on the direction of fuel prices.

<sup>8</sup> Anna Gelpern, *Domestic Bonds, Credit Derivatives, and the Next Transformation of Sovereign Debt*, 83 Chi.-Kent L. Rev. 147, 169 (2008).

<sup>9</sup> Total return swaps can be used as a substitute for repurchase agreements, which I extensively discuss in Part II.

<sup>10</sup> John D. Beck, *Cashing In At The Debtor's Expense: How Total Return Swaps Can Alter Creditor Voting Incentives in a Chapter 11 Bankruptcy*, 41 Tex. Tech L. Rev. 1275, 1285-86 (2009).

<sup>11</sup> See Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 Yale L.J. 1457, 1466-67 (1993).

<sup>12</sup> See Lynn A. Stout, *Why the Law Hates Speculators: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 Duke L.J. 701, 735-40 (1999).

Traditionally derivatives have been traded “over the counter” – that is, they are bilateral contracts negotiated directly between the parties.<sup>13</sup> Following the financial crisis, in particular the disruption caused by Lehman and AIG’s collapse, there has been increased regulatory pressure to move derivative trades, particularly CDS trades, to exchanges or at least increase the central clearance of such trades.<sup>14</sup> Even with these efforts, it seems likely that a substantial number of derivative trades will remain OTC, bilateral transactions, because the parties will want to customize the terms to their specific needs.

From a pure bankruptcy perspective, when a party to a derivative trade files a bankruptcy petition, these contracts are just like other executory contracts.<sup>15</sup> But Congress, after much lobbying from the financial community, including the Federal Reserve and the FDIC, concluded that derivatives should not be treated as regular contracts in bankruptcy.<sup>16</sup> This led to the enactment of the safe harbors, discussed below.

For chapter 11 purposes, it is also important to note that many derivative transactions, particularly those among financial institutions and investors, involve an element of secured lending. First, parties to derivative transactions typically exchange “mark to market” collateral to reduce the counterparty risk of a transaction.<sup>17</sup> This involves the transfer of assets to the party on the winning side of the transaction – often called the “in the money” party – to ensure the “out of the money” party’s performance.<sup>18</sup> As a matter of best practices, the balance of the mark to market collateral should be adjusted with some frequency, although there are indications this was not always the case before Lehman’s collapse.

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<sup>13</sup> The key exception being commodity futures, which are regulated and trade on exchanges.

<sup>14</sup> Centrally cleared trading involves trades cleared through a central counterparty, which assumes responsibility for the counterparty performance of both sides of a trade. That is, the central counterparty becomes a “middleman” in the transaction. Christian A. Johnson, *The Enigma of Clearing Buy Side OTC Derivatives* (December 1, 2009). *Futures and Derivatives Law Report*, Vol. 29, No. 11, December 2009. Available at SSRN: <http://ssrn.com/abstract=1544017>. Trading on an exchange brings price transparency that some have argued will also reduce systemic risk. <http://www.ft.com/cms/s/0/3b52b642-217c-11df-830e-00144feab49a.html>.

<sup>15</sup> Jay Westbrook, *A Functional Analysis of Executory Contracts*, 74 *Minn. L. Rev.* 227, 231 (1989).

<sup>16</sup> See Shmuel Vasser, *Derivatives in Bankruptcy*, 60 *Bus. L.* 1507 (2005).

<sup>17</sup> Traditionally non-financial, corporate users of derivatives have not been required to post collateral. Large highly-rated financial institutions – like AIG – often did not have to post collateral either. All this may change as part of proposed legislation requiring central clearing of more derivative transactions.

<sup>18</sup> Stephen R. Kruff, *Cross-Default Provisions in Financing and Derivatives Transactions*, 113 *Banking L.J.* 216, 231 n.24 (1996).

In addition, large financial institutions have historically required their clients to post additional collateral, termed “Independent Amounts” in the ISDA documentation, to reflect the disparity in credit ratings between, for example, a double-A rated investment bank and an unrated hedge fund.<sup>19</sup> After Lehman Brothers’ collapse, when several hedge funds found themselves as unsecured creditors seeking the return of this collateral in the London administration proceeding of Lehman’s European subsidiary,<sup>20</sup> there have been moves to either reduce the amount of this “up front” collateral or place it in the hands of a neutral party.<sup>21</sup>

*a. The Safe Harbors*

The safe harbor provisions of the Code developed incrementally, growing from narrowly targeted provisions that addressed specific concerns about the interaction of bankruptcy and certain financial products, to the wide-open provisions enacted in 2005.<sup>22</sup> Following the 2005 amendments to the Code,<sup>23</sup> it is hard to envision a derivative that is not subject to special treatment.<sup>24</sup>

The safe harbors cover a wide range of contracts that might be considered derivatives, including securities contracts,<sup>25</sup> commodities contracts,<sup>26</sup> forward

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<sup>19</sup> See, e.g., 1994 ISDA Credit Support Annex (Security Interest - New York Law).

<sup>20</sup> Although termed “collateral,” the funds and securities in question were commingled with Lehman’s own funds and in many cases rehypothecated (i.e., used as collateral in Lehman’s own transactions). See Christian J. Johnson, *Derivatives and Rehypothecation Failure: It's 3:00 P.M., Do You Know Where Your Collateral Is?*, 39 Ariz. L. Rev. 949, 951 (1997).

<sup>21</sup> The latter move, of course, creates a three-way credit exposure, and probably does not accomplish much that could not be accomplished with an escrow arrangement, other than perhaps neutral monitoring of compliance with the escrow agreement. The key to reducing risk would seem to be prohibitions or limits on rehypothecation.

<sup>22</sup> See Lubben, *supra* note 3.

<sup>23</sup> The Financial Netting Improvements Act of 2006, Pub. L. 109-390, makes certain technical amendments and clarifications to the provisions enacted as part of The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109-8, but for simplicity I will refer throughout to these as the 2005 Amendments.

<sup>24</sup> Michael Simkovic, *Secret Liens and the Financial Crisis of 2008*, 83 Am. Bankr. L.J. 253, 282 (2009).

<sup>25</sup> The definition of “securities contract” in section 741(7) includes:

a contract for the purchase, sale, or loan of a security, a certificate of deposit, a mortgage loan . . . or option on any of the foregoing, including an option to purchase or sell any such security, certificate of deposit, mortgage loan . . . including any repurchase or reverse repurchase transaction on any such security, certificate of deposit, mortgage loan . . .

contracts,<sup>27</sup> repurchase agreements,<sup>28</sup> and, most importantly, swap agreements.<sup>29</sup> The latter has become a kind of “catch-all” definition that covers the whole of the derivatives market, present and future.

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The definition of "securities contract" was amended in 2005 to conform to the definition in the Federal Deposit Insurance Act. The term “security” is itself defined in §101(49).

<sup>26</sup> 11 U.S.C. §781(4). As explained in *Collier's*:

The meaning of the term "commodity contract" differs depending upon the type of commodity broker at issue. A commodity contract with respect to a futures commission merchant is a contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade. Such a contract is known in the commodities trade as a "commodity futures contract." A commodity contract with respect to a foreign futures commission merchant is a foreign future, and with respect to a leverage transaction merchant is a leverage transaction. A commodity contract with respect to a clearing organization is either a commodity futures contract that is cleared by such clearing organization or is a commodity option traded on, or subject to the rules of, a contract market or a board of trade that is cleared by such clearing organization. A commodity contract with respect to a commodity options dealer is a commodity option.

Collier on Bankruptcy ¶761.05 (footnotes omitted). Commodity is defined in §761(8) through cross-reference to the Commodity Exchange Act ("CEA"). CEA §1a(4) defines "commodity" to include agricultural products "and all other goods and articles, except onions as provided in section 13-1 of this title, and all services, rights, and interests in which contracts for future de-livery are presently or in the future dealt in." The origins of the amusing “onion” exception are detailed in <http://www.time.com/time/magazine/article/0,9171,891311,00.html>. Several other parts of Code §761 also cross reference the CEA. See *Olympic Natural Gas*, 294 F.3d 737, 740-41 (5th Cir. 2002) ("The term 'commodity contract' 'encompasses purchases and sales of commodities for future delivery on, or subject to the rules of, a contract market or board of trade . . . .' In contrast, 'forward contracts' are 'contracts for the future purchase or sale of commodities that are not subject to the rules of a contract market or board of trade.'").

<sup>27</sup> Forward contract is defined in §101(25), to include contracts (other than commodity contracts, see *supra* note 26) for the purchase, sale or transfer of a commodity at least two days in the future, and includes “a repurchase or reverse repurchase transaction . . . consignment, lease, swap, hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction, or any other similar agreement.”

<sup>28</sup> 11 U.S.C. §101(47). A repurchase agreement or “repo,” is essentially the sale of a financial instrument combined with a forward contract to repurchase the same. The initial “buyer” is compensated by the “seller” through a difference between the

A protected contract, that is one that falls within one of the foregoing categories, is only protected if the holder is also a protected person, as defined in the Bankruptcy Code. Financial participants<sup>30</sup> – essentially very large financial institutions – are always protected. And with regard to each class of protected derivative contract there is also a more specific class of protected parties.<sup>31</sup>

In some cases these latter categories have some real meaning. For example, forward contracts are only subject to the safe harbors with regard to financial participants and “forward contract merchants.” A forward contract merchant means either a Federal Reserve Bank or an entity “whose business consists in whole or in part of entering into forward contracts.”<sup>32</sup> On the other hand, the current definitions of “repo participant”<sup>33</sup> and “swap participant”<sup>34</sup> are essentially vacuous, requiring nothing more than the person in question be party to a repo or swap with the debtor. In short, anyone who is a party to these sorts of contracts is apt to be a protected person with regard to these contracts.

The safe harbors provide non-bankrupt counterparties with the ability to exercise contractual rights allowing liquidation, termination or acceleration of derivative contracts upon bankruptcy,<sup>35</sup> the right to set off or net derivative contracts free of

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initial payment and the final payment. To qualify under the Code’s definition, the repurchase obligation must occur within one year, but the definition expressly excludes a repurchase obligation involving a participation in a commercial mortgage loan. Note, however, that these types of repos might constitute another type of protected contract, particularly a swap or securities contract. *See In re Hamilton Taft & Co.*, 114 F.3d 991 (9th Cir. 1997).

<sup>29</sup> 11 U.S.C. §101(53B). The definition includes not only obvious swaps, like CDS, interest rate swaps, and currency swaps, but also any instrument “of a type that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap markets” including “a forward, swap, future, option or spot transaction on one or more rates, currencies, commodities, equity securities, or other equity instruments, debt securities or other debt instruments, quantitative measures associated with an occurrence, extent of an occurrence, or contingency associated with a financial, commercial, or economic consequence, or economic or financial indices or measures of economic or financial risk or value.” In short, every conceivable derivative contract.

<sup>30</sup> 11 U.S.C. §101(22A) (defining “financial participant”).

<sup>31</sup> With regard to securities contracts with the debtor, the counterparty must be a “stockbroker,” “financial institution,” “financial participant” or “securities clearing agency.”

<sup>32</sup> 11 U.S.C. §101(26). *See also In re Mirant Corp.*, 310 B.R. 548, 568 (Bankr. N.D. Tex. 2004).

<sup>33</sup> 11 U.S.C. §101(46).

<sup>34</sup> 11 U.S.C. §101(53C).

<sup>35</sup> 11 U.S.C. §§555 (securities contracts), 556 (forward and commodities contracts)

the automatic stay,<sup>36</sup> and broad immunity from avoidance actions.<sup>37</sup> These protections also extend to derivative transactions nestled under a master agreement, even if the master agreement aggregates disparate types of derivative contracts.<sup>38</sup> Security agreements and other credit enhancements are also encompassed within the definitions of protected contracts, and thus subject to the safe harbors.<sup>39</sup>

*b. The Problematic Theoretical Foundations of the Safe Harbors*

There have been two traditional justifications for the foregoing safe harbor provisions. First, the provisions are said to prohibit unfair “cherry picking” of

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559 (repurchase or “repo” agreements), 560 (swaps). The exceptions apply to a “contractual right,” which includes rights provided for in a rule by various trade organizations or exchanges.

<sup>36</sup> 11 U.S.C. §§362(b)(6) (securities contracts, forwards and commodity contracts), 362(b)(7) (repos), 362(b)(17) (swaps). *See also* 11 U.S.C. §§362(o) (exercise of rights under the foregoing provisions not subject to any stays), 556 (forwards and commodity contracts protected parties’ right to margin payments under those contracts shall not be stayed, avoided or limited), 560 (under a swap right to offset or net-out any termination values or payment amounts shall not be stayed, avoided or limited).

<sup>37</sup> 11 U.S.C. §§546(e), (f), (g), (j), 548(d)(2)(B), (C), (D). The foregoing sections of section 546 prohibit the bringing of avoidance actions under sections 544, 545, 547, 548 (a)(1)(B), and 548 (b) of the Bankruptcy Code. The foregoing provisions of section 548 provide that a derivatives counterparty always takes for value, potentially complicating an attempt to recover a transfer as an actual fraudulent transfer. 11 U.S.C. §548(c). This author is at a loss to explain how a derivative might be a statutory lien under section 545. These provisions do not seem to prohibit the lifting of the automatic stay to allow a creditor to bring an avoidance action under state or federal non-bankruptcy law, so long as the creditor did not bring such action on behalf of the estate. *Cf.* 11 U.S.C. §544(b)(1).

<sup>38</sup> 11 U.S.C. §§362(b)(27) (allows setoffs and netting under master netting agreements) 561 (right to terminate, accelerate or liquidate, or to offset, or net termination values, payment amounts or other transfer obligations arising under or in connection with one or more securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements or master netting agreements, shall not be stayed, avoided or limited by operation of the bankruptcy code or by order of a court or administrative agency). *See also* 11 U.S.C. §§101(38A) (definition of “master netting agreement”). The definitions of securities contracts, commodities, forward contracts, repurchase agreements, and swap agreements also include “a master agreement” that includes the defined contracts. Note the slight difference in terminology between “master agreement” and “master netting agreement.”

<sup>39</sup> *See, e.g.,* 11 U.S.C. 101(25)(E) (definition of “forward contract”).



contracts by debtors.<sup>40</sup> And second, the safe harbors are said to reduce systemic risk, that is, the risk system-wide crisis resulting from a bankruptcy case.<sup>41</sup>

In particular, the safe harbors as currently enacted were promoted by the derivatives industry as necessary measures to support “close out netting.”<sup>42</sup> Close out netting is, in short, a technical term for enforcement of *ipso facto* (i.e., bankruptcy termination) clauses and setoff of the resulting mass of claims resulting from the terminated derivative contracts.<sup>43</sup> According to the financial community, only with close out netting could cherry picking and systemic risk be avoided.

The cherry picking argument rests on the belief that it is somehow inequitable for a debtor to retain favorable derivatives while rejecting unfavorable contracts.<sup>44</sup> Of course, this ability to decide whether to treat a contract as an asset or a debt is key to the operation of section 365, and applies to all sorts of contracts.<sup>45</sup> It thus imposes no special burden on derivative contracts.<sup>46</sup> Moreover, the safe harbors simply give the non-debtor party an option to terminate upon a bankruptcy – which amounts to cherry picking from the other side of the deal.<sup>47</sup>

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<sup>40</sup> See *In re Enron, Inc.*, 349 B.R. 96, 106 (Bankr. S.D.N.Y. 2006).

<sup>41</sup> See Steven L. Schwarcz, *Systemic Risk*, 97 Geo. L.J. 193, 196–204 (2008) (defining systemic risk as: “the risk that (i) an economic shock such as market or institutional failure triggers (through a panic or otherwise) either (X) the failure of a chain of markets or institutions or (Y) a chain of significant losses to financial institutions, (ii) resulting in increases in the cost of capital or decreases in its availability, often evidenced by substantial financial-market price volatility”).

<sup>42</sup> The President’s Working Group on Financial Market, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management* (1999); H.R. Rep. No. 109-31(I), at 3, 20, 131-32 (2005), reprinted in 2005 U.S.C.C.A.N. 88, 89, 105-06, 191-92.

<sup>43</sup> The safe harbor provisions permit qualifying non-debtor counterparties to liquidate, terminate or accelerate contracts and net out positions. All other *ipso facto* provisions remain unenforceable under the Bankruptcy Code. See *In re Lehman Bros. Holdings Inc.*, 416 B.R. 392 (Bankr. S.D.N.Y. 2009).

<sup>44</sup> Adam R. Waldman, *OTC Derivatives & Systemic Risk: Innovative Finance Or The Dance Into The Abyss?*, 43 Am. U. L. Rev. 1023, 1059-60 (1994).

<sup>45</sup> Lubben, *supra* note 2.

<sup>46</sup> Although rarely made, one argument that might support the safe harbors or at least some special treatment of derivatives in bankruptcy turns on the “zero sum” nature of derivative contracts. While most contracts can have value to both parties, most derivatives are only valuable to the debtor in situations where they are not valuable to the non-debtor, and vice-versa.

<sup>47</sup> The safe harbors give the non-debtor the option to terminate, but do not require it, and thus create a kind of assumption and rejection power on behalf of the non-debtor. Jonathon Keath Hance, *Derivatives at Bankruptcy: Lifesaving Knowledge for the Small Firm*, 65 Wash. & Lee L. Rev. 711, 736 (2008).

The systemic risk argument for the safe harbors is based on the belief that the inability to close out a derivative position because of the automatic stay would cause a daisy chain of failure amongst financial institutions.<sup>48</sup> The problem with this argument is that it fails to consider the risks created by the rush to close out positions and demand collateral from distressed firms.<sup>49</sup> Not only does this contribute to the failure of an already weakened financial firm, by fostering a run on the firm, but it also has consequent effects on the markets generally, as parties rush to sell trades with the debtor and buy corresponding positions with new counterparties.<sup>50</sup> It is not clear that this latter disruption, created by the safe harbor exceptions to the automatic stay and the debtor's avoidance powers,<sup>51</sup> is not systemically more important than the risk that is put forth in support of the safe harbors, particularly if one considers that the automatic stay can always be lifted by the bankruptcy court.<sup>52</sup> And while it is sometimes said that repealing the safe harbors will simply move the run on the debtor to the pre-bankruptcy period, this neglects the effect of the debtor's ability to bring a preference action.<sup>53</sup> Unless the non-debtor counterparty plans their run 90 days in advance – and can convince the debtor not to file during the interim – this argument does not seem plausible.<sup>54</sup>

Indeed, the current safe harbors would seem to be the source of considerable dead weight and systemic losses. These losses effect both the bankruptcy estate directly and larger questions of societal wealth.

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<sup>48</sup> It is also sometimes suggested that the mere act of a financial firm's bankruptcy filing creates systemic risk, but that seems to confuse the process of bankruptcy with the general reality of default. Jean Helwege, *Financial Firm Bankruptcy and Systemic Risk*, 20 J. Int'l Fin. Markets, Institutions & Money, Feb. 2010, at 1, 2 (arguing that bankruptcies of financial firms "are symptomatic of common factors in portfolios that lead to wealth losses regardless of whether any particular firm files for bankruptcy").

<sup>49</sup> Lubben, *supra* note 1.

<sup>50</sup> <http://online.wsj.com/article/SB123050916770038267.html>

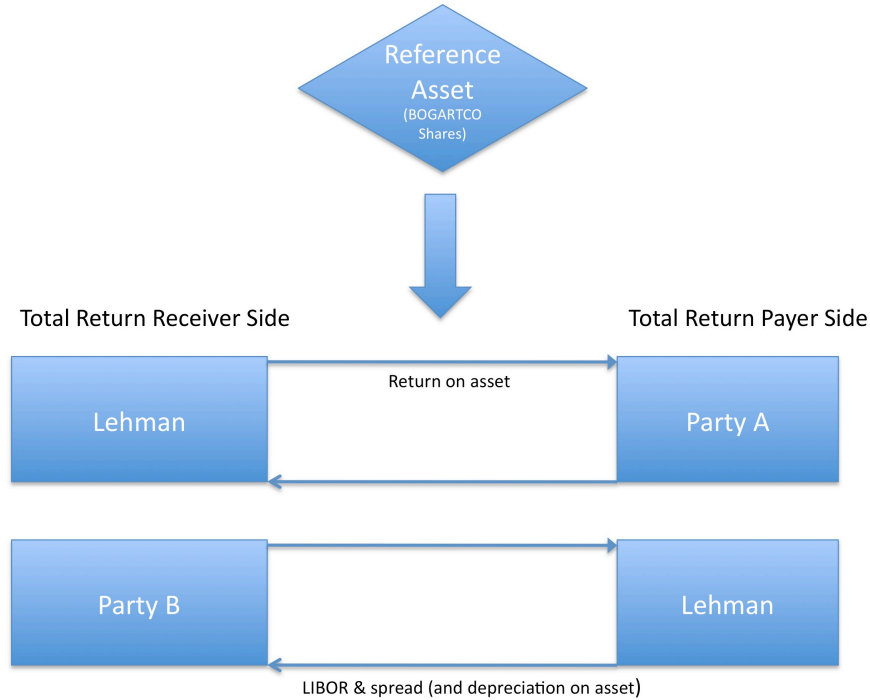
<sup>51</sup> For example, the knowledge that the debtor will be unable to bring a preference action related to a derivative contract removes any incentive to refrain from demanding collateral on the eve of bankruptcy.

<sup>52</sup> 11 U.S.C. §362(d). Given the numbers of contracts involved in the chapter 11 case of a large financial institution, it may be that the bankruptcy court would have to rule on entire classes of derivatives, absent unique facts regarding a specific transaction that might warrant lifting the stay.

<sup>53</sup> 11 U.S.C. §547.

<sup>54</sup> *Cf.* In re Enron Creditors Recovery Corp., 422 B.R. 423 (S.D.N.Y. 2009) (non-ordinary course termination of commercial paper on eve of bankruptcy not avoidable because of safe harbor provisions).

**Figure 2: Total Return Swap Transaction**



For example, imagine Lehman Brothers has intermediated a total-return swap on a million shares of BOGARTCO stock<sup>55</sup> where Party A receives and Lehman pays the BOGARTCO return. BOGARTCO shares are currently trading at \$40. At the same time, Party B pays the return of BOGARTCO and Lehman receives the return of BOGARTCO for some period of time, with Lehman earning a return on the difference or spread between the two variable interest rate legs of these transactions.

When Lehman enters bankruptcy, this transaction is an asset of the estate, because it earns a valuable return for Lehman. But that asset is destroyed under the safe harbors, which permit and encourage termination of the deal. Moreover, when Party A terminates its deal with Lehman under the safe harbors and has to replace his long swap on the million shares, imagine he sends his termination notice the day Lehman files and buys the one million shares--his buying pushes the stock price up from 40 to 42 dollars and he pays, on average, 41 for his new shares.

Party B is in Asia and it takes her a few additional days to act, and her termination notice goes out a week later. She then reestablishes her position, which is short BOGARTCO, and sells her BOGARTCO shares and pushes the price from 40 to 38

<sup>55</sup> As my students well know, BOGARTCO is the leading hypothetical manufacturer of trenchcoats and fedoras. See Lubben, *supra* note 2.

with average of 39. Each party then files a proof of claim for \$1 million, their respective losses, for a total of \$2 million against the estate. This amount plus the loss to Lehman is the total wealth destroyed by the safe harbors.

It seems clear that it would both reduce systemic risk and enhance the return to the debtor's creditors to dispose of a financial firm's derivative portfolio as a whole, perhaps as part of a quick §363 sale of the debtor's entire business, rather than see it dismembered in a panic in the sales before and immediately after a chapter 11 filing. In short, the safe harbors would seem to promote the premature liquidation of a debtor, with bad effects for the larger financial markets. Knowing that the safe harbors are in place, potential debtors with large derivative positions are encouraged to avoid chapter 11 for as long as possible, meaning that when they do finally enter bankruptcy they are likely to have dissipated their working capital and reached a point of extreme illiquidity.

The systemic risk justification for the safe harbors also does nothing to explain why they apply to all debtors, no matter how systemically unimportant.

Because the safe harbors seem to lack good justifications, and are at the very least overbroad, I have argued that they should be repealed or drastically amended. The remainder of this paper examines the issues that arise from such a repeal.

## II. Derivatives and the Bankruptcy Code

Given that the broad justifications for the safe harbors have been found wanting, this section examines the issues that arise from the interaction of derivatives with chapter 11 specifically and the Bankruptcy Code generally. The goal here is to develop a list of the real issues that merit attention, a list that will drive the discussion of possible changes to the Code set forth in Part III.

Initially, consider a specific instance where the "cherry picking" argument might be more persuasive. It is sometimes said that the safe harbors have a special salience with regard to centrally cleared derivative contracts, like commodity futures. In particular, because a central clearing agency is exposed to counterparty credit risk from each of its participants, the safe harbors are said to reduce the risk that the central agency might fail. And it is true that the early safe harbors were only applicable to centrally cleared derivatives, a point Congress seems to have forgotten as it expanded the safe harbors to OTC transactions.

Nevertheless, it is not clear that safe harbors provide any real systemic protection even in this context. Central clearing of derivatives has been promoted since the financial crisis as a tool for reducing systemic risk, as the central clearing agency can use its position in the hub as a monitor of the exposure of the parties it trades with

and provide information to regulators about market in general.<sup>56</sup> Systemic risk is reduced by forcing a large volume of trades to be central cleared, and then requiring members in the clearing organization to post collateral and enter into obligations to fund the central agency in times of crisis, when the collateral or margin accounts may not provide sufficient liquidity. Safe harbors would seem to undermine this structure by dulling the central agency's incentives to monitor its members – the centrally clearing agency must have some degree of counterparty risk, so that it has incentives to use its position to reduce overall systemic risk. Safe harbors that allow the central clearing party to remove itself from the middle of trades are directly contrary to the goals of increased central clearing.

A more substantial set of concerns involves the period of time between the debtor's bankruptcy filing and its decision to assume or reject a particular derivative.<sup>57</sup> For example, consider an "in the money" call option that expires a week after the petition date.<sup>58</sup> The non-debtor counterparty will have legitimate concerns about the debtor's willingness to perform and its ability to do so without court authorization.<sup>59</sup> And if the non-debtor party has to seek a court order to compel the debtor's performance or authorize the same, the strike price of the call has effectively been increased by the amount of the legal fees incurred. While these concerns are somewhat true of all contractual counterparties, they seem likely to arise with greater frequency with respect to derivative transactions, given the relatively short durations and sheer number of contracts that might be involved, and debtor "stonewalling" is apt to have graver consequences.

Similarly, although derivative transactions are increasingly secured by posted collateral, these transactions are unlike most other secured debts in that the values at stake change daily, and often change quite dramatically. This volatility is likely to be exacerbated by the chapter 11 filing of a large dealer. The Code recognizes the rights of a secured creditor to "adequate protection" while they are stayed from realizing on their collateral,<sup>60</sup> but its structure does not anticipate the possibility of a claim that might change in value on a daily or hourly basis.

Indeed, the Bankruptcy Code is designed to address collateral value fluctuations, not claim value fluctuations, which is what is really at issue with regard to derivatives. The Code was designed with a fixed loan obligation in mind, and the concern was that the collateral supporting that loan might deteriorate during the delay caused by the bankruptcy case. The collateral posted in a derivative transaction is often cash

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<sup>56</sup> <http://www.ft.com/cms/s/0/e81c32c0-0077-11df-b50b-00144feabdc0.html>

<sup>57</sup> 11 U.S.C. §365(d)(2) ("In a case under chapter 9, 11, 12, or 13 of this title, the trustee may assume or reject an executory contract or unexpired lease of residential real property or of personal property of the debtor at any time before the confirmation of a plan . . .").

<sup>58</sup> That is, an option to buy an asset at a price less than the current market price.

<sup>59</sup> 11 U.S.C. §363(c)(1).

<sup>60</sup> 11 U.S.C. §361.

or high quality securities, and thus not especially likely to decline in value, but the debtor's potential liability on the derivative instrument changes rapidly. The Code expressly recognizes that a derivative contract might be valued post-petition to calculate rejection damages,<sup>61</sup> but it does nothing to solve the related adequate protection problem.<sup>62</sup> This represents a key issue to be addressed upon repeal of the safe harbors.

The derivatives community's interest in safe harbors is tied to the belief in the benefits of close out netting, which involves the termination of all derivatives with a particular debtor and the setting off of settlement payments owed under those contracts. Of course, if the safe harbors are repealed, there will be fewer contracts terminated. But there remains a possibility that many setoff situations will arise nonetheless, as the debtor rejects unfavorable derivative trades but the counterparty deducts the breach damages from payments owed to the debtor on other trades that the debtor assumes.

One potential problem for future setoffs is the general rule that a setoff is not appropriately effectuated against two different debtors, even if those debtors are part of a single corporate enterprise.<sup>63</sup> Thus, a hedge fund who enters into a put option on a particular company's shares with Debtor Brokerage, Inc. and a total return swap on the same shares with Debtor Special Financing, Inc. is unable to offset these two positions in bankruptcy, even though they likely were designed as a single trade on the underlying shares. This problem is further exacerbated in cases like Lehman Brothers, where the debtor entities might have bankruptcy cases pending in different countries.<sup>64</sup>

But it is not clear that this problem needs or warrants a bankruptcy solution.<sup>65</sup> Instead, the easy answer is for larger derivatives dealers to conduct all of their trades through a single subsidiary, giving counterparties the comfort that their setoff rights will be preserved if the worst happens.

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<sup>61</sup> Although the cases are split on the issue, many courts hold that breach claims on traditional contracts are "as of" the petition date.

<sup>62</sup> 11 U.S.C. §562.

<sup>63</sup> *In re SemCrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009). *But see* Martin J. Bienenstock et al., *Are Triangular Setoff Agreements Enforceable in Bankruptcy?*, 83 Am. Bankr. L.J. 325 (2009) (arguing that *SemCrude* was wrongly decided).

<sup>64</sup> Although the development of "resolution authority" to handle the collapse of financial institutions is beyond the scope of this article, this suggests a need to coordinate such authority across the key financial jurisdictions – at the very least, New York and London need to be integrated in this regard.

<sup>65</sup> *See In re Beville, Bresler & Schulman Asset Mgmt. Corp.*, 896 F.2d 54, 57 (3d Cir. 1990) ("setoff is at odds with a fundamental policy of bankruptcy, equality among creditors ...").

Avoidance actions are also an obvious concern for the derivatives industry, inasmuch as a fraudulent transfer or preference action has the potential to “undo” a seemingly complete and settled transaction.<sup>66</sup> But many stated concerns about avoidance actions appear to be inflated, once closely examined. For example, most common derivative operations would seem to be protected against preference attack by the Code’s “ordinary course of business” defense, which protects transactions that are regular either as to the parties or the relevant industry.<sup>67</sup>

On the other hand, a party that attempts to force an early exit, without either contractual right or industry practice to back it up, should face an avoidance action.<sup>68</sup> And the Code will have to guard against attempts to grab massive amounts of collateral on the eve of bankruptcy, in a way that is unrelated to the underlying value of the trades being collateralized. For example, increased collateral posting obligations that are tied to the debtor’s credit rating should not be deemed ordinary course, as I discuss in greater detail in the next part of the paper.

It is conceivable, however, that pre-bankruptcy adherence to certain derivative terms might lead to a viable claim of fraudulent transfer. For example, some derivatives contain “walk-away” provisions that provide that a breaching party – and filing a chapter 11 petition constitutes a breach – is not entitled to any payment upon termination of the derivative.<sup>69</sup> To the extent this non-breaching party retains value that is greater than its damages, there is an argument to be made that this constitutes a transfer of the debtor’s property for less than reasonability equivalent value, and is thus avoidable.<sup>70</sup> On the other hand, if the non-debtor can point to some value given at the inception of the transaction, then the transaction is not avoidable.<sup>71</sup> In short, it is not clear that there is a real problem here, and from a

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<sup>66</sup> Stephen J. Lubben, *Beyond True Sales: Securitization and Chapter 11*, 1 N.Y.U.J.L. & Bus. 89, 107 (2004).

<sup>67</sup> 11 U.S.C. §547(c)(2).

<sup>68</sup> See *In re Enron Creditors Recovery Corp.*, 422 B.R. 423 (S.D.N.Y. 2009) (non-ordinary course termination of commercial paper on eve of bankruptcy not avoidable because of safe harbor provisions).

<sup>69</sup> The enforceability of “walk-away” provisions is presently being litigated in the context of several adversary proceedings in the Lehman Brothers Holdings Inc. and Lehman Brothers Special Financing Inc. bankruptcy proceedings. See e.g., *Lehman Brothers Special Financing Inc. v. Harrier Finance Ltd.* (In re Lehman Brothers Holdings Inc.), Ch. 11 Case No. 08-13555, Adv. No. 09-01241 (Bankr. S.D.N.Y. 2009) (regarding the enforceability of a credit default swap “walk-away” provision). Some of the adversary cases have been settled without a decision. *But see* *Drexel Burnham Lambert Prods. Corp. v. Midland Bank PLC*, 1992 U.S. Dist. LEXIS 21223 (S.D.N.Y. Nov. 9, 1992) (similar provision found enforceable).

<sup>70</sup> 11 U.S.C. §548(a)(1)(B).

<sup>71</sup> *Mellon Bank, N.A. v. Metro Comm’cns, Inc.*, 945 F.2d 635, 647 (3d Cir. 1991). In the context of CDOs, ratings agencies often demanded these provisions to protect the special purpose entity from incurring a large payment obligation.

policy perspective it seems doubtful the Bankruptcy Code should go out of its way to accommodate a contractual term that seems deliberately designed to strip assets from the estate.<sup>72</sup>

Of course, even if there is no legal basis for an avoidance action, counterparties still have to worry about a suit brought to induce a settlement. This is particularly true as an increasing number of chapter 11 plans are offering unsecured creditors a recovery that is contingent on the results of litigation. Thus avoidance actions, while not a primary concern, do present some real risk to the derivatives markets in the form of uncertainty.

Finally, the interaction of chapter 11 with the repo markets needs to be addressed. But first, we need to consider the broad range of transactions that come under the heading of “repurchase agreements.”

A traditional repo agreement involves the sale of a high-quality asset, often Treasury or other government paper, or highly rated bonds, with an agreement to repurchase the same in the very near term, often the next day.<sup>73</sup> The spread between the sale and purchase price amounts to interest, and the rates on overnight repos are usually quite close to rates on overnight loans in the federal funds market. In addition to charging interest, the lender/purchaser in a repo transaction typically only provides cash equal to a fraction of the collateral value “sold” in the transaction – which provides an extra margin of protection in case of default.<sup>74</sup>

These traditional repos play an important role in the functioning of financial markets.<sup>75</sup> They are widely used by securities dealers and they provide a way for mutual funds, depository institutions, and others to earn a return on funds that are above the deposit insurance limits for traditional bank accounts. Repos are also frequently used in open market operations by the Federal Reserve, since they provide a convenient way to add or subtract cash reserves from the financial system.<sup>76</sup>

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<sup>72</sup> 12 U.S.C. §1821(e)(8)(G) (“walk-away” provisions unenforceable under the Federal Deposit Insurance Act).

<sup>73</sup> Stephen A. Lumpkin, *Repurchase and Reverse Repurchase Agreements*, in TIMOTHY Q. COOK AND ROBERT K. LAROCHE EDS., *INSTRUMENTS OF THE MONEY MARKET* ch. 6 (1993).

<sup>74</sup> This discount or “haircut” was extremely small before 2007, but began to grow, particularly for housing-related assets, as counterparties began to doubt their ability to properly value the assets. Obviously the growth of these haircuts can create a liquidity crunch for an institution that is heavily reliant on the ability to borrow against mortgage-backed securities to finance daily operations. See Gary Gorton, *Questions and Answers About the Financial Crisis*, 12-13 (2009) (<http://www.fcic.gov/day2/Gorton.pdf>).

<sup>75</sup> See Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 *Cardozo L. Rev.* 1553, 1640-43 (2008).

<sup>76</sup> <http://www.newyorkfed.org/aboutthefed/fedpoint/fed04.html>.



The repo market as thus described plays an important role in the financial system that needs to be protected. Moreover, because of the exceedingly small margins involved in these trades, imposition of bankruptcy costs on the market might have serious untoward consequences. Accordingly, this is an issue to be addressed if the safe harbors are repealed.<sup>77</sup>

But in the past decade, the repo market has expanded far beyond its traditional roots. First, investment banks became highly reliant on repo transactions to provide funding, and increasingly these repo transactions were conducted with mortgage-backed securities.<sup>78</sup> The high ratings these securities received from the rating agencies, combined with the favorable treatment of repos under the Bankruptcy Code, may have encouraged excessive use of this type of financing by convincing the recipients of these securities that they were just as good of collateral as that used in “old fashioned” repo arrangements.<sup>79</sup>

More importantly, in a move that seems extremely inopportune in hindsight, the 2005 Amendments to the Bankruptcy Code broadened the definition of a “repurchase agreement,” previously limited to obligations of the United States and other highly rated securities, to include mortgage loans and interests in mortgage loans. In addition to facilitating or, more likely, acknowledging, the substantial expansion of short-term repo financing already described, this change had at least two other effects that may have contributed to the financial crisis.

First, the traditional “warehouse loan” used by mortgage originators was transformed into a repo agreement that received the protections of the safe harbors.<sup>80</sup> Traditional warehouse loans were short-term loans secured by mortgages recently originated. The loan provided the originator with liquidity until enough mortgages had been originated to form the basis for a securitization. Post 2005, warehouse financing arrangements typically have been documented as “master repurchase agreements” under which an originator sells mortgage loans to its former lender with a simultaneous agreement by the originator to repurchase

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<sup>77</sup> I approach this from a bankruptcy perspective. It is, of course, quite possible that the size and extensive reliance on the repo market, even in its traditional form, represent a systemic risk problem in need of a regulatory solution. But that solution would not occur through the Bankruptcy Code.

<sup>78</sup> Claudio E. Raddatz, *When the Rivers Run Dry: Liquidity and the Use of Wholesale Funds in the Transmission of the U.S. Subprime Crisis* (February 1, 2010). World Bank Policy Research Working Paper Series, Vol. , pp. -, 2010. Available at SSRN: <http://ssrn.com/abstract=1559720>.

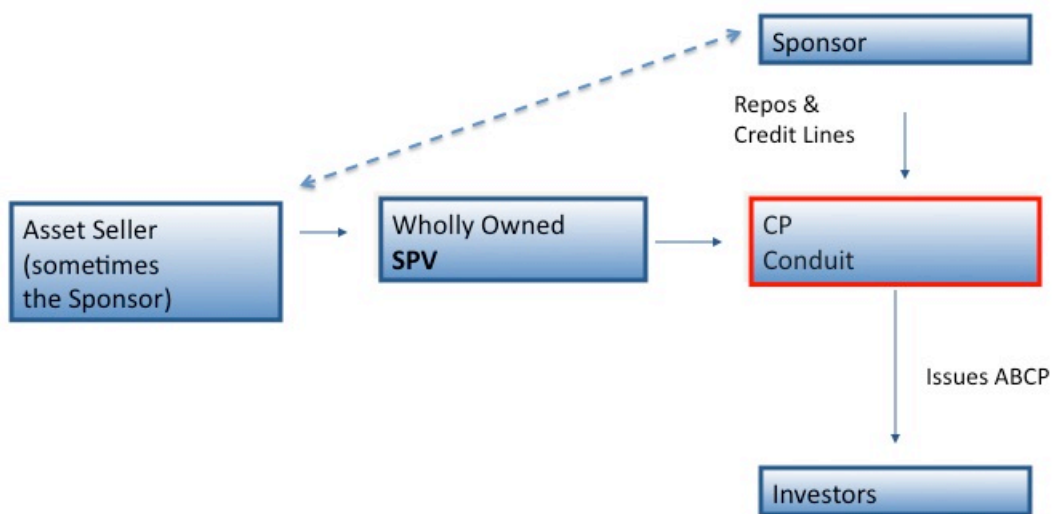
<sup>79</sup> Although data on the total size of the repo market is limited, it is often said to have been in the \$10 to \$12 trillion range in early 2007.

<sup>80</sup> Thomas E. Plank, *Toward a More Efficient Bankruptcy Law: Mortgage Financing Under the 2005 Bankruptcy Amendments*, 31 S. Ill. U. L.J. 641, 666-67 (2007) (lauding this development).

from the lender. The repurchase is then consummated when the securitization happens.

The economic effect of the deal is the same, but now the lender no longer has to worry about becoming involved in a bankruptcy proceeding. This may have encouraged excessive lending to mortgage originators.

**Figure 3: ASCP Conduit Structure**



Perhaps more importantly, following the 2005 Amendments, repurchase agreements became much more common in asset-backed commercial paper (ABCP) conduits and structured investment vehicles (SIVs), the financial structures that were amongst the first to collapse in the financial crisis.<sup>81</sup> At heart, an ABCP facility is a means of securitizing lower quality assets in a way that will allow the originator or buyer of these assets to issue highly rated money market instruments, traditionally among the cheapest form of corporate finance available.<sup>82</sup> Banks and

<sup>81</sup> Defaults in this market began to occur more than a year before the Lehman bankruptcy. [http://mba.yale.edu/news\\_events/pdf/financial%20conf-paper%2019.pdf](http://mba.yale.edu/news_events/pdf/financial%20conf-paper%2019.pdf)

<sup>82</sup> Frank Partnoy, *Shapeshifting Corporations*, 76 U. Chi. L. Rev. 261, 268-69 (2009) (“An SIV is sometimes called a “conduit” because it raises short-term funds and channels those funds into longer-term assets. An SIV’s business model resembles

similar lenders found conduits and SIVs attractive because they allowed them to continue to offer traditional receivables financing without the regulatory implications of making a loan that would appear on their balance sheet.<sup>83</sup>

These off-balance-sheet vehicles were thus holders of long-term assets financed using short-term paper. This presented an obvious problem, since there are historical examples of periods when commercial paper would not “roll,” such as after the Penn Central bankruptcy filing in 1970.<sup>84</sup> To overcome this problem, the sponsoring bank granted a credit line, or “liquidity backstop,” to the conduit.<sup>85</sup>

Moreover, after the 2005 amendments to the Code, which were accompanied by corresponding amendments to the relevant banking statutes,<sup>86</sup> sponsoring financial institutions increasingly used repo agreements to increase the credit rating of the ABCP issued by conduits and SIVs. If a repurchase agreement provided for full recourse to a highly rated sponsor – that is the ability to return all the assets<sup>87</sup> – the ABCP could be rated based on the credit rating of the sponsor, which seemed to remove any need to reflect on the quality of the underlying assets being placed in the conduit – and thus the ability to turn lead into gold, or so it seemed.<sup>88</sup>

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that of a bank: it seeks to earn a spread between the interest rate at which it borrows and the interest rate at which it lends.”).

<sup>83</sup> Trade receivables, auto loan transactions, and credit card receivables were the most common assets used in multi-seller facilities – that is, facilities where the sponsor did not generate the assets. Seller facilities – where the sponsor generated the assets – often involved credit card receivables and mortgages.

<sup>84</sup> <http://www.time.com/time/magazine/article/0,9171,878374,00.html> (“Until the collapse of the Penn Central, commercial paper was the nation's fastest-growing type of credit, but now it has become a prime source of financial worry.”).

<sup>85</sup> Arthur E. Wilmarth, *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 Conn. L. Rev. 963, 1033-34 (2009).

<sup>86</sup> 12 U.S.C. §1821(e)(8).

<sup>87</sup> Conduits entered into reverse repo agreements with sponsors under which the sponsor sold assets to the conduit. On the maturity date of the repo, if the conduit was unable to roll (i.e., refinance) the ABCP the repo counterparty was then required to repurchase the assets at the agreed upon price, and the conduit would use the proceeds to repay maturing ABCP and the facility would come to an end. The safe harbors gave investors and rating agencies comfort that the assets could be sold if the sponsor experienced financial distress – an assumption that rested on a faith in the ability to sell the underlying assets. See Carrick Mollenkamp & Margot Patrick, *Credit Crunch: Citigroup Moves to Quell SIV Concerns*, Wall St. J., Sept. 7, 2007, at C2.

<sup>88</sup> See Viral V. Acharya et al., *Securitization Without Risk Transfer*, NBER Working Paper 15730 (2010) (available at <http://www.nber.org/papers/w15730>).

These latter extensions of repo agreements are obviously undeserving of too much concern, and thus when considering how the Bankruptcy Code might accommodate this market after repeal of the safe harbors, it becomes important to distinguish among the various facets.

In short, following the repeal of the safe harbors in the Code, there are several key areas that need to be addressed. Adequate protection rules in the Code are ill equipped to handle derivatives. This could lead to problems if the debtor is given an extended period of time to decide whether to assume or reject financial contracts. Traditional repo agreements perform useful functions in the financial system that may be limited if the safe harbors are repealed and avoidance actions, particularly preference actions, could benefit from some added clarity. I address each of these issues in greater detail in the next part of this article, but the list of issues does illustrate the substantial overbreadth of the existing safe harbor provisions, which cover essentially the entire derivatives markets.

### III. Accommodating the Reality of Derivatives

In this section I suggest specific amendments to the Code that should accompany any repeal of the safe harbors. But even this may be too narrow, inasmuch as the issue of safe harbors is closely tied to the debates over the nature of the “resolution authority” to unwind a failed financial firm. For example, while I discuss placing limits on the debtor’s time to assume or reject a derivatives contract, plainly such limits need to be integrated with the time provided for the reorganization, recapitalization, or sale of the debtor. Recognizing that this paper is just a piece of an overall puzzle, I proceed.

#### *a. Adequate Protection*

As noted in Part II, a key problem presented by the current Bankruptcy Code when applied to derivatives is that the Code is designed to address comparatively stable claim values in the face of declining collateral values, but not the converse. This traditional understanding of adequate protection is rooted in situations where the non-debtor party’s obligations are essentially complete and non-executory, and is of little use in the context of an ongoing, bilateral relationship.

In the derivatives context, I argue that adequate protection should be conceptualized on a proportionate basis: the non-debtor counterparty should be protected to the same relative degree as they were protected on the petition date. So, if a debtor’s obligations were 80% secured with mark to market collateral on the petition date, they should continue to be 80% secured until the debtor decides to assume or reject, even if the size of the debtor’s obligations increase. On the other hand, if the non-debtor party was remiss in allowing the mark to market collateral to drift below an appropriate level, perhaps illustrated in my 80% case, the non-debtor party would not be able to seek 100% coverage after the bankruptcy filing.

This would give the non-debtor party appropriate incentives to monitor and readjust collateral before the onset of financial distress – a counterparty with a fully collateralized position will continue to maintain that position throughout the chapter 11 case, but a counterparty with a lesser position will not be able to prejudice other unsecured creditors. This should give parties an incentive to adjust their collateral on a daily basis, with the obvious benefit of reducing the systemic effects of a large dealer’s collapse.<sup>89</sup>

The continuation of mark to market collateral post-petition would be a presumption that would remain in place until the court ordered otherwise. Thus, if the debtor for some reason felt the continued posting of collateral was unwarranted, it could go to court to seek a change. The presumption would be tied to a further presumption that the automatic stay would be lifted shortly after the non-debtor party gives notice that a necessary collateral posting has not been made.<sup>90</sup>

Moreover, collateral changes not based on changes in the underlying asset values – for example, collateral calls based on the debtor’s credit rating – would not be protected under this rule. They also would not be protected under the avoidance rules, as I discuss in further detail below. Instead, the goal would be to protect the proportionate degree of protection that the non-debtor party had at the commencement of the case.

As part of this, Congress also needs to reexamine section 507(b) of the Bankruptcy Code, which provides a super priority claim for a creditor who was granted adequate protection that turned out to be inadequate. In a world with controlling secured bank lenders, with pervasive liens on all the debtor’s assets, that often become controlling chapter 11 DIP lenders, this provision is apt to be little comfort, as section 364(c)(1) gives the DIP lender an even higher priority.<sup>91</sup> Creditors of all types deserve better and more realistic protection against judicial valuation errors.

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<sup>89</sup> Currently collateral posting is a function of both the exposure of the “in the money” party (the “Secured Party” in ISDA terms) and any applicable “Independent Amounts.” *See supra* note 19. In addition, the parties sometimes agree to a “threshold” under which collateral will not be exchanged, meaning that collateral is only exchanged if the derivative price moves outside a kind of “tolerance interval.” One additional effect of allowing ongoing mark to market collateral during chapter 11 at the pre-bankruptcy relative level would be to move all thresholds to zero.

<sup>90</sup> After filing the notice, the bankruptcy court would have to have a short period of time, perhaps 24 hours, to address any claims by the debtor that the non-debtor party had improperly demanded the collateral in question.

<sup>91</sup> *See generally* Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 Tex. L. Rev. 795 (2005).

*b. Retaining a Narrowed Repo Safe Harbor*

In part II I described how the expansion of the safe harbors with regard to repurchase agreements had likely contributed to the recent financial crisis, yet there is a traditional core of the repo market that seems worthy of saving. This is particularly obvious with regard to repos used by the Federal Reserve system as an instrument of monetary policy. Moreover, I suggested that the margins involved in these traditional transactions are so slight that they might not readily accommodate the imposition of any serious bankruptcy costs.

The problem then is the current breadth of the repo safe harbor: it covers things that look like routine secured loans and guarantees. When used as such, there is no reason why the form of the transaction should lead to special treatment of the non-debtor party. To narrow the potential for abuse of the safe harbors, I suggest two changes to the definition of “repurchase agreement” in the Code.<sup>92</sup>

First, the current definition allows for special status even if the repurchase obligation is up to a year in the future. The ability to use repo agreements as substitutes for other structures would be reduced if time period were substantially reduced, perhaps to 30 or 60 days.

Second, the 2005 Amendments, which granted special status to repos based on securitized collateral – namely mortgage loan securities – should be rolled back. Repurchase agreements could continue to be written on “ineligible” collateral, but the parties would assume greater risks if they decided to do so.

Taken together, these changes would preserve the safe harbors for the benefit of short-term contracts written on higher-quality collateral.

*c. Time Limits on Assumption and Rejection*

The Code expressly attempts to give a reorganizing debtor a bit of “option value” by allowing it to make the assumption or rejection decision in connection with the formulation of a reorganization plan. But in the case of derivatives, the extreme volatility associated with these contracts arguably takes the range of possible outcomes, and harm to the non-debtor, beyond those contemplated by Congress in 1978.

A non-debtor counterparty will be somewhat protected from these sorts of risks by the continuation of mark to market collateral arrangements, as described above. But for those counterparties that lack such protection, and because derivatives often form part of a larger investment plan that may be held in abeyance while the debtor decides what to do, it makes some sense to limit the amount of time the debtor can

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<sup>92</sup> 11 U.S.C. §101(47).

take to make its decision.<sup>93</sup> That is, the Code should put an expiration date on the debtor's option. The time limit should allow the debtor a reasonable opportunity to review its positions and make a decision as to whether a particular agreement should be assumed or rejected, while ensuring that the examination proceeds with all possible haste.<sup>94</sup>

Closely related to this, section 363(c) of the Code, which allows for operation of a business during bankruptcy "in the ordinary course" without prior court approval, should be amended to expressly provide the debtor with the ability and *obligation* to perform under its derivative contracts pending a decision to assume or reject the same. Required periodic payments should be made, securities delivered, and, of course, collateral posted. Non-performance should lead to quick termination of the automatic stay.

*d. Codifying "Ordinary Course" and "Reasonably Equivalent Value"*

While I have argued that counterparties have little to fear from the Code's avoidance actions, there is some uncertainty about the definition of certain key terms, which might create an opportunity to bring litigation, particularly if a suit is brought by creditors with no other source of recovery.

This issue is easily remedied by providing some interpretive guidance in the Bankruptcy Code. For example, the Code's preference provisions provide a defense for transactions undertaken in the "ordinary course of business."<sup>95</sup> A provision in the Code that made clear that actions taken according the express terms of an industry standard derivative contract would be presumed to be in the "ordinary course," would reduce much of the incentive for unwarranted preference litigation.<sup>96</sup>

Similarly, "constructive" fraudulent transfer provisions under state and federal law are based on the idea that a purchase of the debtor's assets for less than reasonably equivalent value can be avoided. A provision in the Code providing that a derivative transaction done on "market terms" is presumptively for "reasonably equivalent value" would be similarly useful, and should reduce the uncertainty that the avoidance powers present.

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<sup>93</sup> For several years the Code has had a similar provision with regard to non-residential real estate leases, although arguably the 2005 amendments may have overly constricted the time the debtor has in this regard. 11 U.S.C. §365(d)(4).

<sup>94</sup> While short timelines no doubt will cause the debtor to incur additional professional fees, which reduces the overall value of the estate, the balance of the economic losses would seem to tilt toward reducing the period of uncertainty for non-debtors.

<sup>95</sup> 11 U.S.C. §547(c)(2).

<sup>96</sup> Of course, this could not extend to *ipso facto* provisions, lest the preference defense become a new safe harbor.

#### IV. Conclusion

The safe harbor provisions are unloved, particularly by legal academics. But simple repeal of those provisions may not be appropriate, in that the financial markets will never return to 1978. The Bankruptcy Code needs to reflect the current reality of corporate finance, and thus I have suggested some valid concerns that are buried within the overly broad safe harbors. If the safe harbors are repealed, this paper highlights some issues that will have to be considered at the same time.