

Financial Engineering Meets Chapter 11 Safe Harbors and the Bankruptcy Code

“The Long and The Short of It”

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10/14/2011

Article on the bankruptcy treatment of financial contracts (including recent case summaries in relation to the safe harbors), together with bibliography of authorities and ISDA Research Note on close out netting.

Financial Engineering Meets Chapter 11 – Safe Harbors and the Bankruptcy Code

These educational materials include contributions from Riz Mokal of The World Bank, Ted Janger of Brooklyn Law School and Bankruptcy Judge James M. Peck. The panel is indebted to Riz Mokal for permitting us to use and modify certain content taken from one of his works in progress – a deeply insightful but not yet final paper on financial contracts and bankruptcy immunities that is being prepared as part of a study of best practices for dealing with the insolvency of counterparties to financial contracts. The content excerpted from this draft paper has been adapted and expanded to provide more of a focus on the United States Bankruptcy Code and recent case law developments, but the author’s ever present English law background and global perspectives are hard to miss and serve to illuminate a subject matter (*i.e.* the unintended consequences of granting immunities from bankruptcy risk) with implications for bankruptcy regimes in jurisdictions around the world. Ted Janger also acknowledges his collaboration with Associate Professor Adam J. Levitin of Georgetown University Law Center who helped in developing the concepts set forth in the section on the “empty creditor”. Given the multiple contributions and editorial changes to the text and the overriding purpose to stimulate critical thinking on unsettled questions of law, none of the opinions expressed below should be attributed to any of the authors or to the organizations with which they are affiliated.

I. Introduction

The multi-trillion dollar global market in derivatives provides an important source of liquidity and is a principal means by which financial institutions manage and mitigate financial risks. Transactions in this market range from the relatively routine (interest rate and currency swaps) to the more exotic (e.g. swaps linked to synthetic collateralized debt structures). Because underlying valuations of referenced assets and indices necessarily are variable, market participants expect that the offsetting obligations of counterparties will be marked to market without interruption in order to fulfill the essential business purposes of the applicable financial contract. The prompt resolution of these obligations helps to avoid potential mismatches caused by market movements that would distort financial outcomes.

Derivatives are included among the financial contracts that are granted special protections under the United States Bankruptcy Code (the “Code”). Depending on the financial contract that is entitled to such protection, counterparties to a debtor have the right to liquidate, terminate or accelerate such a contract, and that right may not be stayed, avoided or otherwise limited. This immunity from conventional impediments, risks and delays of a bankruptcy case is set forth in a number of Code provisions that are known generally as the “safe harbors”. These provisions cover a variety of identified financial contracts including a securities contract as defined in Section 741(7) of the Code (Section 555), a commodity contract as defined in Section 761(4) or forward contract (Section 556), a repurchase agreement (Section 559), a swap agreement (Section 560) and a master netting agreement (Section 561). Section 546(e) of the Code also limits certain avoiding powers with respect to margin payments and settlement payments made in connection with a securities contract, commodity contract or forward contract. These provisions of the Code, especially those relating to repurchase agreements and swap agreements, are the primary focus of these materials.

Insolvency lawyers may understand repurchase agreements (or ‘repos’) as short-term secured lending agreements structured as sales and buy-backs of financial instruments, often Treasury bills or other government-backed securities, marketable securities and certain bank-backed instruments. The debtor sells these instruments to the creditor and simultaneously agrees to buy them back at a later date at a somewhat higher price, the difference between the sale (‘spot’) and repurchase (‘forward’) prices in effect functioning as interest on the loan. The repurchase is frequently agreed to occur the day after the sale,

though the term may be seven, 14, 30, or 60 days, or longer. From the lender's point of view, the transaction is a 'reverse repo'. Repos are a staple of many a central bank's operations and are used temporarily to add or drain away reserve balances to or from the banking system, but this financial policy function of repos is not a relevant concern to those involved in routine financial transactions with market participants that use repos as a means to use financial assets to raise needed funds.

Swaps are a type of derivative contract. A derivative derives its value from an asset ('the reference asset') such as stocks, bonds, commodities, or market indices. Derivatives may be traded on an exchange ('on-exchange') or bilaterally between parties through dealers ('over-the-counter' or 'OTC'), and are used to hedge risk or to speculate and enhance total returns. A swap is an exchange of risks. For example, an interest rate swap involves Party X promising for the duration of the agreement periodically to pay a floating interest rate (say, LIBOR) on a notional amount to Party Y in return for Y's promise to pay X a fixed rate (say, 3%) on the same amount. In a currency rate swap, X may promise to pay a fixed or floating rate of interest on a notional amount in one currency (say, US dollars) in return for Y's promise to pay a fixed or floating rate of interest on the same notional amount in another currency (say, Japanese Yen). Credit default swaps ('CDSs'), which played a prominent role in period leading up to the financial crisis, are OTC contracts under which the 'protection seller' in effect guarantees to the 'protection buyer' the credit worthiness of the bonds (or other financial instruments) designated as the reference assets. Upon the occurrence of a 'credit event' – for example, default by the bond issuer – the protection seller would pay the difference between the par value of the bonds and their prevailing market value. A CDS offers protection against the risk that the reference assets may suffer a credit event, but 'total return swaps' provide protection against both credit and interest rate risk. Swaps, regardless of subject matter, are a means to allocate risk in exchange for a price.

Some of the points discussed in these materials relate to commodity, forward, and securities contracts, and these contracts, together with repos and swaps, constitute 'qualified financial contracts' under the Code. A commodity contract is an on-exchange agreement for future delivery of a commodity. A forward is an OTC agreement for future delivery of a commodity for a price determined as of the date of contract. A securities contract is an agreement for the purchase of a financial instrument or an interest in such an instrument.

Tension results from exempting financial contracts from the various harms that can be suffered when one party to a contract (or a credit support provider) commences a bankruptcy case. The non-debtor party to the contract clearly benefits, but the debtor and its creditors suffer as a consequence of losing control of property and potential causes of action to recover property. With the objective of minimizing systemic risks and protecting other financial institutions from contagion, the debtor is stripped of rights that are quite fundamental to bankruptcy policy. The following section highlights this issue and provides context for considering the treatment of these financial contracts by distinguishing between two core objectives of bankruptcy, and by explaining the significance of the distinction.

II. Priorities, Immunities, and Vulnerability to Bankruptcy Harm

In general, a category of claims accorded priority over another enjoys the privilege of a superior repayment position within an insolvency case. By contrast, a claim with immunity finds itself in the even more exalted position of being excluded from relevant insolvency law restrictions altogether. Bankruptcy cases involve tools both for gathering in, preserving and maximizing the value of the bankrupt estate ('preservation tools') and for distributing that value ('distribution tools'). Given these complementary tools, priorities engage the bankruptcy regime's distribution tools, while immunities disengage the regime's preservation tools. The latter implies that the bankruptcy regime's distribution tools are rendered irrelevant because a claim with immunity would typically have what amounts to priority over the claims of other creditors that are relegated to await distributions from the debtor's estate.

This immunity/priority distinction is crucial. Priorities determine the order in which creditors will be entitled to distributions of value from the bankruptcy estate, while immunities remove assets from that estate and primarily affect how much value will be available for distribution in the first place. As a corollary, while respecting the priority of claims may result in allocating how value is to be distributed, the impact of respecting immunities is not merely to allocate value but also to destroy value within the estate by overriding the estate's preservation tools. The impact is quite severe – financial counterparties take property from the estate even if that taking causes substantial harm to the estate and its creditors. This is an example in which the collective goals of bankruptcy are sacrificed to aid participants in a broader market of interconnected financial relationships. However, when considered from the perspective of any single benefitted institution, the immunity is enormously helpful and may result in a full recovery from a counterparty that will only be paying pennies on the dollar to general unsecured creditors. The goal of protecting the system as a whole produces disparate outcomes that elevate the entitlements of the few at the expense of the many.

Bankruptcy proceedings are designed to allocate loss from the insolvency in a predictable and defensible manner. The statutory priority regime is a critical tool, channelling the loss away from creditors placed in a higher ranking to those placed in a lower one. The priorities adopted in the Code reflect the history of bankruptcy as it has developed in the United States and the judgment of Congress as to the proper ranking of claims under our absolute priority rule. That is the model against which we must measure any deviations from the norm. Financial contracts escape that measurement altogether by virtue of being excluded from the ranking and immunized from the priority scheme applicable to all other creditors. However, the effect of that exclusion is to allow a recovery to the non-debtor party to a qualifying contract that for all practical purposes functions as a fully protected superior claim against designated property.

III. The Contracts and their Bankruptcy Immunities

The events of the global financial crisis raise questions as to fundamental assumptions underlying the safe harbor provisions and the possible need to reconsider the guidance on the bankruptcy treatment of financial contracts provided by the World Bank's *Principles on Effective Insolvency and Creditor Rights Systems* ('*Principles*') and the *Legislative Guide on Insolvency* ('*Guide*') issued by the United Nations Commission on International Trade Law. The *Principles* and *Guide* (together, the 'ICR Standard') constitute 'international best practice' as recognised by the international Financial Stability Board. The ICR Standard forms the basis on which the World Bank, the International Monetary Fund, and various other international institutions assess client country legal systems and provide advice and technical assistance in law reform. As formulated well before the onset of the recent crisis,¹ the ICR Standard broadly requires financial contracts to be rendered immune from characteristic bankruptcy law rules for preserving and reconstituting the insolvent estate.² This contrasts starkly with its recommended treatment of all other types of contract.

So as to contextualise the discussion, this Section introduces the relevant provisions of the English and US bankruptcy regimes as two sophisticated bankruptcy regimes, which provide explicitly, and in the case of English law, also by omission, for the treatment of financial contracts. Some of the arguments to follow may also usefully be illustrated by drawing on the transactions the subject of recent high-profile

¹ The *Principles* were formulated in 2001, revised in 2005, and are likely to be expanded later in 2011 to cover enterprise groups. The *Guide* was issued in 2004 and expanded in 2010 to provide extensive coverage of enterprise groups. To reiterate, there has been no revision relevant to the topics considered here to the *Principles* since 2005, and to the *Guide* since 2004.

² *Guide*, Paragraphs 208-215 and Recommendations 101-107; *Principles*, C10.4.

litigation on both sides of the Atlantic.³ Financial Firm 1 ('FF1') creates a special purpose vehicle ('SPV') that issues notes ('the Notes') to investors ('Investors'). The subscriptions paid by Investors are used to buy securities ('the Collateral'), which are vested in a trust entity ('Trustee'). SPV agrees with its affiliate Financial Firm 2 ('FF2') to swap a sum equal to the yield on the collateral (which SPV pays to FF2) with the payments due on the Notes (which FF2 pays to SPV). The latter sum exceeds the former to reflect what with some inaccuracy can be described as the premium element for the credit insurance provided by Investors to FF2. At the conclusion of this arrangement or upon its early termination because of a credit event, FF2 agrees to pay SPV a sum equal to the principal amount due on the Notes less a sum calculated by reference to the credit event. The payment obligations of both SPV and FF2 are secured on the Collateral.

Several elements of this type of arrangement would potentially engage rules of the relevant bankruptcy regime. The most important of these are described below, together with their rationale, and with the special treatment in relation to them provided to financial contracts. Employing the immunity/priority distinction introduced in the previous Section, it becomes clear that this treatment amounts not simply to priorities over some other claim categories, as commentators have previously thought, but immunities from a significant part of the standard bankruptcy law value preservation tools. Financial contracts are not bound by the automatic stay, restrictions on the termination of contracts upon bankruptcy and the enforcement of contractual *ipso facto* and netting provisions, and the statutory provisions avoiding certain transactions.

Consider, first, four aspects of English insolvency law, whose general preservation tools remain relatively underdeveloped in certain key respects. In relation to financial contracts, they have been further weakened by the effect of the European Financial Collateral Directive ('the FCD').⁴

First, secured claimants in effect have immunity in winding-up proceedings from the moratorium on claim enforcement. They may, with the court's permission but to which they are entitled 'as of right', proceed to enforce their claims against a company in liquidation, unless the liquidator is able to guarantee within the liquidation proceedings functionally identical treatment of the secured claim and relevant collateral.⁵ The secured creditor's right to demand this treatment is inconsistent with international best practice, since it is not qualified by any concern for whether the collateral is needed for a going concern sale.⁶ Be that as it may, returning to the illustrative transaction described above, in SPV's liquidation, both FF2 and Investors would potentially have the right to grab the Collateral without being concerned with the bankruptcy moratorium. What is more, were SPV to be put in administration with a view to being restructured, secured creditors would ordinarily be presumptively stayed from enforcing claims. However, the FCD exempts FCCs from the administration moratorium, and precludes the administrator from dealing with encumbered financial collateral.⁷

³ *Perpetual Trustee Company Ltd v BNY Corporate Trustee Services Ltd* [2009] EWCA Civ 1160; *Lehman Bros. Special Financing, Inc. v. BNY Corp. Trustee Serv'cs Ltd. (In re Lehman Bros. Holdings Inc.)*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010).

⁴ Implemented in England through the Financial Collateral Arrangements (No 2) Regulations 2003 ('FCAR'), as most recently amended by the Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements) (Amendment) Regulations 2010.

⁵ *In re St Cuthbert Lead Smelting Co* (1866) 35 Beav 384, 55 ER 944 and *In re David Lloyd & Co* (1877) LR 6 Ch D 339. For detailed discussion of the doctrinal and normative features of English liquidation law, see Riz Mokal, "What Liquidation Does for Secured Creditors, and What it Does for You" (2008) 71(5) *Modern Law Review* 699-733.

⁶ *Guide*, Recommendations 39, 49, and 51; *Principles*, C5.3.

⁷ FCAR, regulation 8. The same provision also preserves for FCC the right to appoint a receiver in relation to security interests; this privilege for circumventing collective distress resolution procedures in favour of one serving

Second, in both liquidation and administration, an expansive insolvency set-off provision applies whenever there are mutual credits, debts, or other mutual dealings between the bankrupt and any counterparty.⁸ This is regardless of whether there would have been any set-off outside of insolvency, and what is more, insolvency set-off is retroactive, mandatory, and self-executing.⁹ While best practice is to preserve, within insolvency proceedings and subject to avoidance rules, certain pre-insolvency set-off rights,¹⁰ there is little justification for expanding upon any such rights, or indeed for creating new ones, only within insolvency. This is especially true since insolvency set-off is a statutory inroad into the collectivity principle, in effect mandating a non-collective disposal of some of the bankrupt's assets (its claim against the party benefiting from insolvency set-off) in the interests not of the creditors as a group but solely of the set-off counterparty; and not rationally so as to maximise the bankrupt estate's value but on the happenstance of the existence of mutual credits, debts, or other mutual dealings.¹¹ The traditional justification,¹² that it would be unfair for the solvent party to have to pay in full on its obligation while being restricted only to a dividend in insolvency on its claim,¹³ amounts merely to a bare restatement of the absence of set-off but says nothing about why this absence would be unfair. A useful contrast is with equitable set-off outside insolvency, which is available only where the cross-claims are so closely connected that it would be manifestly unjust to allow one of them to be pressed without taking account of the other.¹⁴ To the extent that insolvency set-off goes beyond this requirement – which it does by focusing merely on the existence of cross-claims – it cannot be justified by reference to fairness. Nor, of course, can its being mandatory and self-executing, which have the added disadvantage of precluding the need for affected parties to be notified, and also depriving the court of the opportunity of considering in any given case whether and to what extent set-off should be permitted. Be that as it may, in SPV's insolvency, insolvency set-off would operate to deprive SPV's estate of its rights against solvent counterparties, and in any case, the extensive protections accorded by the Financial Collateral Directive to close-out netting would render the solvent counterparties immune from the bankruptcy process.¹⁵

Third and relatedly, English insolvency law has few effective tools against contractual clauses terminating a contract upon the commencement of insolvency proceedings ('*ipso facto* clauses').¹⁶ The traditional English law argument against invalidating *ipso facto* clauses asserts that to do so would contravene the freedom of contract of those agreeing to such clauses. The reference to 'freedom' gains this argument some emotional traction, but in fact, the argument is not merely bad but incoherent. The 'freedom' in question is not a freedom or a liberty at all; X and Y remain *free* to agree to anything, regardless of the

primarily the sectarian interests of secured creditors was in general prospectively abolished by the UK Enterprise Act 2002.

⁸ Insolvency Rules 1986, rules 2.85 (administration) and 4.90 (liquidation).

⁹ *National Westminster Bank Ltd. v Halesowen Presswork and Assemblies Ltd.* [1972] A.C. 785 and *Stein v Blake* [1996] 1 A.C. 243.

¹⁰ *Guide*, paras 204-206 and Recommendation 100, and *Principles*, C10.4.

¹¹ That not everything rendered mandatory in relation to an insolvent debtor by (even an insolvency) statute serves the objectives of collectivity is sometimes overlooked; for an example, see Mokal (2005), 108-109.

¹² Another, even weaker, traditional justification is that not allowing set-off would violate legitimate expectations; however, if the law clearly and prospectively precluded insolvency set-off, any expectation of nevertheless being able to exercise it would be rendered unfounded.

¹³ *Forster v Wilson* (1843) 12 M & W 191, 204. This alleged justification of insolvency set-off is frequently rehearsed; for an example, see Mokal, 'Resolving the *MS Fashions* "Paradox"' [1999] *Company Financial and Insolvency Law Review* 106.

¹⁴ *Geldof Metaalconstructie NV v Simon Carves Ltd* [2010] EWCA Civ 667, [43].

¹⁵ See Look Chan Ho, 'Practitioner's Perspective: The Financial Collateral Directive in England', in Dan Prentice and Arad Reisberg (eds), *Corporate Finance Law in the UK and EU* (Oxford: Oxford University Press, 2011), 323, 349-355.

¹⁶ *Perpetual Trustee Company Ltd v BNY Corporate Trustee Services Ltd* [2009] EWCA Civ 1160.

content of contract or insolvency law. Instead, the so-called 'freedom' amounts to the claim that the state's authority and power be drawn upon to compel the breaching party to put the other in the position in which it would have been if the agreement were performed, through payment of damages or indeed specific performance. This brings out the argument's incoherence. Where would this claim to require the state to compel payment of damages or enforcement of the agreement come from? A contract is a product of law, of course, but the alleged claim upon the state could not derive from the law itself: if the law provides for the unenforceability of a particular type of agreement or provision, then it is simply unenforceable. Nor is it plausible that X has some general moral claim upon the state to act so as to compel Y either to comply with whatever agreement X and Y may have struck or to pay damages. Further and in any case, when X and Y purport to contract in a way that is injurious to Z's interests, where Z is not a party to the agreement, then it is often essential for well-ordered legal systems to refuse enforcement. This is true of certain anti-competitive agreements, for example. And indeed, of agreements whereby solvent debtor X agrees with one of its creditors Y to trade away that part of the X's insolvency estate which would otherwise go to X's other creditors, Z, in circumstances where Z are not party to the agreement and do not receive any benefit from it. *Ipsa facto* clauses are a variation on this latter theme: the solvent debtor has agreed that, in its insolvency, its standard legal rights to press its counterparty for damages or performance would be given up, to the detriment – not of its managers, who are negotiating the clause, nor of shareholders, pursuit of whose group interests would or ought to be driving the managers – but that of the debtor's other creditors, who are not at the bargaining table. It is entirely legitimate for a legal system to render such clauses unenforceable. English law does not. Consider, for example, the illustrative transaction described above, which may contain a 'priority flip' clause: in relation to the security over the Collateral, FF2's claims would generally enjoy priority over the Investors', except upon the happening of an event of default on FF2's part, in which case the Investors' claims would have priority. English courts would reject the argument that the priority flip violates English law's 'anti-deprivation' principle,¹⁷ notwithstanding that it would demonstrably remove value from FF2's insolvent estate if the value of the Collateral were insufficient to fully meet both FF2's and the Investors' claims.¹⁸

Fourth, English law's preference avoidance provision is weak, not least because it generally requires demonstration that the challenged transaction was motivated at least in part by the debtor's "desire" to prefer.¹⁹ Not only does it remain unclear which corporate organ is the seat of a company's desires, this focus on the parties' state of mind invites uncertainty, unnecessary litigation, and thus inefficacy, and is inconsistent with international best practice.²⁰ What is more, the judicial glosses put on the provision render it incapable of catching transactions brought about through creditor pressure.²¹ In relation to financial contracts, as we will see, this leaves FCCs free to demand and obtain collateral at a late stage in the debtor's decline, in a way which improves the FCC's position without bringing any accompanying benefits to the debtor's other creditors.

The Code is in general noticeably more efficacious in preserving the distressed estate for value-maximising treatment. However, repos, swaps, and other derivatives are accorded very extensive immunities (these are the 'safe harbours' or 'carve-outs') under bankruptcy law. First, the bankruptcy moratorium or automatic stay generally prohibits creditors from suing on or otherwise collecting on their debts and attempting to seize or liquidate collateral.²² It also stays the exercise of set-off.²³ However,

¹⁷ A recent discussion of this principle is in *Folgate London Market v Chaucer Insurance* [2011] EWCA Civ 328.

¹⁸ See e.g. *Perpetual Trustee Company Ltd v BNY Corporate Trustee Services Ltd* [2009] EWCA Civ 1160, where the Collateral does appear not to have had sufficient value to meet both the Investors' and FF2's claims in full.

¹⁹ IA, s. 239, particularly 239(6).

²⁰ *Guide*, paragraphs 148 *et seq*, particularly 199-200.

²¹ *Re MC Bacon Ltd* [1990] BCLC 324.

²² See 11 U.S.C. § 362(d).

²³ 11 U.S.C. § 362(a)(7).

FCCs can continue to collect debts on the eve of bankruptcy, can seize collateral,²⁴ and can exercise extensive set-off rights.²⁵ Second, creditors who have received preferential payments within 90 days prior to bankruptcy commencement are ordinarily required to make restitution,²⁶ but FCCs are exempt.²⁷ Third, transactions on the eve of bankruptcy by which the distressed entity gives up an asset or accepts a liability for less than reasonably equivalent value are avoidable,²⁸ but not in the case of FCCs.²⁹ And fourth, bankruptcy law generally places restrictions on the ability of solvent parties to terminate contracts upon a counterparty's bankruptcy,³⁰ and accords to the bankrupt the right to affirm or repudiate an executory contract.³¹ When the counterparty is an FCC, however, the situation is reversed, with the choice vested in it rather than the bankrupt.³²

Immunities for financial contracts from the normal bankruptcy process have long been part of the US system, yet it is instructive to be aware of the manner of their expansion.³³ The original 1978 Bankruptcy Code exempted set-off pursuant to commodity and forward contracts from the automatic stay,³⁴ and precluded the debtor or trustee from avoiding and recovering pre-filing settlement payments from clearing corporations and margin payments to brokers under such contracts.³⁵ The 1982 amendments to the Code extended the set-off immunities to margin and settlement payments to and from brokers, clearing organisations and financial institutions. Congress intervened again in 1984, exempting set-off of repo obligations and their liquidation from the stay, and margin and settlement payments for repos from avoidance.³⁶ Amendments in 1990 exempted swap agreements from the stay and from avoidance provisions. The overarching rationale for these expanding immunities has been said to lie in the policy favouring "protection of the liquidity and systemic stability of the financial markets through assurances that close-out netting and settlement of contracts will be preserved despite the debtor's insolvency."³⁷

The next, and significant, stage in the expansion of the immunities came through the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ('BAPCPA'). In order to understand an important purported rationale for the relevant provisions of this legislation, it is useful to compare the treatment accorded to financial contracts pursuant to the bank resolution regime under Federal Deposit Insurance Act ('FDICA'), particularly as amended by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 and the Federal Deposit Insurance Corporation Improvement Act 1991.³⁸ Under FDICA, (i) the counterparty could again terminate the contract, and offset or net out obligations, though unlike under the bankruptcy regime, netting rights here could only be exercised one business day after the appointment of the receiver, which gave the receiver the right to transfer all relevant contracts with the same

²⁴ 11 U.S.C. §§ 362(b)(17) and (27), 560 and 561.

²⁵ 11 U.S.C. § 362(b)(6).

²⁶ 11 U.S.C. § 547.

²⁷ 11 U.S.C. §§ 546(g) and (j).

²⁸ 11 U.S.C. § 548.

²⁹ 11 U.S.C. §§ 546(g) and (j).

³⁰ 11 U.S.C. §§ 365(e)(1) (prohibition on *ipso facto* clauses; see also *Reloeb Co. v. LTV Corp. (In re Chateaugay Corp.)*, (S.D.N.Y. 1993)), 541(c)(1) (anti-deprivation provision), and 365 (executory contracts and unexpired leases).

³¹ 11 U.S.C. § 365. In relation to the sorts of facts depicted in Table 1, see *Lehman Bros. Special Financing, Inc. v. BNY Corp. Trustee Serv'cs Ltd. (In re Lehman Bros. Holdings Inc.)*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010).

³² 11 U.S.C. §§ 555, 559 and 560.

³³ A useful survey is provided by Michael Krimminger, 'The Evolution of US Insolvency Law for Financial Market Contracts' (2006), on which this part of the discussion draws.

³⁴ 11 U.S.C. § 362(b)(6).

³⁵ 11 U.S.C. § 546.

³⁶ 11 U.S.C. §§ 362(b)(7), 546(f), and 559.

³⁷ Krimminger (2006), 7.

³⁸ Krimminger (2006), 7-13.

counterparty (and its affiliates) to another institution and notify the counterparty; (ii) except if the transferee had an actual intent to hinder, delay, or defraud, the receiver could not avoid any transfer in connection with the financial contract; (iii) termination or repudiation of a relevant contract by the receiver would result in more generous damages for the counterparty than under the bankruptcy regime; (iv) while the bankruptcy regime allowed immunity only to specific types of counterparties to the relevant contracts, the bank resolution regime extended this immunity to any “financial institution”; and (v) while both the bankruptcy and the bank resolution regimes accorded immunities to the same five types of contract,³⁹ the latter included mortgages and related interests in its definitions of repos and securities contracts.

Against this background, the financial contract provisions of BAPCPA were said to be intended to update the definitions of the relevant contracts so as to catch up with developing market practices, and also to “provide a common set of rules for the failure of a derivatives counterparty and... to help market participants better manage their risks by allowing participants to exercise a virtually uniform right to terminate and close-out their exposure to an insolvent contracting party.”⁴⁰ Five changes are worth noting.⁴¹ First, bankruptcy immunities now cover a far broader range of contracts, and in addition, also include catch-all clauses covering contracts “similar to any agreement or transaction referred to”, for example, or “any other similar agreement”.⁴² Second, repos and reverse repos were explicitly covered, thus excluding them for the risk of being recharacterised as ‘standard’ secured loans. Third, margin loans are accorded immunity so long as they involve the extension of credit for the purchase, sale, carrying or trading of securities. Fourth, cross-product netting was allowed if covered by a single master agreement, such that solvent party A can net its claims and liabilities against bankruptcy party B under all qualified financial contracts between them. And fifth and relatedly, the full range of these broadened immunities was extended beyond financial institutions to “financial participants” and “master netting agreement participants”. The cumulative effect is to provide virtually complete bankruptcy immunity to close-out netting arrangements.

IV. Ex Ante Incentives: Monitoring and Capital Structure

A crucial shortcoming of much of the extant debate on the appropriate bankruptcy treatment of financial contracts has been its neglect of the parties’ longer-term incentives. Professor Mark Roe of Harvard Law School has undertaken the process of plugging this gap,⁴³ and some of his insights are reflected below.

The critical insight is as follows: parties enjoying immunity from standard bankruptcy restrictions would tend to lend more and at a lower price than they would in the absence of those immunities, and they would tend to monitor their counterparty’s transactions less than they otherwise would. This raises the overall risk of the debtor’s activities, to the detriment of its other creditors. Yet these other creditors are unable or unwilling to respond in a way that would force the debtor to fully internalise the costs of this additional risk. In the result, bankruptcy immunities enable some riskier and less transparent activities to be funded, activities that, in the absence of those immunities, either would not have been funded, or would have been structured in a more transparent manner, or both. They tend also to increase the degree to which the relevant parties are exposed to each other.

³⁹ Repos, securities contracts, commodity contracts, forward contracts, and swaps.

⁴⁰ Krimminger (2006), 14.

⁴¹ See generally Krimminger (2006), 15-18.

⁴² The catch-all clause in relation to swaps ‘limits’ its scope to agreements “of a type that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap markets”.

⁴³ Mark Roe, ‘The Derivatives Market’s Payment Priorities As Financial Crisis Accelerator’ (2011) 63 Stanford Law Review 539.

As it happens, a similar line of argument has in the past been directed at the insolvency treatment of standard secured claims.⁴⁴ Considering the differences in the nature and bankruptcy treatment of secured claims on the one hand and financial contracts on the other helps illuminate why the argument fails when deployed against secured credit – which can reduce the overall riskiness of the debtor’s projects⁴⁵ – but appears to succeed against the bankruptcy treatment of financial contracts, which at best redistribute this risk to parties many of whom are less able to bear it, and may even increase it.⁴⁶

a. Secured claims and counterparty risk mitigation

In order to provide context for the discussion to follow, let us briefly consider the economic rationale for, and the ‘best practice’ recommendations on, the bankruptcy treatment of secured claims.⁴⁷ Let us begin with the reminder that whether secured or not, creditors wish to reduce the probability of their debtor’s bankruptcy. Unsecured creditors tend to receive little or nothing in such an eventuality. Even secured creditors tend to lose out as measured by the terms of their loan agreement,⁴⁸ and the entanglement of the collateral in the bankruptcy process⁴⁹ requires that, instead of focusing exclusively on the value of the collateral, they continue to pay at least some attention also to the value of the debtor’s business.

Consider the fictional world in which Debtor wishes to borrow \$1m from a variety of Creditors, who start off being equal in every respect, including, were it to come to it, their share of Debtor’s bankruptcy estate. Debtor’s dealings with each Creditor are perfectly transparent to each other Creditor, each utilises this knowledge in writing their loan agreement, and each has equal influence over Debtor. Suppose now that Debtor were to offer Creditor 1 a security interest, and thus repayment priority in its bankruptcy, over Creditors 2, 3, and so on. Anticipating that they would now each receive less from Debtor’s bankruptcy estate by virtue of their lower ranking, all other Creditors would raise their interest rates to compensate. The priority of secured credit thus turns out to be harmless to all unsecured creditors.

The artificiality of the assumptions in this hypothetical about the equality of the various creditors’ knowledge of and influence over their debtor have motivated various criticisms of secured credit’s bankruptcy priority. At the core of each of these criticisms is the quite correct observation that not all creditors can adjust the terms on which they lend to compensate themselves for being subordinated to the secured lender in their mutual debtor’s bankruptcy. At the same time, however, the criticisms are marred by an insufficient appreciation that, at least in the standard case of ‘new money’ security, the grant of the security interest reduces, not merely the proportionate share of the bankruptcy estate available to

⁴⁴ See e.g. J. Hudson, ‘The Case Against Secured Lending’ (1995) 15 *International Review of Law and Economics* 47, and L. Bebchuk and J. Fried, ‘The Uneasy Case for the Priority of Secured Claims in Bankruptcy’ (1996) *Yale Law Journal* 857.

⁴⁵ See e.g. Mokal, ‘The Search for Someone to Save: A Defensive Case for the Priority of Secured Credit’ (2002) 22(4) *Oxford Journal of Legal Studies* 687, and Mokal, *Corporate Insolvency Law: Theory and Application* (Oxford: Oxford University Press, 2005), Chapter 5.

⁴⁶ A most illuminating variant of the argument to follow is found in Janis Sarra, ‘Credit Derivatives, Market Design, Creating Fairness and Sustainability’, *Network for Sustainable Financial Markets: Consultation Paper 1*, January 2009, 8-12.

⁴⁷ The discussion here is restricted to the paradigmatic situation where new money is provided and fixed proprietary security obtained over the debtor’s assets. The distinctive issues arising from floating security (that is, security where the debtor may unilaterally, without obtaining the creditor’s consent, alienate or consume the collateral or otherwise place it beyond the ambit of the security) and security given for past value are not considered here. For detailed discussion, see Mokal (2005), Chapters 5 and 6.

⁴⁸ A frequently made point is that court-determined ‘adequate protection’ good enough to satisfy bankruptcy code requirements is frequently not good enough to place the secured creditor in the same position that it would have been, had there been no bankruptcy proceedings at all.

⁴⁹ As in the general US Bankruptcy Code context and also under the UK administration regime.

unsecured creditors, but also the risk of the debtor's becoming insolvent in the first place. This reduction in the risk of their mutual debtor's insolvency raises the expected value of the claims of all creditors, including unsecured ones. The argument revolves around the role of security in controlling 'financial agency' and 'adverse selection' costs.

Financial agency costs arise from the debtor's incentive to engage in excessively risky projects in the anticipation that it would capture the upside (the lender being restricted to its principal and interest), whereas the downside would be shared also with the lender (who in the borrower's bankruptcy would lose some or all of what it was owed). It is important to note that, while financial agency costs are *costs* from the perspective of lenders, they may be regarded as *beneficial* by borrowers, since, as noted, the increase in variance in the expected returns from the projects they undertake represents higher expected *debtor* returns. With this in mind, note that security is an effective way of controlling agency costs. It encumbers the debtor's title to the collateral, disabling the borrower unilaterally, without the lender's consent, from placing the collateral beyond the ambit of the security.⁵⁰ The collateral acts as a 'hostage', enhancing the lender's ability to stipulate and enforce loan covenants. Through such covenants, the lender characteristically obtains the right to declare a 'technical' default even when the debtor is dutifully making repayments on the loan, for example, if the debtor's income or the value of the collateral fall below a particular multiple of the outstanding secured liability. The threat that in any such eventuality, the lender may seize the collateral (the 'hostage') and sell it, thus disrupting the debtor's business and inflicting disproportionate harm on it, gives the lender considerable influence over the debtor. The debtor thus has strong incentives to comply with loan covenants, to take early steps to anticipate and remedy falls in the value of the business or the collateral, and if this is not practicable, to commence negotiations with the lender in an attempt to head off enforcement action. The cumulative effect is to moderate financial agency costs, thus lowering the riskiness of the debtor's projects and hence the probability that it would be rendered insolvent. From the point of view of all creditors, not merely the secured one(s), security is value-maximising, since, at the time at which it is given, it raises the expected value of all debt claims. From the point of view of the borrower, however, the loss in its freedom to add to the variance of its projects is itself a cost.

Second and again from the debtor's perspective, the grant of security has opportunity costs. Anticipating that if distressed, it would need financing but would find it difficult or impossible to borrow on an unsecured basis (on which more below), a firm would prefer to leave its assets unencumbered until just such a time. Also, if it foresaw growth opportunities that could only be taken up with additional outside funding, it would anticipate potential lenders' reluctance to lend, arising from their anticipation that they would be subordinated to existing secured creditors. This 'debt overhang' problem represents another opportunity cost for the debtor in prematurely encumbering some or all its assets. Third and finally, granting security to one or more of its lenders may harm the reputation of a debtor operating in some sectors of the economy.⁵¹

It follows that a debtor would agree to grant security only if the benefits from doing so sufficiently outweighed the sum of these costs. In broad analytical terms, security would be offered in either of two situations.

The first of these situations is where the borrower is able to borrow on an unsecured basis but nevertheless chooses to do so on a secured one. Here, its choice would be a factor of the interest rate difference on the secured and unsecured loans available to it. The difference between these two rates

⁵⁰ The transferee's title to the collateral would remain encumbered with the original security if the transfer occurred without the lender's consent.

⁵¹ Frequently, the strongest firms in the economy do not offer security over their assets (other than non-recourse security in relation to particular projects).

would be determined by (among other things) the potential lenders' *ex ante* assessment of the extent of financial agency costs and the ability to control these costs through the extraction of security. In other words, the lender anticipates facing one of two states of the world. It would either lend unsecured and charge more to be compensated for the high risk that the debtor would over-invest and suffer insolvency, thus causing the lender to have to share proportionately with like creditors. Or alternatively, the lender could obtain security and lend at a lower rate, reflecting its increased influence over the riskiness of the debtor's choice of projects and also the increased comfort it obtains in being able to stand first in line for the distribution of the collateral's value. Here, security is a substitute for a higher interest rate.

In the second situation, the borrower simply cannot borrow on an unsecured basis. This would be the case where lenders assess its risk profile to be such that no level of interest alone would compensate the lenders for accepting it. An important factor here would be 'adverse selection'. Charging a very high interest rate becomes counterproductive when the obligation to pay it itself significantly increases the probability of the borrower's insolvency by encouraging it to take excessive risks that it would not have taken if under lower repayment obligation; or when only those potential borrowers agree to borrow at the high rate who intend to overinvest in any case, or in marginal cases, who do not intend to repay at all. In each of these scenarios, a higher interest rate tends to exacerbate rather than ameliorate the lender's risk. Here, security would be combined with a relatively high interest rate rather than substituting for it.

In summary, the existence of security allows the secured creditor to (i) effectively exercise a moderating influence on the debtor's decision-making, thus reducing the expected variance of its returns; or (ii) to lend at a price that does not attract adverse selection and to compensate for the remaining risk through its rights in and to the collateral, and again, its influence over the riskiness of the debtor's projects. Critically, the outcome in both scenarios is to reduce the probability of the debtor's default – or to put this differently, to mitigate what we may call *counterparty risk* – and in turn, to raise the expected value of all credit claims against it, unsecured as well as secured. That secured claims bring *ex ante* benefits to the very parties (namely, unsecured creditors as a group) who *ex post* (i.e. upon the onset of insolvency) are harmed by it provides a justification for sophisticated bankruptcy regimes to accord priority to them.⁵²

Equally critically, no *immunity* from standard bankruptcy restrictions is thereby justified, with the secured creditor being presumptively bound by the moratorium unless a court could be persuaded that its collateral was not required in order to preserve any going concern surplus, or alternatively, that it was not practicable to provide the secured claimant with adequate protection within bankruptcy proceedings.⁵³ The same holds for bankruptcy law's other preservation tools, including those guarding against preferential and undervalue transactions. Bringing about this delicate balance between priority and graduated absence of immunity allows for a socially value-maximising retention of, both, the benefits of security, and also those of bankruptcy law's preservation tools.

b. Financial contracts and counterparty risk

Return to the hypothetical introduced in the previous sub-Section. Now, however, Creditor 1 is not simply to be offered payment priority within Debtor's bankruptcy, but instead is to be rendered immune from the bankruptcy process altogether. Several points are worth noting.

First, since Creditor 1's fear of becoming entangled with Debtor's bankruptcy is likely to be far lower, it is likely to engage in lower levels of pre-lending due diligence, to extract fewer loan covenants, and to

⁵² *Principles*, C12.2.

⁵³ *Principles*, C5.3.

engage in lower levels of monitoring to ensure continuing compliance. Counterparty risk would now be dealt with, to some considerable degree, through reliance on bankruptcy immunity.⁵⁴

Second, Creditor 1 would possess weaker incentives to obtain collateral from, or close to, the beginning of the transaction. Obtaining and exercising control over collateral can have costs, which Creditor 1 would wish to minimise. Because of the specific immunity in the US system and the general weakness of the preference avoidance provision in English law, a bankruptcy-immune Creditor 1 could demand such collateral at a late stage in the transaction, even on the eve of the debtor's distress. As a result, the ability that other secured creditors enjoy of diluting the over-investment risk of the debtor's activities may not be available to it for some significant proportion of the currency of the transaction. This effect is not merely theoretical: the literature notes that non-financial corporate users of derivatives and also large, highly rated financial institutions have not been required to post collateral.⁵⁵

Third, creditors generally have an incentive to diversify, since they anticipate a proportion of their debtors becoming insolvent, with a consequent risk of loss. Diversification is a strategy for increasing the probability that the creditor would be able to make a profit across a portfolio as a whole, by more than compensating for its losses from these failed loans through the profits it makes on the other, successful, loans in the portfolio. By contrast, bankruptcy-immune Creditor 1 would not anticipate having to share with non-immune creditors in any of its debtors' insolvencies. It therefore anticipates being able to recoup itself against all of a failed debtors relevant assets, without having to share any proportion of that value with non-immune creditors. Creditor 1 is thus more likely to be relatively undiversified. The problem is that if and when a significant debtor does become insolvent, Creditor 1 may still be exposed to non-trivial losses, because its calculations about the value of its collateral were awry, for example, or because it might have to compete against other immune creditors. Given its relative lack of diversification, such losses, when they do occur, are likely to be more significant. When put together with the observation in the previous paragraph on how immunity would tend to weaken external checks on the debtor's excessive risk-taking, the potential for significant losses to occur is greater still.

Fourth, that Creditor 1 no longer fears entanglement with Debtor's bankruptcy is likely to induce it to lend more and at a lower cost. As noted, it can now afford to incur lower costs on pre-lending due diligence (except as to the sufficiency of collateral), and in extracting covenants and monitoring them. The reduced rate also reflects Creditor 1's anticipated greater share of the debtor's bankruptcy estate.

Fifth, some of the costs thereby saved can be passed on to Debtor, which here means its managers (through higher salaries and bonuses) and shareholders (through dividends). That this is the case would frequently be a strong inducement for solvent debtors and their managers to make use of bankruptcy-immune contracts in the first place. Another inducement is Debtor's continuing freedom of action, relatively unconstrained by creditor monitoring. As we have seen, the *solvent* Debtor values this freedom of action, precisely because it is thereby enabled to increase the riskiness of its projects, the variance of its expected returns and the pay outs it can make to its shareholders and managers. Inevitably, riskier projects by definition involve a greater risk of loss, but the solvent Debtors' managers and shareholders anticipate externalizing much of this loss onto Creditors 2, 3, 4, etc. In effect, then, the decision to borrow from bankruptcy immune Creditor 1 as opposed to non-immune creditors is a manifestation of financial agency costs, with Debtors' managers and shareholders colluding with Creditor 1 to run greater risks, with the upside captured by shareholders and managers, the downside disproportionately loaded onto non-immune creditors, and the position of Creditor 1 protected precisely through the existence of the immunity.

⁵⁴ Roe (2011), 555-556, and the sources cited at nn. 35-41.

⁵⁵ Stephen J. Lubben, 'The Bankruptcy Code Without Safe Harbors' (2010). *American Bankruptcy Law Journal*, Vol. 84; Seton Hall Public Law Research Paper No. 1569627. Available at SSRN: <http://ssrn.com/abstract=1569627>, at p. 4, notes 17.

Fifth and following from that, Creditors 2, 3, 4, etc., no longer have a share of the financial collateral to the extent of Creditor 1's claim. They may therefore have an incentive to lend less, to expend greater monitoring efforts, and/or to charge more on their loans. Not all Creditors would be able to do any or all of these things, however. Certain categories of non-adjusting creditor have been discussed in Section II, above. Further, if Debtor is a systemically significant and/or politically salient firm, this is particularly true of Creditor X – namely, the state – which potentially and implicitly stands as the lender of last resort. Leaving aside the bankruptcy law itself, the state has no (even implicit) contractual relationship with such firms, and may have little or no influence over the terms on which it might be forced to 'lend'. The state is also not in a very good position to monitor the Debtor transaction by transaction, week by week. The rejection of future bailouts in the Dodd Frank legislation also indicates that, at least in the United States, political support is lacking for a state rescue of 'too big to fail' firms that may require ultimate recourse to the taxpayers. This suggests that the last resort lender may only be available in the future in cases of orderly liquidation that will entail total losses to the Debtor's managers and shareholders.

Sixth, because bankruptcy immunity brings about a reduction in the overall levels of pre-loan due diligence by Creditors, fewer debt covenants binding on Debtor, and lower levels of monitoring of its activities, the cumulative effect is to increase the overall riskiness of Debtors' activities in an environment in which taxpayers in the United States and in the Euro Zone have little interest in making sacrifices to aid the financial sector.

Seventh and to reiterate, not only would Creditor 1 be less likely to monitor Debtor and possess less of an incentive to mitigate its over-investment incentives, the loss of these socially beneficial effects is brought about by giving Creditor 1 the power to withdraw collateral from Debtor's bankrupt estate, thus reducing or destroying the potential for an effective reorganisation or going concern sale.

Eighth and finally on this point, it may be possible to structure a transaction either as a 'standard' secured loan or a repo. Since the bankruptcy regime provides more favorable treatment for repos than for secured loans, potential lenders would have a powerful incentive to adopt the repo form for their transaction. The favorable treatment includes not merely bankruptcy immunities but also dispensation from rules requiring disclosures regarding the existence and terms of the financial contracts. As a consequence, transactions that in economic substance constitute loans but are documented as repos are rendered immune from the risk of being recharacterized as loans.⁵⁶ For the system as a whole, this may exacerbate the negative effects outlined above.

V. Eve-of-insolvency incentives

a. Credit contagion

We confront here the core argument in support of bankruptcy immunities. It is important to note that the main ambit of the application of this argument is the financial sector. The financial sector is characterized by far greater horizontal integration than all other sectors of the economy. That is to say, a financial firm is likely to be both lending to and borrowing from any other financial firm, in a way that would not be true in other sectors. This means that distress of one or more significant actors within the financial sector can quickly radiate outwards. Consider the insolvency of a significant financial firm. Its counterparties would, both, have borrowed from and lent to it under multiple transactions. Assume that the insolvent firm becomes subject to the bankruptcy stay, effective against all. Counterparties would be in a difficult position. As creditors, they would be unable to withdraw assets from the insolvent estate. In the absence

⁵⁶ Michael Simkovic, 'Secret Liens and the Financial Crisis of 2008' (January 4, 2009). *American Bankruptcy Law Journal*, Vol. 83, p. 253, 2009. Available at SSRN: <http://ssrn.com/abstract=1323190>.

of effective mechanisms of close-out netting, they would be forced to bear the risk of adverse market movements on related transactions and might also face demands for full repayment from those managing the insolvent counterparty. This would be likely to have a significant adverse effect of their own liquidity, rendering them less likely to be able to meet their own liabilities. Consequently, the contagion would spread.

This argument has been almost universally accepted by regulators in sophisticated jurisdictions, at least until recently. It is bolstered by two other arguments extensively invoked in favour of the bankruptcy effectiveness of close-out netting, and of other immunities. The first of these is the argument against 'cherry-picking' and the second the argument for the firm non-specificity of financial contracts. Let us take these in turn.⁵⁷

Cherry-picking would occur where those managing the insolvent firm, say, the liquidator, could decide which of the insolvent contracts to reject and which to assume. The argument is that the liquidator would cherry-pick the contracts on which the insolvent company was in the money, and repudiate those on which it was out of the money. A counterparty on the other side, holding both types of contract with the insolvent firm, would suffer the loss and injustice of having to pay up in full on some of its contracts with the insolvent, while being restricted only to a proportionate share of the insolvent estate on the remaining contracts. Despite the almost ritualistic invocation of the cherry-picking objection, the argument on examination turns out to be weak. All contractual counterparties, whether or not subject to insolvency law, are able to cherry-pick in precisely the way just described, so long as they are willing to pay expectation measure of damages to those of the contractual partners to whom they breach contractual obligations. The position of the bankrupt firm is no different. Nor, indeed, is the position of a solvent counterparty of the bankrupt firm. A solvent counterparty remains able to breach its contractual obligations to the bankrupt, so long as it is willing to pay the usual expectation measure of damages. The asymmetry in the position of bankrupt and non-bankrupt parties resides, not in the ability to cherry-pick, but rather from the fact that the solvent counterparty would be restricted only to a proportion of the damages owed by the bankrupt, while having to pay out in full to it. But this difference arises not from any particular feature of bankruptcy law, but from the fact of insolvency itself, that is, from the fact that the bankrupt counterparty is unable to meet all of its obligations in full. The objection to cherry-picking then is not an objection against any unfair feature of bankruptcy law, but in fact, a demand to be protected against a counterparty's insolvency, at the expense of the latter's other creditors. The question that must squarely be faced, then, is whether, and to what extent, parties to financial contracts are more deserving of such protection against insolvency than others. A more nuanced position would be that such counterparties might merit such protection in some insolvency proceedings but not in others.

Turning next to the alleged firm non-specificity of financial contracts, the argument is that the retention of such benefit is not essential to the ability of the distressed firm successfully to reorganise, nor is it required in order to maximise the value of the distressed business upon sale. Financial contracts are neither like essential bits of machinery that the distressed firm needs in order to continue operating, nor like the expertise of skilled employees uniquely proficient in the firm's business activities. In assessing this argument, however, some nuance is again valuable. Take non-financial firms. Professor Stephen Lubben gives the persuasive example of an airline in bankruptcy with the benefit of an in-the-money fuel

⁵⁷ The treatment of these issues here is indebted to Stephen J. Lubben, 'Derivatives and Bankruptcy: The Flawed Case for Special Treatment' (September 8, 2008). Seton Hall Public Law Research Paper No. 1265070. Available at SSRN: <http://ssrn.com/abstract=1265070>.

hedge. Under very plausible assumptions, the hedge may create considerable value in the bankrupt estate, and might indeed be decisive in determining the success or failure of the restructuring effort. For non-financial end users of such hedges and similar financial contracts, any general argument for firm non-specificity clearly does not hold. Turning to financial firms, the argument is again dubious in its generality. The going concern value of financial firms may well be constituted in significant part by financial contracts. The point, then, is not that financial contracts are never extraneous to a distressed firm's going concern, but rather, that whether this is so is fact-dependent, much like most other categories of asset.

Notwithstanding the weakness of the arguments from cherry-picking and firm non-specificity, the risk of credit contagion has persuaded regulators in many sophisticated jurisdictions, at least until recently, to accord extensive bankruptcy immunities, particularly in relation to close-out netting arrangements. We should recall one exception. In relation to financial institutions, subject to central bank or bank supervisory insurance schemes, legal systems according extensive immunities have nevertheless seen fit to impose brief stays on close-out netting (one trading day in the FDIC regime in the US, two days under the proposed new EC regulations). The purpose of these brief periods is to enable the supervisory authority to assign the benefits and the burdens of financial contracts to the bridge bank or the "good" bank, thus retaining within that estate the benefit of financial contracts while simultaneously mitigating the perceived risk of cherry-picking. There is an asymmetry between treatment of insured depository institutions under the FDIC regime and the treatment of unregulated institutions such as *Lehman*. The one day stay gives regulated entities an opportunity to prevent termination of financial contracts long enough to effectuate a transfer of the bank's assets. No such stay was available to *Lehman*.

This disparity of treatment between institutions based on the regime that applies to resolution or liquidation may be even more pronounced due to enactment of the Dodd-Frank Bill. Title II of that legislation extends the FDIC's resolution power to cover financial institutions that are deemed "systemically important." The line between regulated banks and other institutions is generally well understood, but there is a great deal of uncertainty as to those institutions that will be considered systemically important and those that will not be. As such, immediate close-out netting is the standard that will apply to counterparties dealing with a failed institution in bankruptcy while others will be subjected to an abbreviated stay (until the close of the next business day following the date of appointment of the FDIC as receiver) in order to permit possible transfer of financial contracts to a bridge institution before the termination of these contracts.

What has recently become apparent is that the conventional analysis of contagion is partial, incomplete, and thus possibly misleading. Post-crisis literature has begun to identify two other forms of contagion, which appear to be exacerbated rather than mitigated by the existence of bankruptcy immunities. We turn next to these.⁵⁸

b. Information contagion

Recall that parties enjoying bankruptcy immunity have weakened incentives to monitor borrowers and to control the riskiness of their activities. Their incentive is to rely not so much on the continuing viability of the debtor, and thus on its cash flows, but on the value of their collateral, which they anticipate being able to seize on the eve of the debtor's insolvency. Correspondingly, the debtor has an incentive to create increasingly obscure, increasingly impenetrable capital structures, which mask from potential lenders the true state of the debtor's leverage, thus inducing them to lend at a lower rate or indeed to lend at all. This can give rise to a self-reinforcing cycle, with bankruptcy immune creditors increasingly unable to discern the actual state of the debtor's operations, and therefore increasingly reliant on the value of their collateral

⁵⁸ The arguments in the two subsequent sub-Sections draw on Roe (2011).

and their ability to seize it, unbound by bankruptcy restrictions. Suppose now that these parties are suddenly confronted with reasons to believe that their collateral may be less valuable than they had previously taken it to be. In order to assess their net exposure to and risk in relation to the relevant borrower, the creditor would have an incentive to cease its lending activities and to attempt to inform itself of the overall viability of the debtor. Collateral value no longer being sufficient to repay them in full, whether they would get paid and how much they might lose is once again a function of the overall health and cash-generating ability of the debtor. This is an important change in perception and may cause a freeze in the credit market.

c. Collateral contagion

Perhaps most significantly, bankruptcy immunities can lead to a crash in collateral values. The absence of the bankruptcy stay enables bankruptcy immune creditors to seize collateral and liquidate it in order to pay off amounts owed. Naturally, this brings a lot of the same type of assets to the market. A rise in supply leads to a fall in the price. Further, the market has reason to believe that collateral is being liquidated because sellers have private information about its value, and/or that sellers are desperate to liquidate. This exacerbates the tendency for buyers to bid low, because they believe collateral has low value and/or they wish to extract bargaining advantages from the perceived desperation of the sellers. What is more, falls in collateral value may trigger borrower obligations to provide more collateral to cover the appropriate proportion of their liabilities, thus increasing rather than diminishing the risk of credit contagion discussed above.

In order to assess the contribution of bankruptcy immunities to the risk of systemic contagion, account must be taken not simply of credit contagion, but also of information and collateral contagion, and to the ways in which they may exacerbate credit contagion. Taking this fuller picture into account, it is fair to say that the net effect of bankruptcy immunities on the risk of contagion is uncertain and requires further analysis.

VI. Fine-tuned legislative responses

The literature has just started to explore how bankruptcy statutes could be designed to preserve the socially valuable features of the operation of financial contracts while countering some of the costs associated with expansive bankruptcy immunities.⁵⁹ The basic contours of such a fine-tuned legislative response appear to be reasonably clear, and would take as a starting point the ‘best practise’ bankruptcy treatment of secured claims. The elements of this latter approach are (i) presumptively including the collateral within the bankruptcy estate; (ii) requiring the bankrupt to assure adequate protection to the secured creditor; and (iii) vesting in the secured creditor the right to ask the court to lift the bankruptcy stay if either its collateral is not required for a successful reorganisation or a going concern sale or if the bankrupt is unable to accord it adequate protection.

First, consider the effect of preference avoidance rules. Two types of party interaction needs to be distinguished. In the operation of derivatives, the out of money party frequently has an obligation to post additional collateral. This obligation may arise to reflect changes in the reference entity or event. The requirement to post additional collateral analytically relates to the creation of a new debt. On the standard understanding of preference avoidance rules, the posting of additional collateral in these circumstances is not an avoidable preference, since it does not improve the recipients position compared to what it would have been in the absence of the additional posting, but rather, prevents a deterioration in its position compared to what it would have been in the absence of the additional posting. Contrast this situation with one in which the requirement to post additional collateral is triggered not by changes in the reference

⁵⁹ See in particular Roe (2011) and Lubben (2010).

entity but instead by the circumstances, particularly the credit worthiness, of the obligated counterparty. Analytically, this requirement to post collateral is an attempt to improve the position of the beneficiary counterparty compared to what it would have been in the absence of the additional collateral. The improvement comes in relation to all other creditors who suffer at least as badly from the deterioration in their contracting parties credit worthiness. This is a classic case of avoidable preference and there seems little reason to prefer the financial counterparty over other types of creditor.

Second, consider netting rights, and let us distinguish between two situations. In the first, what is in substance a single transaction has been undertaken through multiple contracts. In an interest rate swap, for example, party A has agreed to pay the floating interest rate on the notional amount to party B under Contract 1, in return for the latter's agreement to pay a fixed interest rate on the same notional amount through Contract 2. The distinct contracts notwithstanding, each party has entered into Contract 1 because and only because they were also entering also into Contract 2, and *visa versa*. The legal form notwithstanding, this is one economic transaction in substance. In this situation, it would be inappropriate to preclude the solvent party from setting off its liabilities under one contract against its claim on the other. In the second situation, by contrast, a master agreement drafted so widely as to include virtually every financial contract within its ambit may purport to enable cross product netting across all A/B contracts. Here, there would appear to be no economic unity amongst most of these agreements, and correspondingly, little justification for prohibiting bankruptcy law from disallowing netting.

Third, consider termination rights. We have addressed this issue in the context of the cherry picking argument above. Under the Code, the Debtor may require performance from contractual counterparties, notwithstanding any *ipso facto* clauses in the relevant agreement even before formally assuming the contract. The solvent counterparty, it is important to note, is not obligated to perform so long as it is able and willing to pay the usual expectation measure of damages. What it cannot do is to rely on an *ipso facto* clause to deprive the bankrupt both of performance and appropriate damages. The Debtor is symmetrically bound. It has the choice to either assume an executory contract and perform it in full, or reject it and be bound to pay expectation damages. The asymmetry, economic rather than legal, is that the solvent counterparty would have to pay up in full if it breached the contract, but would be restricted to a bankruptcy dividend if the Debtor were the party that breached. There does not seem to be much justification for granting privileges to financial counterparties in this regard. Such counterparties may legitimately require that the decision to assume or reject be made in a reasonably short period of time, so as not to expose the solvent counterparty either to inappropriate uncertainty or excessive loss. In the context of bank resolutions, as noted, international best practise is moving towards according the resolution authority between one and two trading days to make decisions of this nature, or in the event of the failure to do so, to entitle the counterparty to terminate.

Fourth, consider changes to the language of the Code. The safe harbors are expansive carve outs that have become broader and more extensive with each amendment. They are a means for qualifying parties to insulate themselves from bankruptcy risk. The question is whether these provisions have evolved to the point that they have become so overly broad and all-encompassing that they frustrate some of the fundamental rehabilitative and distributive goals of bankruptcy by embracing transactions with little or no systemic significance that do not deserve to be immunized from collective bankruptcy treatment.

VII. Selected recent cases dealing with the 'safe harbors'

Courts in the United States, especially the bankruptcy courts in the Southern District of New York and the District of Delaware, have been called upon to construe and apply the language of various safe harbor provisions of the Code in a number of recent cases. This section briefly summarizes these authorities.

Given the diverse range of subjects covered (e.g. setoff, relief from stay, application of immunities to private transactions and redemptions, *ipso facto* clause violations, valuation of claims and timeliness of exercising rights), it is difficult to identify a single unifying theme among the cases other than that these provisions are being actively tested to determine the nature and possible limits of these statutory immunities and that this testing, both at the bankruptcy court and appellate levels, will likely continue. See, for example, District Judge McMahon's memorandum and order dismissing appeals in *Dante Fin. PLC Multi-Issuer Secured Obligation Programme Noteholders, et al. v. Lehman Bros. Special Financing Inc. (In re Lehman Bros. Holdings Inc.)*, 2011 U.S. Dist. LEXIS 67768, *11 (S.D.N.Y. June 21, 2011) but noting that "sooner or later" certain of the "one of a kind" decisions of the bankruptcy court will be tested on appeal.

***In re Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V. et al.*, __F. 3d__, 2011 WL 2536101 (2d Cir. June 28, 2011) (2-1).**⁶⁰ The United States Court of Appeals for the Second Circuit affirmed a district court decision holding that pre-petition payments that Enron Corp. ("Enron") made to redeem certain of its commercial paper prior to maturity constituted "settlement payments" protected from avoidance by section 546(e) of the Bankruptcy Code. In the months prior to its bankruptcy filing, Enron paid more than \$1.1 billion to retire certain of its unsecured commercial paper at the accrued par value of the notes. Enron's payments redeeming the notes were funneled to individual noteholders through certain broker-dealers that acted as intermediaries via their respective accounts at the DTC. Enron commenced the adversary proceeding before the bankruptcy court to avoid and recover the redemption payments as preferential and constructively fraudulent transfers under sections 547 and 548 of the Bankruptcy Code. The bankruptcy court found that the redemption by Enron of its commercial paper did not fall within the safe harbor of section 546(e). The district court reversed finding that the exemption of section 546(e) applied to the early redemption.

On appeal to the Second Circuit, Enron argued that the redemption payments did not constitute "settlement payments" protected from avoidance by section 546(e) because (i) the final phrase of section 741(8)'s definition encompassing payments "commonly used in the securities trade" does not apply to unusual redemption payments, (ii) section 741(8)'s definition applies only to purchase-and-sale transactions that, unlike the redemption payments, involve a transfer in title to securities, and (iii) the redemption payments do not implicate the policy concerns that motivated Congress's adoption of the safe-harbor provisions because the payments were not "cleared" through a systemically-critical financial intermediary. *Id.* at 15. A majority of the three judge panel affirmed the district court and limited its analysis to the plain language of section 741(8) of the Bankruptcy Code and rejected each of Enron's arguments. First, it concluded that the unique nature of the redemption payments does not render them ineligible from being "settlement payments" because "the grammatical structure" of section 741(8) "strongly suggests that the phrase 'commonly used in the securities trade' modifies only the term immediately preceding it..." *Id.* at 16. Second, the majority declined to adopt a rule excluding redemption payments from the definition of "settlement payment" under section 741(8), concluding instead that neither the statute nor case law requires that any such payment be made in connection with a purchase or sale. *Id.* Lastly, the court held that a payment may qualify for the safe-harbor protection even if it is not cleared through a financial intermediary: "we do not think the absence of a financial intermediary that takes title to the transacted securities during the course of the transaction is a proper basis on which to deny safe-harbor protection." *Id.* at 23. A thoughtful dissent disagrees with the majority and expresses concern as to the broad potential impact of the decision in limiting the right to pursue preference claims in relation to the repayment of debt obligations and in threatening routine avoidance proceedings.

⁶⁰ As of the date of submission of this paper, a motion for a rehearing *en banc* was pending before the Second Circuit.

Official Comm. of Unsecured Creditors of Quebecor World (USA) Inc. v. Am. United Life Insurance Co. (In re Quebecor World (USA) Inc., et al.), 2011 Bankr. LEXIS 2788 (Bankr. S.D.N.Y. July 27, 2011). The bankruptcy court granted summary judgment for the defendants in a preference action that sought to recover approximately \$376 million in payments made by Quebecor to redeem its privately placed notes. Relying on the Second Circuit's *Enron* decision, *In re Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V. et al.*, ___F. 3d___, 2011 WL 2536101 (2d Cir. June 28, 2011) (2-1), the bankruptcy court held the disputed transfers to be "settlement payments" shielded from avoidance under section 546(e) of the Bankruptcy Code. In so ruling, the bankruptcy court relied on the plain language of the statute, noting that "*Enron* effectively eliminates the need for any inquiry into the legislative history of section 546(e) or close attention to any distinguishing circumstances..." *Quebecor*, 2011 Bankr. LEXIS at *51. As a result, the bankruptcy court interpreted the term "settlement payment" as defined in section 741(8) of the Bankruptcy Code in accordance with the straightforward direction given by the majority opinion in *Enron*: A payment is a "settlement payment" if it is simply a "transfer of cash ... made to complete [a] securities transaction." *Id.* at * 37. In dicta, the decision notes that "even though an examination of context and market impact is not required, the Court is satisfied that the payments ... come within both the letter and spirit of the exemption and that systemic consequences could be demonstrated if that were necessary." *Id.* at *40-41. Nonetheless, the bankruptcy court recognized the possibility that, under *Enron*, even small-scale private transfers with an inconsequential impact on the broader securities market could qualify as "settlement payments" that would be immunized from avoidance. *Id.*

Geltzer v. Mooney, et al. (In re MacMenamin's Grill Ltd.), Case No. 08-23660 (RDD), Adv. Pro. No. 09-8266 (RDD), 2011 Bankr. LEXIS 1461 (Bankr. S.D.N.Y. Apr. 21, 2011). The bankruptcy court denied a motion for summary judgment filed by the defendants to an avoidance action that challenged payments made to the defendants in a private stock transaction in connection with a private leveraged buyout. The defendants conceded that the challenged transfer satisfied the requirements for a constructively fraudulent transfer, but argued that the transfer was nonetheless shielded from avoidance by section 546(e) as a protected "settlement payment." 11 U.S.C. § 546(e). The bankruptcy court noted that the definition of "settlement payment" contained in section 741(8) of the Bankruptcy Code was self-referential and of little help in construing section 546(e). This led to an examination of the context and legislative history of section 546(e), with the court concluding that "Congress was limiting the ... reach of section 546(e) as a whole to the business of engaging in securities transfers" and thus "did not intend section 546(e)'s exemption to apply to the modest private LBO transaction at issue here." *Id.* at *19-20. In concluding that the transfer at issue lay outside the scope of the safe harbor, the Bankruptcy Court noted that the private transfer did not "involve[] any entity in its capacity as a participant in any securities market," and that avoidance posed no danger to the broad functioning of any financial market. *Id.* at *31. Lastly, the bankruptcy court denied the defendant lender's alternative argument that section 546(e) protects from avoidance the debtor's incurrence of a loan obligation and construed the plain language of section 546(e) to protect "transfers," not "obligations," contrasting the language in sections 544(a) and 548(a)(1), which permit the avoidance of "any transfer ... or any obligation." *Id.* at *40-47 (emphasis added).

The *Enron*, *Quebecor* and *MacMenamin* cases are the most recent of a number of court decisions that address the scope of section 546(e). See, e.g., *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009); *QSI Holdings, Inc. v. Alford (In re QSI Holdings, Inc.)*, 571 F.3d 545 (6th Cir. 2009), *cert denied*, 130 S. Ct. 1141 (2010); *Brandt v. B.A. Capital Co. (In re Plassein Int'l Corp.)*, 590 F.3d 252 (3d Cir. 2009), *cert denied*, 130 S. Ct. 2389 (2010).

***Crédit Agricole Corp. v Am. Home Mortg. Holdings, Inc. (In re Am. Home Mortg. Holdings, Inc.)*, 637 F.3d 246 (3d Cir. 2011).** The Court of Appeals for the Third Circuit affirmed a bankruptcy court holding that a discounted cash flow analysis constitutes "a commercially reasonable determinant[] of [the] value" of damages under section 562 of the Bankruptcy Code. Prior to filing for bankruptcy, the debtors defaulted on a repurchase agreement concerning a portfolio of mortgage loans with Calyon New York Branch ("Calyon"). Calyon declared an event of default and accelerated the agreement, thereby obligating the debtors to repurchase the mortgage loans at the repurchase price pursuant to the terms of the agreement. *Id.* at 248. Calyon later filed proofs of claim against the debtors for amounts that exceeded this repurchase price. *Id.* The debtors objected to such claims, arguing that they should be disallowed or reduced when calculated under section 562(a) of the Bankruptcy Code. *Id.* Section 562 provides that "(a) [I]f a ... repo participant ... liquidates, terminates, or accelerates such contract or agreement, damages shall be measured as of the earlier of – (1) the date of such rejection; or (2) the date or dates of such liquidation termination or acceleration. (b) If there are not any commercially reasonable determinants of value as of any date referred to in paragraph (1) or (2) of subsection (a), damages shall be measured as of the earliest subsequent date or dates on which there are commercially reasonable determinants of value." Calyon argued that the only commercially reasonable determinant of value was the market or sale price, which could not be used on the acceleration date because the market was not functioning properly at that time. *Id.* at 249. The court rejected Calyon's position, recognizing that although market price "should be used to determine an asset's value when the market is functioning properly," value may be determined using other commercially reasonable methods (such as discounted cash flow) in the absence of a properly functioning market. *Id.* at 257. In reaching its conclusion, the Third Circuit held that section 562 "align[s] the risks and rewards associated with an investment in those assets,' and prevents the 'moral hazard' that would result if damages were measured at a date other than the date of termination, acceleration, or liquidation, such that 'the repo participant [here Calyon] could hold the asset at little or no risk ... [T]his would make the debtor an insurer of the repo participant's investment even though the debtor has no control over the management of the asset-thus, the moral hazard.'" *Id.* at 253 (quotation omitted).

***Bank of America, N.A., v. Lehman Bros. Holdings Inc., et al. (In re Lehman Bros. Holdings Inc.)*, 439 B.R. 811 (Bankr. S.D.N.Y. 2010).** On cross-motions for summary judgment filed in an adversary proceeding commenced by plaintiff Bank of America, N.A. ("BOA") against defendants LBHI and LBSF, the bankruptcy court rejected BOA's argument that section 362(b)(17) entitled it to setoff funds held in a security account for overdrafts against unrelated debts owed to BOA under an ISDA master agreement without first moving for relief from the automatic stay. The bankruptcy court concluded that the exemption from the automatic stay in section 362(b)(17) for "the exercise by a swap participant or financial participant of any contractual right (as defined in section 560) under any security agreement ...forming a part of or related to any swap agreement ..." does not permit a setoff against collateral lacking any connection to any safe-harbored swap transaction. *Id.* at 834-5. In reaching this conclusion, the bankruptcy court narrowly construed the plain language of section 362(b)(17), together with section 560's definition of the term "contractual right," to mean that "the automatic stay should not impact the exercise of a contractual right of setoff that is otherwise consistent with recognized customs and practices of market participants who engage in swap transactions." *Id.* at 835 (internal citation omitted).

***In re SemCrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009), *aff'd by Chevron Prods. Co. v. SemCrude, L.P. (In re SemCrude, L.P.)*, 428 B.R. 590 (D. Del. 2010).** The bankruptcy court declined to lift the automatic stay to permit Chevron USA, Inc. ("Chevron") to offset amounts that it owed to debtor SemCrude, L.P. ("SemCrude") against amounts owed to Chevron by two SemCrude affiliates named SemFuel, L.P. ("SemFuel") and SemStream, L.P. ("SemStream"). The decision concludes that the so-called "triangular" setoff contemplated by Chevron failed to satisfy the element of mutuality required for setoff under section 553(a). Debts are only considered mutual when "they are due to and from the same persons in the same capacity," and in the absence of mutuality a debt may not be set off against the credit

of an affiliate, subsidiary or parent. *Id.* at 393-394 (citations omitted). The bankruptcy court rejected Chevron's argument that this lack of mutuality could be cured by the parties' private contractual agreement, concluding that "a multi-party agreement allow[ing] for setoff of non-mutual debts between parties to the agreement" fails to "create an indebtedness from one party to another." *Id.* at 397-398. The bankruptcy court decision was affirmed on appeal. *See Chevron Prods. Co. v. SemCrude, L.P. (In re SemCrude, L.P.)*, 428 B.R. 590, 594 (D. Del. 2010).

***In re Lehman Bros. Holdings, Inc.*, 433 B.R. 101 (Bankr. S.D.N.Y. 2010), *aff'd* by 445 B.R. 130 (S.D.N.Y. 2011).** The bankruptcy court granted the debtors' motion for an order enforcing the automatic stay and compelling the payment of funds held by creditor Swedbank, N.A. ("Swedbank"). The court found that Swedbank lacked the right to setoff funds deposited by LBHI at Swedbank after the petition date against Swedbank's prepetition debt to LBHI under an ISDA master agreement because the debts lacked the mutuality required by section 553(a). In so ruling, the bankruptcy court rejected Swedbank's argument that it should be entitled to setoff notwithstanding the lack of mutuality because it had a contractual right to setoff under its ISDA master agreement with LBHI that qualified under the Bankruptcy Code safe harbors of section 560 and 561. *Id.* at 104. Upon examination of the plain language and legislative history of these sections, the court concluded that language permitting a derivatives-contract counterparty to exercise "any" contractual right notwithstanding the automatic stay did not "change well established law that conditions such a right on the existence of mutual obligations." *Id.* The Swedbank decision was affirmed on appeal. *See In re Lehman Bros. Holdings, Inc.*, 445 B.R. 130 (S.D.N.Y. 2011).

***Lehman Bros. Special Fin., Inc. v. BNY Corp. Trustee Serv'cs Ltd. (In re Lehman Bros. Holdings Inc.)*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010).** The bankruptcy court held for Plaintiff LBSF on cross-motions for summary judgment in an adversary proceeding commenced against defendant BNY Corporate Trustee Services Limited ("BNY") as trustee of a multi-issuer secured obligation program. As part of this program, Saphir, a special purpose entity, issued various series of credit-linked portfolio notes to noteholders including Perpetual Trustee Company Limited ("Perpetual"), entered into a swap agreement with LBSF, and held collateral in trust for the benefit of its creditor noteholders and LBSF. The adversary proceeding, and a parallel proceeding commenced by Perpetual in the High Court in London, arose from uncertainty surrounding whether the noteholders or LBSF had a priority claim to the collateral. The series of notes held by Perpetual were governed by documentation that ordinarily functioned to entitle LBSF to priority to the collateral, but, upon an "event of default" by LBSF under the swap agreement (including the bankruptcy of LBSF or LBHI) called for a reversal of priorities in favor of Perpetual. Saphir terminated the swap agreement on December 1, 2008, asserting that LBSF's chapter 11 filing constituted an event of default. Thereafter, LBSF commenced the adversary proceeding to challenge this so-called "flip" provision as an invalid *ipso facto* clause that improperly deprived LBSF of its property right to the collateral solely as a result of a chapter 11 filing.

The bankruptcy court concluded that the "flip" language constituted an unenforceable *ipso facto* clause in violation of sections 365(e)(1) and 541(c)(1)(B) of the Bankruptcy Code. In reaching this holding, the bankruptcy court noted that the plain language of section 365(e)(1) proscribed *ipso facto* clauses conditioned on the commencement of "a case under this title" -- not the commencement of a particular debtor's case -- and that this nuanced language, combined with its legislative history and the facts and circumstances of the Lehman chapter 11 cases, warranted a finding that the relevant commencement date for purposes of analyzing the legality of the disputed clause was the earlier petition date of the LBHI bankruptcy on September 15, 2008. *Id.* at 418-21. The bankruptcy court also rejected BNY's alternative argument that, even if the disputed clause were deemed to constitute an *ipso facto* clause, it is nonetheless enforceable under the safe harbor provision of section 560 of the Bankruptcy Code as a protected "contractual right" to "cause the liquidation, termination, or acceleration of one or more swap agreements because of a condition of the kind specified in section 365(e)(1)..." In so ruling, the bankruptcy court

noted that LBSF's swap agreement neither included nor even mentioned the disputed provisions contained in the note documentation and, therefore, that the relevant provisions did not constitute part of a "swap agreement" for purposes of section 560. *Id.* at 421.

Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007-1 Ltd., et al. (In re Lehman Bros. Holdings Inc.), Case No. 08-13555 (JMP), Adv. Pro. No. 09-01032 (JMP), 2011 Bankr. LEXIS 1759 (Bankr. S.D.N.Y. May 12, 2011). This decision dealt with a motion to dismiss filed by defendant Ballyrock ABS CDO 2007-1 Ltd. ("Ballyrock"), a special-purpose entity that issued notes to investors pursuant to an indenture and entered into an ISDA master swap agreement with Lehman Brothers Special Financing Inc. ("LBSF"). The swap agreement provided that, upon an event of default (including a bankruptcy filing by LBSF or its parent Lehman Brothers Holdings Inc. ("LBHI")), the non-defaulting counterparty could designate an "Early Termination Date" that would entitle the in-the-money counterparty to receive a termination payment. *Id.* at *6-7. The indenture, in turn, set forth a waterfall distribution scheme that, *inter alia*, entitled LBSF to receive any such termination payment from Ballyrock ahead of any distributions to Ballyrock's noteholders but subordinated and capped LBSF's right to a termination payment if LBSF were the defaulting party. *Id.* at *8-11. Following LBHI's bankruptcy, Ballyrock terminated the swap agreement, thereby entitling LBSF to a termination payment that, according to Ballyrock's noteholders, was subordinated and capped under the waterfall. In the complaint, LBSF characterized those waterfall provisions purporting to subordinate LBSF's rights to the termination payment as an invalid *ipso facto* clause. Relying on the earlier decision in *Lehman Bros. Special Financing, Inc. v. BNY Corp. Trustee Serv'cs Ltd. (In re Lehman Bros. Holdings Inc.)*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010) summarized above, the bankruptcy court held that LBSF's complaint stated plausible claims alleging that the disputed provisions may be unenforceable *ipso facto* clauses. *Id.* at *15. The court held that the reference in Section 365(e)(1) to "commencement of a case under this title" was sufficiently broad "to protect a debtor from the operation of a clause triggered by not only its own bankruptcy filing but also by the bankruptcy of a related entity" such as LBHI. *Id.* at *19. The bankruptcy court further concluded that this *ipso facto* clause was not protected under Section 560 because it operated to "effectively nullify[]" LBSF's right to an early termination payment, and that such "a mandated elimination of a substantive right" exceeded the scope of a safe harbor section exclusively limited to preserving a counterparty's right to liquidate, terminate, or accelerate a qualifying financial contract. *Id.* at *22.

In re Lehman Bros. Holdings Inc., et al., Case No. 08-13555 (JMP) (Bankr. S.D.N.Y. Sept. 15, 2009), ECF No. 5261 (Transcript of Bench Ruling in connection with Debtors' Motion To Compel Performance Of Metavante Corporation's Obligations Under An Executory Contract And To Enforce The Automatic Stay). The bankruptcy court granted LBSF's motion to compel performance by Metavante Corporation ("Metavante") under an interest rate swap transaction pursuant to a 1992 ISDA master agreement. Tr. at 113:2-9. Following the occurrence of events of default caused by the bankruptcy filings of LBHI and LBSF, Metavante ceased performing under the contract but elected not to terminate the agreement, arguing that section 560 grants it the right, but not the obligation, to terminate all outstanding derivative transactions under the agreement. Tr. at 107:9-20. The bankruptcy court rejected Metavante's position, concluding that although the safe-harbor provisions of the Bankruptcy Code do not require Metavante to terminate the swap agreement, they do not permit Metavante to "ride[] the market" for more than a year "while taking no action whatsoever." Tr. at 110:21-25. The bankruptcy court noted that the legislative history evidences Congress' intent to allow for the "prompt" closing out of positions under safe harbor contracts, and concluded that "Metavante's window to act promptly under the safe harbor provisions has passed and while it may not have had the obligation to terminate immediately upon the filing of LBHI and/or LBSF, its failure to do so, at this juncture, constitutes a waiver of that right at this point." Tr. at 111:3-112:2.

Calyon New York Branch v. Am. Home Mortgage Corp. (In re Am. Home Mortgage Inc.), 379 B.R. 503 (Bankr. D. Del. 2008). The bankruptcy court held, *inter alia*, that a pre-petition contract between the debtor-mortgage company and Calyon New York Branch ("Calyon") for the sale and repurchase of mortgage loans constituted a "repurchase agreement" for purposes of section 559 of the Bankruptcy Code. The debtor argued that, in light of extrinsic evidence and the relationship between the counterparties, the agreement did not constitute a "repurchase agreement" and should instead be characterized as a secured financing agreement unable to be terminated without relief from the automatic stay. *Id.* at 508-9. The bankruptcy court limited its examination to the plain language of section 101(47) of the Bankruptcy Code, concluding that the contract satisfied that section's definition of a safe-harbored "repurchase agreement" because, among its other provisions, it "provides for the transfer of one or more mortgage loans or interests in mortgage loans." *Id.* at 518. As a result, Calyon could immediately terminate the contract and enforce its rights against the underlying mortgage loans irrespective of the automatic stay. *Id.* The bankruptcy court also concluded that the contract also constituted a "securities contract" under section 741 of the Bankruptcy Code, the termination of which was exempt from the automatic stay under section 555 because the "the definition of securities contract has been expanded to expressly include a repurchase agreement..." *Id.* at 519.

VIII. The impact of derivatives on creditor behavior in bankruptcy cases

Traditionally, bankruptcy courts have viewed the trading of claims with a relatively *laissez-faire* attitude. The automatic stay does not interfere with a creditor's right under non-bankruptcy law to assign its claim. Allowing claims to trade has many perceived advantages. Creditors who do not wish to wait for a distribution, or do not have expertise in monitoring or participating in bankruptcy cases, may prefer to exit and obtain a cash payment for their claims. Other parties who may have a comparative advantage in creating value thereby may be able to enter a case. Also, by buying a claim at a discount, the assignee may be able to look at a plan or liquidation proposal with clearer eyes because the decision is framed as "how much money can I make?" rather than "how much money have I lost?"

More recently, a number of concerns have arisen about possible negative consequences and implications of such claims trading. These concerns all derive from the same basic insight: some forms of claim trading, particularly trading in derivatives, provide a mechanism that allows a creditor to separate its economic interest in the claim from its ownership interest – and hence, in bankruptcy, its governance rights. This concern first arose, outside of bankruptcy, in connection with the trading of equity securities. Stockholders get to vote on major corporate decisions. Therefore, investors may purchase stock in a company in order to influence the company's governance, but they may also acquire "short" options, and thereby limit long exposure to the company's financial future. Such "hedging" has certain beneficial consequences but it may also affect a stockholder's incentives. More troubling, however, since no insurable interest is required to purchase a "short," a stockholder may "insure" more stock than it owns and position itself to profit if the stock price declines. In other words, such an investor or group of investors will have an economic incentive to exercise their governance rights to harm the company. This separation of economic interest from governance rights has been referred to as "empty voting."

Outside of bankruptcy, creditors have no governance rights, so this problem was thought not to exist for creditors. In bankruptcy, however, creditors become, in effect, the "owners" of a now insolvent company, and have the power to vote on a plan of reorganization and may exercise significant influence over the debtor. Depending on the circumstances of the case, they may find themselves stockholders upon consummation of the plan, and might even hold sufficient voting power to control the reorganized company. As a result, at least in theory, the "empty voting" concept can be a problem in bankruptcy. Indeed, there have been anecdotal reports concerning the effects of derivative trading on the dynamics of a number of plan confirmations, and Bernard Black and Henry Hu have also published articles describing

what they call the “empty creditor” hypothesis.⁶¹ The various bankruptcy consequences relating to the role of “empty creditors” have not been thought through or thoroughly considered.

This section of the materials does not attempt to prove or disprove the “empty creditor” hypothesis, but does seek to identify the various mechanisms that creditors can use to separate their economic interests from their governance rights, to highlight some of the concerns caused by such separation, and to evaluate the various tools available under the Bankruptcy Code for addressing these concerns.

a. Mechanisms for separating economic interest from governance rights

Voting rights can be separated from economic interests in more ways than one might think. Probably the simplest and most direct way of hedging the economic risk associated with distressed debt is through a credit default swap that pays when a debtor files for bankruptcy. This may affect the willingness of a creditor to negotiate a workout prior to bankruptcy. There are other financial contracts that may be used to achieve this separation after a debtor has filed for bankruptcy. These include total return swaps, where all of the risk associated with a particular investment is transferred from one party to the other. But there are simpler, less novel devices that may have this effect as well. Since distressed debt continues to trade, one can simply purchase a short-option. Less obviously, and more commonly, creditors in bankruptcy often have investments across the capital structure of a business. For example, a secured creditor might also hold an unsecured position in outstanding bonds, a second lien position, an equity position, or any of the above. Concerns about the potential conflicts associated with these situations are not new, but the advent of robust trading in claims and the increased sophistication of credit derivatives warrants a reexamination of the available mechanisms for dealing with these conflicts, and a reconsideration of whether they are adequate.

b. Problems created by separating economic interest from governance rights

There are two conceptual sets of problems potentially created by the separation of economic interest from governance rights. The first lies in the way those governance rights may be exercised. An economic “short” may seek to sabotage a workout, and encourage a bankruptcy filing early in an out of court restructuring, or a claimant who acquires a short position later in a case may seek to block confirmation or bargain aggressively due to its hedged or inverted economic interest.

The concern about behavior is compounded when one recognizes that empty creditor status can lead to informational consequences as well. As a general rule, creditors are only required to disclose their “claim,” not what they paid for it, and not whether they have engaged in any hedging behavior. Therefore it is difficult for other claimants or the court to evaluate whether, for example, an unsecured creditor’s behavior is driven by an interest in maximizing recoveries as an unsecured creditor, or for some other reason. This, in turn, results in false signaling.

False signaling is a particular problem in a bankruptcy case, where it is hoped that smaller creditors will be able to take advantage of the information gathering of more sophisticated creditors with a larger stake in the enterprise. This is the logic behind the creation of creditors’ committees, and the reason that committee members are held to a high standard of care and must act as fiduciaries. Fiduciary duties, however, are an imperfect and incomplete source of protection, and not all signaling is done by committee members.

⁶¹ Henry Hu and Bernard Black. (2008a) ‘Equity and Debt Decoupling and Empty Voting II: Importance and Extensions’ (2008) 156 *University of Pennsylvania Law Review* 625-739, and Henry Hu and Bernard Black. ‘Debt, Equity, and Hybrid Decoupling: Governance and Systemic Risk Implications’ (2008) 14 *European Financial Management* 663-709.

Finally, the ability to separate economic interest from governance rights can create coordination problems at both the workout stage and at the plan confirmation stage. These coordination problems can emerge naturally as a product of the alienability of claims. For example, a debtor may work out an agreement regarding treatment of a claim with one key creditor, only to have that creditor sell its claim to a third party who wants to renegotiate the deal. At least as a theoretical matter, where both the seller and the buyer are motivated to maximize the value of their claims, the consequences should be tolerable. However, it is possible that the purchaser of the claim could have a short position and rather than wanting to tinker with or improve the distribution may instead wish to obstruct any agreement.

c. Possible mechanisms for dealing with these problems

To the extent that these problems are viewed as ones that need to be resolved through some form of regulation, either by judges or Congress, there are a number of possible approaches that might be tried individually or in combination. They are: mandating disclosure, limiting the voting power of creditors to correct the mismatch between voting power and economic interest, limiting the alienability of claims, and limiting distribution rights through the subordination or disallowance of claims. Each of these remedies exists to some extent within the Bankruptcy Code as currently written. Each also has certain limitations and possible unintended consequences. The following paragraphs address each of these mechanisms separately.

i. Disclosure

Under current law creditors need only disclose the amount they are owed, and to assert that they are the person entitled to receive payment. They do not need to disclose how much they paid to acquire the claim, whether they have assigned all or part of their right to receive payment to somebody else, or whether they have insured or otherwise hedged part of the risk. There is a controversial exception to this rule, in some jurisdictions, for members of ad hoc committees under Rule 2019 of the Federal Rules of Bankruptcy Procedure, and that exception is to be expanded upon the effectiveness of proposed revisions to Rule 2019. Requiring disclosure is a partial solution to the empty creditor problem in helping to eliminate the confusion caused by false signaling. It does not, however, prevent a creditor with a conflict from obstructing a workout or plan, from voting its claim to block a plan, or resolve the tension between fiduciary duty and self-interest if that creditor is serving on a committee.

ii. Limiting franchise

A second mechanism for addressing disconnects between governance rights and economic interest is to limit those governance rights directly. Again, there are existing mechanisms under current law. For example, a hedged claim might need to be classified separately from claims that are not hedged. A creditor who is economically short might have its votes designated as having been cast in bad faith. Another possibility might be to mark down a creditor's voting right by netting the voting power to reflect the portion of the claim that is long and not hedged. In other words, a creditor who has hedged one third of its credit exposure might be allowed to vote only the two-thirds of its claim that is not hedged.

These tools largely eliminate the ability of a creditor to use its voting rights to harm the estate for its own benefit. Their primary weaknesses lie in the difficulty of administering them. Classification solves the signaling problem caused by empty creditors, but the creditor still has other rights. While it may not be able to block confirmation by eliminating an impaired accepting class, the creditor may be able to block consensual confirmation and force a cramdown. Designation may solve the false signaling problem by identifying and punishing the creditor's conflict, but is quite harsh in depriving the creditor of any governance rights whatsoever. Both classification and designation are binary remedies with uncertain triggers. Dilution of voting rights is more nuanced, and need not have a trigger, in that it can be applied relatively continuously.

These mechanisms are limited in that they are only available in bankruptcy. This means that none of them will impact the ability of a “short” creditor to obstruct a proposed workout prior to bankruptcy. The other problem is that by diluting or limiting the governance rights upon bankruptcy, bankruptcy becomes a “realization” event for the claims trading market. Some claims will be more valuable outside of bankruptcy than in bankruptcy, and vice versa. This can be a source of unpredictable and problematic secondary consequences.

A common attribute of these various franchise limiting alternatives is that they depend upon a robust and effective disclosure regime. Unless a creditor has disclosed its position, or another creditor has uncovered that position and disclosed it to the court, none of these possible remedies can be imposed. As a result, in order to work, it may be necessary to impose a general requirement that creditors with significant positions provide regular disclosure of any changes in their economic interest in the debtor.

iii. Trading bars

One possible but extreme solution to certain of the perceived detrimental aspects of postpetition trading in claims would be to simply bar all trading in claims once a debtor has filed for bankruptcy. Such trading restrictions have been issued in certain large chapter 11 cases as a means to preserve the estate’s tax attributes. However, it is one thing to limit trading to preserve value and quite another to limit trading to stabilize or freeze the composition of the creditor body. Given the active market in bankruptcy claims, such a total bar on the right to transfer claims would be highly disruptive and difficult to justify in light of the foreseeable secondary market effects and the harm caused to creditors that want or need to liquidate their claims.

iv. Limitation of distribution

Where a creditor has engaged in some form of bad behavior, there are existing mechanisms for limiting their distribution through equitable subordination or disallowance of a claim. These remedies exist under current law, and are not based on conflicts of interest but on the misconduct that may be caused by such conflicts. As such, limiting distributions by means of subordination or disallowance can be used as a mechanism for punishing prepetition behavior that harmed the estate. The practical problem, however, is proving the causal connection between the conduct of the creditor and harm to the estate. Typically relief is only available in situations involving fairly egregious facts.

d. Need for increased transparency to enhance remedies

Modern trading technology and the financial engineering described in these materials have increased the ability of investors to place bets within the market for secured and unsecured indebtedness. This is a highly liquid market that includes distressed debt. As such, debt now trades in a large unregulated market in a manner similar to equity securities. Because bankruptcy gives governance rights to creditors, the empty voting problem that has been observed in modern mergers and acquisition practice appears to have migrated to the bankruptcy forum. Addressing this problem requires more thought about whether new remedies are needed or whether existing remedies need to be adapted and enlarged. However, one common theme is that virtually all of the new remedies will require (and existing remedies will work better) if there is a more robust set of disclosure requirements. Greater transparency would allow other claimants and the court to gain greater insight as to the behavior of creditors with a hidden agenda who are seeking to influence the outcome of certain cases. The proposed revision of Rule 2019 has provided a forum for discussing these issues, but it has also demonstrated that the problems discussed above are not limited to *ad hoc* committees or groups of creditors and that the development of procedures for dealing with the empty creditor is a subject that requires more study and systematic thought.