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Transaction Consistency and the New Finance in Bankruptcy

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Introduction

One of the few areas of American finance that the financial reforms of 2010 did not dramatically restructure was bankruptcy. Designed for financially-troubled firms (and individuals), bankruptcy has a host of provisions for staying individual debt collection,[2] rearranging capital structures (and changing the relevant decisionmakers),[3] and otherwise sorting out viable from non-viable businesses.[4] The Dodd-Frank Act borrows a few provisions from bankruptcy for the new resolution regime it established for systemically important financial institutions that fall into financial distress;[5] it gives bank regulators new powers to deal with these institutions' distress;[6] and it calls for several studies of bankruptcy.[7] But the legislation does not amend the bankruptcy laws.

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2 Chief among these are the automatic stay, 11 U.S.C. § 362, and the ability to assume valuable executory contracts notwithstanding "ipso facto" clauses, 11 U.S.C. § 365.

3 This is the consequence of the so-called absolute priority rule, 11 U.S.C. §§ 725, 726, as implemented in Chapter 11's reorganization rules, 11 U.S.C. §§ 1123, 1126, 1129.

4 Thomas Jackson, The Logic and Limits of Bankruptcy Law 8-17 (Harvard University Press 1986).

5 *See, e.g.,* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, sec. 210(a)(11)(a)-(b)(2010)(incorporating bankruptcy-like fraudulent conveyance and preference provisions)[hereinafter cited as Dodd-Frank Act § __].

6 Id. §§ 201-217 (Dodd-Frank's resolution rules).

7 Id. §§ 202(e)(bankruptcy study by Comptroller and Administrative Office of the U.S. Courts); 216 (study by Federal Reserve and Administrative Office of the U.S. Courts)

To appreciate just how remarkable the neglect of bankruptcy is, we need only consider the regulatory treatment of the instruments of contemporary finance before and after the 2008 crisis. Prior to the crisis, the financial innovations of the past thirty years—swaps and other derivatives contracts,[8] repurchase agreement (repo) financing,[9] and structured finance[10] in particular—were almost completely unregulated both outside and inside of bankruptcy. Outside of bankruptcy, over-the-counter (OTC) derivatives were treated as private contracts between the two parties, and 2000 legislation explicitly forbade the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) from regulating them.[11] Inside of bankruptcy, repos and derivatives were insulated from core bankruptcy provisions such as the automatic stay, which prohibits creditors from terminating their contracts or seizing and selling collateral.[12]

When the 2008 crisis subjected the privileged status of derivatives and repos to a stress test, it was, to put it mildly, found wanting. Derivatives had been touted as reducing risk, and as a self regulating market.[13] Imposing regulation, the reasoning went,

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[8] The major forms of swaps include credit default swaps, interest rate swaps, and currency swaps. A credit default swap functions like insurance, with one party (the protection seller) promising the other party (the protection buyer) a payment in the event a third party (the reference entity) that is the subject of the contract experiences a "credit event" such as default or bankruptcy. With an interest rate swap, one party agrees to pay one form of interest (such as a fixed interest rate) and the other pays a different rate (such as an interest rate that varies based on the prime rate). With a currency swap, one party agrees to pay a specified amount of one currency (such as dollars) and the other promises a difference currency (such as euros). In each case, the obligations are usually netted out at the end of the contract, and one party pays the other the difference.

[9] In a repurchase or "repo" transaction, one party sells securities to the other, and promises to buy them back at a specified time in the future. Repos are generally used for financing, and are very similar to a secured loan with securities as collateral.

[10] In its most common form, structured finance, or "securitization," involves a sale by the issue of assets such as mortgages or credit card receivables to a new entity. Investors in the new entity receive securities issued by the new entity, and the funds they contribute are used by the entity to purchase its assets. See, e.g., Steven L. Schwarcz, The Future of Securitization, 41 Conn. L. Rev. 1313 (2009)(outlining and explaining a securitization).

[11] Commodities Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (2000). The Commodities Futures Modernization Act of 2000 excluded a broad range of derivatives transactions from the jurisdiction of both the CFTC and the SEC, leaving them unregulated by the federal government. Giovanni P. Prezioso, The Commodity Futures Modernization Act of 2000 3 (2002); Noah L. Wynkoop, Note: The Unregulables? The Perilous Confluence of Hedge Funds and Credit Derivatives, 76 Fordham L. Rev. 3095, 3099 (2008).

[12] 11 U.S.C. §362(a).

[13] The most famous endorsement came from former Federal Reserve Chairman Alan Greenspan, who credited derivatives with easing the effects of the Enron and WorldCom collapses. Alan Greenspan, Chairman Fed. Reserve, Risk Transfer and Financial Stability: Remarks by Chairman Alan Greenspan to the Federal Reserve Bank of Chicago's Forty-first Annual Conference on Bank Structure (May 5, 2005),

would interfere with the market, with potentially catastrophic consequences. Yet the absence of regulation did not cushion the blow of any of the 2008 collapses—Bear, Stearns, Lehman Brothers, or AIG. In each case, it hastened the implosion and magnified the risk that their defaults would paralyze the financial system. The absence of regulation was the problem, not a solution, as we have documented in detail elsewhere.[14]

In response to this unintended stress test, the Dodd-Frank Act has created a massive and entirely new regulatory framework for derivatives outside of bankruptcy. If the new rules work as designed, most derivatives (which are defined as "swaps" in the legislation) will be cleared on a clearing house that will act as the guarantor of the obligations of both parties.[15] They also must be traded on exchanges (referred to in the Act as boards of trade),[16] which will require that they be more transparent and their terms more standardized than in the past. The Dodd-Frank Act does not regulate repos or structured finance nearly as extensively as derivatives. But it imposes important new restrictions on their operation outside of bankruptcy.[17]

The key phrase, once again, is "outside of bankruptcy." Although the Dodd-Frank Act will have important indirect effects on bankruptcy, lawmakers left the bankruptcy treatment of derivatives, repos, and other financial innovations largely untouched.[18] Their special status endures.

In this Essay, we offer a new perspective on the implications of this special treatment. To motivate the analysis, we identify four different distortions caused by the

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available at http://www.federalreserve.gov/Boarddocs/Speeches/2005/20050505/default.htm (attributing the "remarkable resilience of the banking system, which had [by the time of earlier remarks by Greenspan in 2003] "recently shrugged off severe shocks to the economy and the financial system," to derivatives and sophisticated risk management).

[14] We reference this earlier work in Part II, infra.

[15] Dodd-Frank Act § 723 (clearing requirement). Technically, the clearing house is a principal to both parties, becoming a "buyer to every seller and a seller to every buyer." The effect is similar to a guaranty, and we will use this term throughout the Essay.

[16] Id. (exchange requirement).

[17] Most importantly, bank regulators are authorized to limit the amount of short term debt that a systemically important financial institution is permitted to have in its capital structure. Dodd-Frank Act §165(g). For structured finance, the legislation requires that the originator retain at least 5% of the credit risk of the structured finance entity. Dodd-Frank Act § 941.

[18] Our particular concern in this Essay is with repos and derivatives. We have fewer qualms with the current treatment of structured finance, which treats securitization transactions as true sales, and thus as remote from the issuer's bankruptcy, except in egregious circumstances.

special rules for repos and swaps.[19] First, the special treatment diminishes counterparties' incentive to screen and monitor the debtor, particularly with the systemically important firms that dominate the derivatives industry and are likely to be bailed out if they fall into financial distress. Second, the special treatment functions as a credit subsidy for the new finance. Debtors favor the new finance over traditional sources of funding, and creditors do not limit their exposure to a potentially vulnerable debtor. Third, insulation from bankruptcy's core policies exacerbates the risk of runs by removing the debtor's ability to temporarily halt them. Finally, the absence of a stay and the prospect of a mass termination of the debtor's derivatives hinders a debtor's ability to effectively resolve its financial distress in bankruptcy. This initial analysis draws on insights we and others have developed in previous work.

We then turn to the counterfactual that lies at the heart of the Essay: What would applying the core bankruptcy policies—honoring a principle we will refer to as "transaction consistency"—mean for derivatives and repos?[20] We confess that we, like other scholars, had not previously worked through all of the implications. The results are surprising, even stunning. Despite the enormous energy the Federal Reserve, the U.S. Treasury, and the financial services industry have spent over the past thirty years lobbying to insulate repos from the rules that apply to ordinary contracts in bankruptcy, transaction consistency would have only a limited effect on the treatment of repos. Because they are financing transactions—a "financial accommodation," in bankruptcy lingo—the debtor cannot "assume" them in bankruptcy, as it can other executory contracts.[21]

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[19] We recognize that the special treatment may prevent other distortions. We discuss these benefits when we consider the effect that removing the special treatment would have, as discussed in the next paragraph below.

[20] To call this principle "transaction consistency" may seem heretical (or unnecessary) to some bankruptcy insiders. It bears an unmistakable family resemblance to the "equality of creditors" principle, a longstanding staple of bankruptcy that says that similarly situated creditors should be treated equivalent wherever possible. Despite the familiarity of the "equality of creditors" principle, we prefer "transaction consistency" for several reasons. The first is that the traditional term is so familiar that it has lost much of its content in practice. We also prefer transaction consistency because of the different connotations of the two terms. Equality of creditors connotes fairness, and assuring fairness was its historical objective: in the 19th century, sophisticated creditors were often discriminated against, as debtors favored friends and local creditors. Fairness is still an issue, but transaction consistency gives a better sense of the distortions created by deviations, which are our primary concern here.

[21] See 11 U.S.C. § 365(c)(2).

With swaps, on the other, hand, transaction consistency would mean significant changes in the bankruptcy treatment, although here too the fears of the derivatives industry are overstated: under transaction consistency, the debtor could assume these contracts. But the debtor's ability to pick the good swaps and abandon the bad ones—to "cherry pick," as the industry ominously calls it—would be limited, since bankruptcy would largely honor the master swap agreements the industry uses to coordinate and net obligations.[22]

We do not simply call for a reversal of the current rules, as a formalistic application of transaction consistency might suggest. Repos and swaps have characteristics that distinguish them from most ordinary contracts. Most importantly, they are highly volatile, with values often changing dramatically over short periods. Many must be fine-tuned constantly, with the parties recalibrating each others' margin or collateral obligations daily.[23] To account for these distinctive attributes, we propose several adjustments from formal transaction consistency. With repos, we conclude that lawmakers should continue to exempt cash-like collateral such as treasury bills or agency debt from the stay. Not only would this enable counterparties to quickly close out contracts involving securities that are easy to value, are not likely to impose systemic risk on the financial system, and usually will not be essential to an efficient resolution of the debtor's financial distress. The preferred treatment of cash-like collateral also would encourage the parties to use these securities rather than more illiquid securities such as the mortgage-backed securities that featured prominently in the 2008 crisis. With swaps, the stay should be limited to three days, due to the high velocity and volatility of derivatives transactions. Although we argue that master netting agreements should generally be honored in bankruptcy, a counterparty should not be permitted to use the (automatic) termination of a repo as a basis for cancelling all of the contracts in a master agreement that includes swaps and other derivatives.

The Essay proceeds as follows. In Part I, we briefly outline the rationales that were used to justify the special treatment of derivatives and repos in bankruptcy. We

[22] The key provision here is 11 U.S.C. § 553, which honors prebankruptcy setoff rights.
[23] With many derivatives contracts, the parties are required to post "initial margin"—which is value corresponding to a portion of any potential obligations under the contract—as well as "variation margin"—additional margin payments to reflect changes in the current value of the contract.

then show how they fared in the 2008 stress test, culling lessons from the major failures. In Part II, which brings us to our central counterfactual, we analyze the implications of transaction consistency for derivatives and repos, looking at their status as executory contracts, the implications of the automatic stay, the contours of setoff and netting, and the application of bankruptcy's preference and fraudulent conveyance provisions.

Part III considers the implications of the new financial reform legislation for the transaction consistency analysis. Of particular importance are the new requirement that most derivatives be cleared on clearinghouses that will guaranty the performance of both parties to the contracts, and will impose suitable collateral requirements; and the newly minted FDIC resolution rules for large, systemically important financial institutions. For cleared derivatives, the clearing house will become the true party in interest in the event a counterparty fails. This means that the clearing house is more than just a middleman in the transaction. We argue that clearing houses should therefore be subject to the same transaction consistency treatment in bankruptcy as a counterparty is.

The new resolution regime has its own temporary stay and other bankruptcy-like rules, which might seem to make the bankruptcy treatment of repos and derivatives redundant. But the resolution regime only applies to the largest institutions, and even these institutions can not use bankruptcy unless the U.S. Treasury steps in and invokes the resolution rules. Not only would the treatment we propose apply in most cases, but it could make the resolution regime far less necessary. Armed with a stay and other bankruptcy protections, the managers of a large troubled institution—the next AIG, for instance— would have an incentive to file for bankruptcy before regulators intervened, in order to control the disposition of the firm's assets.

Recognizing the realities of the reform process,[24] we offer several more limited alternative proposals for reform in Part IV. Rather than moving to complete transaction consistency, Congress could constrain many of the problematic effects of the current rules with a few very limited adjustments. The most minimalist approach would simply reinstate the bankruptcy rules that prevent contract termination by invalidating so-called

[24] From hard experience. Both of us were involved in numerous discussions with Congressional staff of both parties, and in other ways, during the legislative debates that led to the Dodd-Frank Act. While we would like to think that we made a tiny contribution to the removal of a dedicated $50 billion fund from the original version of the Dodd (Senate) bill, our own influence on the legislation was essentially nil. With this Article, we're going back to the drawing board.

"ipso facto" clauses.[25] A slightly more expansive strategy would also reintroduce a limited stay for swaps, without altering the treatment of repos. Although neither reform promises the full benefits of transaction consistency, either would correct the worst distortions of the current framework.

We conclude by briefly summarizing the implications of our analysis and of the transaction consistency principle.

I. What Happened? The 2008-2009 Stress Test

Bankruptcy's heart and soul lie in two provisions, the automatic stay and the trustee's power to avoid preferential transfers.[26] The automatic stay, which prohibits creditors from taking steps to collect what they are owed once a debtor has filed its bankruptcy petition, is the key to bankruptcy's collective proceeding. From the moment a debtor files for bankruptcy, the stay halts the "race of diligence" by creditors that might otherwise lead to piecemeal liquidation of the debtor's assets, setting the stage for a coordinated resolution of the debtor's financial distress. The preference provision reinforces this collective solution to financial distress by empowering the trustee to retrieve payments or other transfers made to a creditor within ninety days of bankruptcy.[27] The preference power aims to assure that some creditors are not treated more favorably than others, and is designed to encourage creditors to trigger the collective proceeding rather than seeking payments from a troubled debtor outside of bankruptcy.[28]

Since 1978, when the current bankruptcy laws were enacted, Congress has created and steadily expanded exemptions for derivatives, repos and other financial contracts

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[25] The rules that invalidate so-called ipso facto clauses for ordinary contracts can be found in 11 U.S.C. § 365(e) and § 541(c). Derivatives and repos are exempted from these rules. 11 U.S.C. §§ 560 (swaps), 559 (repos), 561 (netting agreements).

[26] 11 U.S.C. § 362(a); § 547.

[27] 11 U.S.C. §547(b)(3). The reachback is extended to one year if the recipient of the transfer is an insider.

[28] See, e.g., Jackson, supra note 4, at 125 (explaining the normative underpinnings of preference law).

from these and related bankruptcy provisions.[29] As of 2006, on the eve of the financial crisis, Congress had exempted these contracts from the stay and the preference provisions, as well as bankruptcy anti-ipso facto clause rules, the trustee's power to avoid fraudulent conveyances, and the limitations on a nondebtor's ability to setoff, or net, obligations the nondebtor owes to the debtor against obligations the debtor owes it.[30]

In this part, we consider how the rationales that were used to justify the special treatment fared under the severe stress of the 2008 financial crisis. Two conclusions emerge: 1) the special treatment creates major distortions in global finance; and 2) remarkably little attention was given (or has been given since) to the precise implications that ordinary bankruptcy treatment would have for these contracts.

A) <u>The Rationales for Exclusion</u>

Proponents of the special treatment—which included both regulators like the Federal Reserve and U.S. Treasury and the principal industry groups-- have offered four primary rationales for excluding derivatives and other financial contracts from the policies that lie at the heart of the bankruptcy framework.

In the earliest debates, which predated the massive expansion of the derivatives markets in the late 1980s and 1990s, the case for exclusion focused on the status of securities professionals as middlemen rather than true parties in interest in securities transactions. Suppose, for example, that Buyer arranged with Broker to purchase a share of stock from Seller for $100, and Buyer filed for bankruptcy after paying $100 to Broker. In theory, the trustee in Buyer's bankruptcy might sue the broker, alleging that Broker had received a $100 preference, even if Broker had simply transferred the funds to Seller.[31] Proponents of an exclusion argued that Broker was a conduit, and was not really

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[29] For the chronology and other details, see Edward R. Morrison & Joerg Riegel, Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges, 13 Am. Bankr. Inst. L. Rev. 641, 644-45 (2005).

[30] Id.

[31] If Buyer did not pay for the stock immediately or bought it on credit, the payment could be construed as a payment "on account of an antecedent debt," which would thus be subject to challenge as a preference. As the initial transferee of the payment, Broker theoretically could asked turn over $100, even if Broker was really just a conduit. *See, e.g.*, 11 U.S.C. § 550(a)(1)(authorizing trustee to recover from an "initial transferee," even if this transferee is not the "entity for whose benefit the payment is made").

the recipient of a preferential transfer.[32] This rationale for exclusion is sensible and is easily reconciled with the transaction consistency objective.

The second rationale for special treatment is that securities and derivatives markets are too complex to be treated the same way as other contracts. The complexity rationale sometimes merged with the middleman rationale. In a 1981 hearing, a lawyer representing the New York Cocoa Clearing Association and the New York Sugar Clearing Association warned:

> It should be borne in mind that when these moneys flow through the clearing chain, they are disbursed in many different directions, and there really is no way of tracing where they have gone.[33]

If the trustee of a bankrupt broker "tried to go out into the system to recover margin," he continued, then the whole system would become paralyzed because nobody would know who was entitled to what."[34]

With the final two rationales, which came to dominate the debate—discussion really, since contrary views were rarely presented—the focus shifts squarely to the financial instruments themselves. Repos and derivatives need to be insulated from the ordinary bankruptcy process, according to the third rationale for special treatment, because subjecting them to the stay and the trustee's preference powers would magnify volatility and retard the growth of the market.[35] With repos, the bête noir was *Lombard-*

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[32] "If a firm or a clearing organization had to return margin payments received from a debtor when he had already transmitted those funds to others in the clearing chain," a witness testified in 1981, "its finances would be seriously undermined to the point where it also might be driven into bankruptcy." Hearings before the Subcomm. on Monopolies and Commercial Law of the House Committee on the Judiciary, 97th Cong. 165 (1981) (statement of Edmund R. Schroeder, Barrett Smith Schapiro Simon & Armstrong, New York City; appearing for New York Cocoa Clearing Ass'n and New York Sugar Clearing Ass'n).

[33] Id.

[34] Id. at 167. SEC Commissioner Bevis Longstreth sounded this theme in the same hearing, opining that the application of ordinary preference law to securities transactions "creates uncertainty which is incompatible with the efficient working of the national clearance and settlement system." Id. at 240.

[35] A slightly wider range of views emerged in the early discussion of repos than with derivatives. The Department of the Treasury opined in the early 1980s that it might not be necessary to exempt repos from the automatic stay. Letter from Roger W. Mehle, Assistant Sec'y of Domestic Fin., Dep't of the Treasury, to Senator Robert J. Dole, Chairman, Subcomm. on Courts., Comm. on the Judiciary (March 16, 1983). Although the Federal Reserve disagreed, they initially were willing to consider minor limitations on the special treatment. One witness testified in 1984 that then-Federal Reserve Chair Paul Volcker had "stated in written correspondence to this committee that amendments that limit protection to repo transactions of $1 million or more" would be sufficient, and would "'avoid major exceptions to existing bankruptcy law.'" Hearing Before the Subcomm of Monopolies and Commercial Law of the House Comm. on the Judiciary

Wall, a 1982 bankruptcy court decision holding that a repo buyer should be treated as a secured creditor in a bankruptcy of the repo seller.[36] Congressman Walter Fauntroy, one of the sponsors of legislation creating the initial repo exclusion, reported that Lombard-Wall shocked market participants, magnifying their uncertainty and slowing the growth of repos.[37] The decision "cast a cloud over the future health of the repo market" and "create[d] a risk of market 'grid-lock,'" according to an industry witness.[38]

This rationale resonated particularly strongly with repos, because the Federal Reserve uses repos itself in its efforts to adjust the nation's money supply and protect the stability of the financial system. If repos could get caught up in a repo participant's bankruptcy, the reasoning went, this could interfere with the Fed's handling of monetary supply.[39]

With swaps, industry representatives warned about the ill effects of "cherry picking."[40] If a debtor could assume the contracts that were "in the money," while rejecting its bad contracts and relegating the counterparty's claim for damages to general unsecured status, the debtor's bankruptcy could destabilize the swaps market.[41]

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on H.R. 2852 and H.R. 3418, 98th Cong. 61 (1984) (testimony of Peter D. Sternlight, Executive Vice President, Federal Reserve Bank of New York)[hereinafter, 1984 House Hearing].

36 In re Lombard-Wall Inc. v. Bankers Trust Co., 23 B.R. 165 (Bankr. S.D.N.Y. 1982). For a good discussion of the Lombard-Wall default and the push for bankruptcy protection, see Kenneth D. Garbade, The Evolution of Repo Contracting Conventions in the 1980s, 12 FRBNY Econ. Pol. Rev. 27, 35-36 (2006). Lombard-Wall's failure came three months after the collapse of another securities dealer, Drysdale Government Securities, had rattled the government securities markets. Id. at 32-34 (discussing Drysdale failure and shift to recognition of accrued interest that followed).

37 1984 House Hearing, supra note 35, at 18 (statement of Rep. Walter Fauntroy).

38 Id. at 85 (statement of Robert Brown, Public Securities Association). Witnesses predicted that the market would flourish, on the other hand, if repo protections were expanded. According to David Stanley of Morgan Stanley, testifying in 1999: "Market participants could … enter into [repo] transactions with greater confidence that they will be easily enforceable, improving the liquidity and cost of financing for the underlying instruments." Bankruptcy Reform Act of 1999 (Part III): Hearing on H.R. 833 Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary, 106th Cong. 93 (1999)(statement of David Stanley, Morgan Stanley)[hereinafter, 1999 House Hearing].

39 Commenting on market concerns about the *Lombard-Wall* decision, Federal Reserve Chairman Paul Volcker told Congress that: "if the repo market were to become less attractive, its usefulness as an instrument of monetary policy would decline." 1984 House Hearing, supra note 35, at 71 (attaching letter from Paul A. Volcker, Chairman, Federal Reserve, to Senator Robert J. Dole, Chairman, Subcomm. on Courts., Comm. on the Judiciary (Jan. 20, 1983)). See also In re Bevill, Bresler & Schulman, 67 Bankr. 557 (N.D.N.J. 1986) for a lengthy exegesis on the importance of repo financing to the nation's financial markets and federal reserve policy-making activities.

40 See, e.g., John C. Dugan, Derivatives: Netting, Insolvency, and End Users, 112 Banking L.J. 638, 640 (1995)(emphasizing "cherry-picking" concern).

41 For criticism of this argument, see Stephen J. Lubben, Derivatives and Bankruptcy: The Flawed Case for Special Treatment, 12 U. Penn. Bus. L. 61, 68-73 (2009).

The final rationale—which tended to silence any lingering objections (but looks more than a little ironic from a post-2008 vantage point, as we shall see)—was the need to keep systemic risk in check. If derivatives and repos were subject to the automatic stay, the argument went, a debtor's failure could have a "domino effect," taking other participants in the derivatives market down with it.[42] A counterparty that had entered into a large derivatives contract with the debtor to hedge its business risks might find itself unhedged if it could not cancel its contract and enter into a new hedging contract with someone else. Any delay in the counterparty's ability to terminate its derivative with the debtor could therefore have a crippling effect and might even undermine confidence in the market more generally. If counterparties could quickly exit their contracts, on the other hand, the derivatives markets would adjust and quickly restore their equilibrium.

Prior to the crisis, these rationales, especially the last, were viewed as dispositive.[43] The special treatment for derivatives and repos was steadily expanded, and there was no serious initiative to rein it in.

B) Evidence from the Crisis

Just as the 2008 crisis called the self-regulating derivatives and repo market into severe question outside of bankruptcy, it also refuted the arguments for their insulation from the core provisions of bankruptcy. The discussion that follows briefly highlights the lessons of the three most prominent collapses, with a particular emphasis on details that will inform our analysis in Part II.

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[42] "The right to terminate or close-out protects [financial institutions] ... on an individual basis," a Federal Reserve representative said in 1999, "and by protecting both the supervised and unsupervised market participants, protects the markets from systemic problems of 'domino failures.'" 1999 House Hearing, supra note 38, at 172-73 (prepared statement of Oliver Ireland, Assoc. Gen. Counsel, Bd. of Governors of the Fed. Reserve Sys.).

[43] See Michael Krimminger, Adjusting the Rules: What Bankruptcy Reform Will Mean for Financial Market Contracts (Oct. 11, 2005), available at www.fdic.gov ("If a counter-party is placed into bankruptcy or receivership, the stay on the termination of the contract and the liquidation of collateral could create escalating losses due to changes in market prices. As a result, the ability for the non-defaulting party to terminate the contract and net exposures quickly can be crucial to limit the losses to the non-defaulting party . . ."); ISDA "Bankruptcy Code Swap Safe Harbor Overview" (January 2010).

1. *Bear Stearns*

As Bear Stearns bled cash in early March 2008, it consulted a team of bankruptcy lawyers about the possibility of a bankruptcy filing.[44] If the bankruptcy exclusions were an effective mechanism for dampening a run, allowing a Bear Stearns bankruptcy should have been a live option. In reality, Bear Stearns' repo counterparties ran even before the bankruptcy decision was made, and Treasury Secretary Henry Paulson and then-New York Fed President Timothy Geithner rejected bankruptcy as unthinkable.[45] Not only did regulators have little confidence that bankruptcy's special repo and derivatives provisions would dampen the risk of a run, they worried that a mass sale of repo collateral could drive down the values of mortgage-related securities and further destabilize the markets. This calculus suggests that the very exclusions that were justified as reducing systemic risk—allowing counterparties to terminate (and sell collateral) notwithstanding the automatic stay—can actually exacerbate it—through the very sale of that collateral—when the troubled institution is a large player in the relevant markets, as Bear Stearns was.

The concerns that the special exclusions would not stop a run and that they might even trigger one are issues that arose once Bear Stearns had become financially distressed—that is, they are ex post concerns. The exclusions may have had pernicious ex ante effects as well. Because repos and derivatives are insulated from the stay and the trustee's avoidance powers, they are privileged as compared to other methods of financing.[46] Bear may have relied more on repo's, and less on equity or traditional secured finance for its funding because of the special status enjoyed by repos. Mark Roe has pointed out, for instance, that the percentage of Bear's repo financing climbed from 7% of its liabilities and twice its equity in 1990, to 25% and eight times its equity in 2008.[47] It is important not to overstate this effect. As demonstrated in the next part,

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[44] William Cohan, House of Cards: A Tale of Hubris and Wretched Excess on Wall Street 54-56 (2009)(describing consultation of Cadwalater, Wickersham, & Taft; Skadden, Arps;and Sullivan & Cromwell attorneys).

[45] See, e.g., Kate Kelly, Fear, Rumors Touched Off Fatal Run on Bear Stearns, Wall St. J., May 28, 2008, at A1.

[46] The possibility of this effect was first identified by Franklin Edwards and Ed Morrison, but Edwards and Morrison concluded that the distortion was unlikely to prove harmful. Franklin R. Edwards & Edward R. Morrison, Derivatives and the Bankruptcy Code: Why the Special Treatment?, 22 Yale J. Reg. 92 (2005).

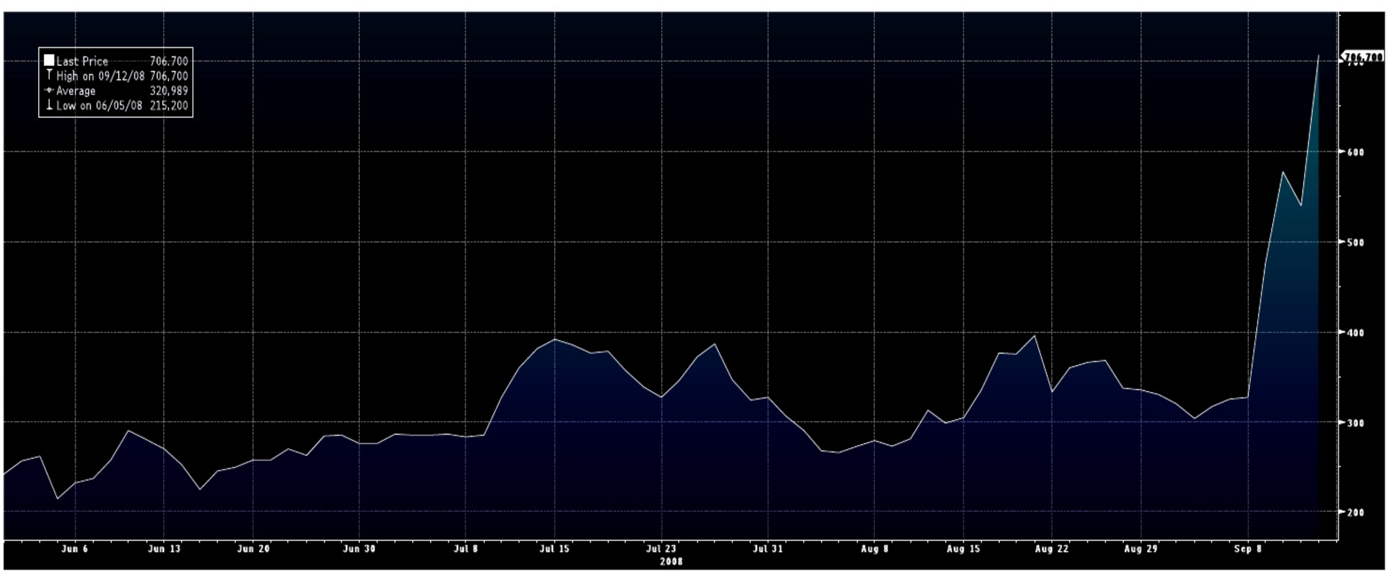
[47] Mark J. Roe, The Derivatives Market's Payment Priorities as Financial Crisis Accelerator, Stan. L. Rev. (forthcoming, 2011), manuscript at 13-14.

transaction consistency in bankruptcy would have a much smaller impact on the treatment of repos in bankruptcy than with derivatives. But even a small advantage for repos over ordinary secured credit may have distorted Bear's financing decisions.

2. Lehman Brothers

A seldom noticed fact about the fateful days before Lehman Brothers filed for bankruptcy in September 2008 was that the credit default swap market was—at least based on CDS prices—almost the last to know about Lehman's travails. As the graph of the spreads on CDS contracts insuring Lehman debt below illustrates, CDS's on Lehman showed little evidence of impending default until immediately before Lehman's collapse on the weekend of September 12-14, 2008. Until September 8, when the spike in spreads finally began, the CDS market showed few signs that anything was amiss. This remarkable pricing pattern does not testify to the market participants' obliviousness, as might seem to be the case at first glance. More likely, it demonstrates the CDS protection sellers' confidence that they would be bailed out if Lehman collapsed.

Figure 1: Lehman CDS Spreads, June-Sept, 2008



Source: Bloomberg

The special protections for derivatives compounded this distortion, and may have magnified the losses caused by Lehman's unexpected collapse, in two respects. The first concerns the now infamous Repo 105 transactions that Lehman employed at the end of each quarter to disguise the amount of its leverage. For accounting purposes, repo transactions are ordinarily characterized as a financing rather than a sale. But the accounting rules allow a repo seller to treat a repo as a sale if the underlying securities are worth at least 105% of the cash paid by the repo buyer. As recounted by the examiner appointed in Lehman's bankruptcy, Lehman took advantage of this rule, characterizing the repos as sales rather than financing—i.e. debt—to buff up its balance sheet in late 2007 and 2008.[48] The repos shaved $38.6 billion from Lehman's debt in fourth quarter 2007, and $49.1 billion and $50.38 billion in the first two quarters of 2008.[49]

Bankruptcy's special treatment of repos subtly but centrally invited this accounting manipulation. If the bankruptcy laws treated repos as the secured transactions that they clearly are,[50] the accounting loophole might never have emerged. Repo 105 is in this sense a legacy of the quest to exempt repos from bankruptcy in the wake of the *Lombard-Wall* decision.[51] The pretence that these financing transactions were sales delayed recognition of Lehman's true financial condition and almost certainly magnified the costs of its failure.

The second contribution of the derivatives exclusions to Lehman's losses is exemplified by JP Morgan's ability to seize and sell Lehman assets immediately before it collapsed. Owed roughly $20 billion by Lehman, JP Morgan froze $17 billion in securities and cash, and demanded a $5 billion payment.[52] Because of the special treatment of derivatives, Lehman could not prevent JP Morgan from selling the assets by

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48 Report of Anton R. Valukas, Examiner, In re Lehman Brothers Holdings Inc., U.S. Bankr. Ct. S.D.N.Y., Ch. 11 Case No. 08-13555 (JMP), at 732 (March 11, 2010)(concluding that the repos were used to "create materially misleading picture of the firm's financial condition"). Spurred by the Examiner's report, the New York Attorney General has sued Lehman's accountants, Ernest & Young, alleging that they were aware of the Lehman's manipulations and failed to disclose them. Complaint, Andrew M. Cuomo v. Ernst & Young LLP, Supreme Court of New York (December 21, 2010).

49 Id. at 739.

50 The question whether repos are lending transactions or sales is discussed in detail in Part II, infra.

51 *See* discussion supra notes 36-38 and accompanying text.

52 See, e.g., Darrell Duffie, The Failure Mechanics of Dealer Banks, 24 J. Econ. Persp. 51, 67 (2010)(describing J.P. Morgan's actions).

filing for bankruptcy; had little choice but to make the payment; and could not expect to retrieve the payment in a subsequent bankruptcy, in each case because of the special protections for derivatives.

The effect of the special provisions once Lehman did in fact file for bankruptcy was somewhat ambiguous. Lehman was able to sell its investment banking operations to Barclays even without the stay, and over 700,000 derivatives contracts were terminated and netted without causing Lehman's counterparties to fail.[53] But the absence of the automatic stay sowed considerable confusion and contributed to a large loss of value at the outset of the case. "Lacking the full benefit of a 'breathing space' within the contours of the bankruptcy code," Harvey Miller, the lead attorney in the Lehman bankruptcy, told Congress a year later, the beginning of the case was "a period of perpetual crisis."[54]

3. *AIG*

With AIG, the derivatives exclusions played an unambiguously problematic role. AIG's fortunes went into a freefall after it was forced to begin posting collateral for its large portfolio of credit default swaps (which were written on pools of mortgage-related securities) due to a ratings downgrade.[55] AIG's counterparties' repeatedly ratcheted up their collateral demands, to the point where compliance threatened to cannibalize the company. If the CDSs had been subject to an automatic stay in the event of bankruptcy, AIG could have just said no to the collateral demands, knowing that bankruptcy would offer a stay and a breathing space for arranging a response to the company's financial

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[53] See, e.g., Debtor's Motion for an Order Pursuant to Sections 105 and 365 of the Bankruptcy Code to Establish Procedures for the Settlement or Assumption and Assignment of Prepetition Derivatives Contracts at 4, In re Lehman Brothers Holdings Inc. et al (Bankr. S.D.N.Y. Nov. 13, 2008)("Debtors are party to approximately 930,000 Derivative Contract transactions of which approximately 733,000 are purported to have been terminated").

[54] Too Big to Fail: The Role for Bankruptcy and Antitrust Law in Financial Regulation Reform: Hearing of the Subcomm. of Comm'l and Adminst Law of the H. Comm. on the Judiciary, 111th Cong. (2009)(prepared statement of Harvey Miller, Weil, Gotshal & Manges, LLP).

[55] According to a subsequent report by the Special Investigator General for TARP, Fed and Treasury officials feared a panoply of potential consequences if AIG stopped making payments to counterparties: "the impact on the American retirement system [because many retirement plans had bought "stable value fund" contracts from AIG], the impact of AIG's commercial paper obligations, the broader effect on the already frozen credit markets and money market mutual funds; and the considerable systemic risk to the global financial system." Office of the Special Inspector General for the Troubled Asset Relief Program (SIGTARP), Factors Affecting Efforts to Limit Payments to AIG Counterparties 9 (Nov. 17, 2009)[hereinafter, SIGTARP Report].

distress.[56] In addition, if the CDSs had been subject to bankruptcy's preference provision, last minute collateral grabs would have been avoidable as preferential transfers.[57] The special exclusions from the stay meant that AIG had no choice but to accede to the collateral demands, and the preference exclusion meant there would have been no way to recover anything from favored creditors like Goldman Sachs, which also received billions of dollars more as a result of the AIG bailout.[58]

The special derivatives provisions also significantly influenced the government's decisions. The potential consequences of mass termination of the CDS contracts—which would be made possible in bankruptcy by the counterparties' ability to invoke ipso facto clauses and their exemption from the stay—were a principal justification for the government's decision to arrange $85 billion (eventually boosted to $182 billion) in rescue funding.[59]

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Distilling the experience of these signature 2008 cases, we can identify four adverse effects of bankruptcy's departure from transaction consistency for repos and derivatives. First, the special treatment dampens counterparties' incentive to screen and monitor. A counterparty that can be confident it will be protected will be less careful about who it contracts with—that is, it may not screen carefully—and it is less likely to actively monitor .[60] In our view, in the case of derivatives, the contribution of the special provisions to that outcome is principally indirect, through a close linkage with the prospect of a bailout of the debtor's derivatives counterparties. The dampening of monitoring incentives appears to be most serious with swaps. Because these contracts are

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56 Compare 11 U.S.C. § 362(a)(general stay) with 11 U.S.C. §362(b)(17)(special treatment of swaps).

57 Compare 11 U.S.C. § 547(b)(transfers, which includes transfers of collateral, within 90 days of bankruptcy avoidable as preferences) with 11 U.S.C. § 546(g)(special treatment of swaps).

58 See, e.g., Carrick Mollenkamp & Serena Ng, Report Rebuts Goldman's Claim on AIG, Wall St. J., Nov. 17, 2009 (questioning Goldman's claim they were fully protected and thus did not need the bailout).

59 See, e..g., SIGTARP Report, supra note 55, at 9 (reciting Federal Reserve Chairman Ben Bernanke's testimony that intervention identifying "global banks and investment banks that had $50 billion in exposure to losses on loans, lines of credit and derivatives" as one of the reasons for intervention).

60 See, e.g., David A. Skeel, Jr., Bankruptcy Boundary Games, 4 Brook J. Corp., Fin. & Comm'l L., 1, 20 (2009)(describing monitoring effect). Mark Roe explores the monitoring issue in detail in Roe, supra note 47, at 21-25.

particularly likely to be bailed out if the debtor is considered by the government to be systemically important, swaps creditors are insulated from the consequences of failing to carefully scrutinize the debtor's financial condition. The special treatment of derivatives in bankruptcy magnifies this problem by removing the debtor's ability to halt a run by filing for bankruptcy, which ratchets up the pressure for a bailout.[61]

Second, the special treatment distorts a debtor's financing decisions. The special treatment makes repos and derivatives a more attractive source of financing than alternatives such as traditional secured loans.[62] The bankruptcy protections are not the only reason for investment banks' dramatic increase in use of repo based financing, but they surely contributed to the trend. Major changes to the bankruptcy laws in 2005 extended the protection of repos to all kinds of collateral, including the mortgage-backed securities that Bear Stearns and Lehman used in their repo transactions, right on the cusp of the 2008 crisis.[63] Unlike traditional secured finance, short term repos can be pulled immediately, at the first sign of trouble. As a result, financial institutions that depend heavily on repo financing are subject to runs, much as commercial banks were before the advent of deposit insurance in the 1930s.[64] By increasing the incentives to use repo financing, the bankruptcy safe harbors exacerbate the fragility of the financial system.

Third, in addition to increasing the risk of runs indirectly, by encouraging the use of short term financing, the special treatment also can directly contribute to runs. This argument is the flipside of the derivatives' industry's contention, most plausible for smaller debtors, that special treatment can prevent system-wide problems. If the debtor is the counterparty to a large number of contracts, as AIG was, the absence of a stay seems especially likely to fuel runs, rather than forestalling them.[65] Absent a stay, the debtor faces a Hobson's choice of meeting escalating collateral demands, even to the point of

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[61] The new Dodd-Frank resolution rules counteract this to some extent for the companies to which they apply by providing for a temporary suspension of ipso facto clauses. But derivatives are still likely to be bailed out by regulators in practice, as we discuss in Part III, infra.

[62] See, e.g., Edwards & Morrison, supra note 46 (noting the substitution effect).

[63] See, e.g., Stephen J. Lubben, The Bankruptcy Code Without Safe Harbors, 84am Bankr. L.J. 123, 138 (2010)(suggesting that the changes may have encouraged use mortgage-back securities as repo collateral).

[64] This comparison is a central feature of Gary Gorton's recent work. See, e.g., Gary Corton, Slapped in the Face by the Invisible Hand (2010).

[65] See, e.g., Kenneth Ayotte & David A. Skeel, Jr., Bankruptcy or Bailouts?, 35 J. Corp. L. 469, 495 (2009)(making this argument).

dismembering itself, or filing for bankruptcy and triggering the simultaneous termination of all of its contracts, which can cause systemic damage by driving down asset prices.[66]

Finally, the special treatment can interfere with efficient ex post resolution of the debtor's financial distress. If the debtor is not able even temporarily to halt its counterparties from terminating their contracts, it may face a crippling loss of value at the outset of the case. This could significantly impair the efficiency of the resolution process.

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Despite these adverse effects, it is still possible that transaction consistency would be worse than the existing protections. To reach firmer conclusions about the regulation of the new finance in financial distress, we need to carefully consider just what effects transaction consistency in bankruptcy would have, as well as the implications of the Dodd-Frank reforms.

II. What Would Transaction Consistency Mean for Derivatives and Repos?

In this part, we ask how repos and derivatives would be treated if transaction consistency were restored in bankruptcy—that is, if repos and derivatives were subject to the same core bankruptcy policies as other contracts.

A. Bankruptcy's Treatment of Ordinary Contracts

Bankruptcy, of course, does not treat all contracts "the same." Contracts that have been completed by one party or another are either "assets" (if completed by the debtor) or "liabilities" (if completed by the other party). And if the contracts remain materially uncompleted by both parties—and thus have elements of both assets and liabilities—they

[66] Id.

fall into a third category: executory contracts.[67] It is, for that reason, only for executory contracts that it makes conceptual sense to talk about the debtor's "choice" between assumption (i.e., a belief that the asset value exceeds the liability value) or rejection (i.e., a belief that the asset value is less than the liability value) of the contract. Even then, the Bankruptcy Code sharply limits the ability of the debtor to assume (or assign) one type of executory contract, and that is a contract "to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor."[68]

We make this point, because different financial contracts would face different bankruptcy rules based on their underlying attributes. Generally speaking, for present purposes, we can identify three "typical" contracts that, because of their underlying attributes, have somewhat different treatment in bankruptcy. Once we identify those three typical contracts, and their bankruptcy treatment, we can "map" various financial contracts to those groupings.[69]

First are loans, as well as contracts to make loans (or extend other financial accommodations), to the debtor. These are all, effectively, "breached" upon the filing of a petition in bankruptcy by the debtor. The value of the breached loan is calculated as of that moment—as is the value of any collateral that may be securing the loan. The claimant without security (or other rights, such as recoupment or setoff) holds an unsecured claim, valued at that point (and without interest or such—unless all unsecured claims are going to be paid in full).[70] The secured creditor's claim, if undersecured, is bifurcated into a secured claim and an unsecured claim.[71] The value of the collateral is likewise determined and "fixed" as of the date of the filing of the petition. Thereafter, the

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67 The classic definition is that of Vern Countryman, Executory Contracts in Bankruptcy (pt. 1), 57 Minn. L. Rev. 439, 460 (1973) (an executory contract is "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other"); see also Thomas Jackson, supra note4, at 105-18.

68 11 U.S.C. § 365(c)(2). This prohibition on assumption or assignment also applies to contracts to issue a security of the debtor, id., or where applicable law "excuses a party . . . from accepting performance from or rendering performance to an entity other than the debtor," 11 U.S.C. § 365(c)(1)(A).

69 We are going to focus here on the treatment of these contracts in bankruptcy in terms of (a) their valuation, (b) their ability to be assumed and/or assigned, and (c) their protection (in the case of contracts backed by security interests). We will later talk about other issues involving such contracts, such as the application of preference law to payments received within 90 days of bankruptcy.

70 In which case, all unsecured claimants will receive "interest at the legal rate from the date of the filing of the petition," 11 U.S.C. § 726(b).

71 11 U.S.C. § 506(a).

secured creditor's rights to the value of the collateral are given "adequate protection,"[72] which effectively means that while the secured creditor does not realize any increases in the value of the collateral (assuming the automatic stay precludes taking the collateral), the secured creditor is also given protection—apart from the time-value of delay—against any diminution in the value of the collateral during the bankruptcy proceeding.

If the loan contract was not yet funded, the debtor would not be able to assume or assign the loan, which means that both parties would be off the hook with respect to the loan.[73] To the extent that the non-debtor party could show damages resulting from this effective rejection of the executory contract, that party would have a claim for those damages valued as of the date of the filing of the petition. We will call these contracts, for simplicity's sake, "loan contracts."

Second are what we can describe as standard executory contracts, with unfulfilled obligations on both sides. While there is a complication—and, hence, a third category—that we will discuss next, the prototype we are thinking about here is a standard commercial contract, such as a contract to buy and sell widgets, with delivery and payment both occurring in the future. Under Bankruptcy Code Section 365, the debtor is given two kinds of choices with respect to such contracts. First, the debtor may either "assume" or "reject" the contract,[74] and may do so at any time during the bankruptcy case unless, on motion, the court orders the decision to be made at an earlier point.[75] If the debtor rejects the contract, it is presumably because the debtor views the contract as burdensome—i.e., in the example above, because the debtor believes that the widgets are not as valuable as the amount the debtor had contracted to pay for them. If the debtor assumes the contract, it is presumably because the debtor views the contract as valuable—i.e., in the example above, the widgets to be delivered are more valuable than the payment obligation for them—and the contract is treated as if it is one made by the debtor-in-possession (an "expense of administration"). And, in the case of assumption, the debtor has a second choice. If the debtor does not have a need to complete the contract, but nonetheless views it as valuable, the debtor may "assign" the contract to

[72] 11 U.S.C. §§ 361, 362(d).
[73] 11 U.S.C. § 365(c)(2).
[74] 11 U.S.C. § 365(a).
[75] 11 U.S.C. § 365(d).

another party; upon assignment, the other party, and not the debtor, is on the hook with respect to performance.[76] Both assumption and assignment can be accomplished despite any contractual provision that is considered to be an "ipso facto" clause; that is, a clause providing that the contract is breached (or terminated) because of "the insolvency or financial condition of the debtor at any time before the closing of the case" or "the commencement of a case under this title."[77] These provisions may not be perfect—they seem to, for example, give the debtor a one-way option during the bankruptcy proceeding to see if the contract turns out to be valuable—and the other party to the contract may be faced during this interregnum with a decision whether to continue to work on the contract at some expense to that party.[78] But our point is more basic: For this kind of contract, these rules, whether entirely "fair" or not, are clear and apply across the board.[79] We will call these contracts "classic executory contracts."

There is a third category—a variation on the second—that is exemplified by classic insurance contracts as well as real estate leases. In these contracts, even if the debtor does not ultimately assume the contract, the debtor receives a "use" benefit during the period between the commencement of the bankruptcy case and a decision to assume or reject the contract. A debtor that uses real property during a bankruptcy proceeding should be required to pay for that use, irrespective of any ultimate decision to assume or reject.[80] Similarly, a debtor whose building is insured should be required to pay for that insurance coverage during a bankruptcy proceeding, again irrespective of any ultimate decision to assume or reject.

The Bankruptcy Code is fully consistent with this intuition. In the case of nonresidential real property leases, the debtor is required to "timely perform all the obligations of the debtor . . . until such lease is assumed or rejected."[81] In other cases such as the case of insurance coverage, the debtor's "use" of the coverage prior to a

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[76] 11 U.S.C. § 365(f).
[77] 11 U.S.C. § 365(e). The assignee, however, would otherwise need to comply with the terms of the contract.
[78] See Douglas Baird & Thomas Jackson, Cases, Problems and Materials on Bankruptcy 278 (2d ed. 1990)(describing the parties' incentives during this period).
[79] In the situations we just noted, the other party's major remedy is to seek a court order requiring the debtor to assume or reject the contract.
[80] See, e.g., In re Thompson, 788 F.2d 560, 563 (9th Cir. 1986).
[81] 11 U.S.C. § 365(d)(3).

decision to assume or reject would give rise to an administrative expense claim at market value.[82] Apart from this issue of paying for the "use" of property (or coverage) during the period prior to the decision to assume or reject, these contracts are treated in parallel with what we are calling classic executory contracts. For want of a better term, we will call these "insurance-like executory contracts."

We can now "map" derivatives, repos and other financial contracts to these categories. As we do so, we will see that not all financial contracts have the same kinds of underlying attributes. We can also see the treatment that each would receive in bankruptcy, which forms the foundation for an examination as to whether and why that treatment is insufficient.

For bankruptcy purposes, repos and swaps, the principal financial contracts, have very different characteristics. Repos are in essence secured loans. Under the analysis above, they would accordingly belong in the category of classic loans. A second, conceptually quite different, type of contract is epitomized by swaps and various other forms of derivatives. At their core, they ordinarily are hedges—analytically indistinguishable from a contract to purchase widgets on June 1st at a certain price[83]—and comfortably fit within the category of classic executory contracts.[84] As executory contracts, they could (were they treated similarly to other contracts in bankruptcy) be assumed and assigned irrespective of "ipso facto" clauses. Those that function like an insurance policy would be given the additional protection of payments for the use of the "insurance" during the pendency of the bankruptcy case.

In the discussion that follows, we unpack the basic treatment of repos and swaps under a transaction consistency norm in more detail, before turning to the two other core

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[82] We have to assume the debtor is in fact using the coverage, as indeed would be the case prior to a rejection. If the building is insured, and there is no fire, the debtor would, at the end of the coverage period, reject the contract; if, however, there was a fire, the debtor would, at that point, assume the contract. Given that, it is clear that, in reality, the debtor is "using" the coverage during that interregnum.

[83] This tension was revealed with the question of whether a natural gas distributor's supply contracts with its customers should be characterized as swaps for purposes of bankruptcy's special rules. National Gas Distributors LLC v. Smithfield Packing Co., 369 Bankr. 884, 900 (Bankr. EDNC 2007), rev'd, 556 F.3d 247 (4th Cir. 2009). Analytically, it is *both* a standard commodities contract *and* a hedge, and it would be strange to have this characterization turn on the "primary purpose" or some such thing.

[84] As we discuss in more detail below, in the event that a swap is embedded in, or used as, a loan, it should be treated as a financial accommodation.

bankruptcy policies that are elided with these contracts: setoff and the trustee's avoidance powers.

B. How Would (and Should) Repos be Treated?

1. Repos as Secured Loans

When Lehman's examiner released his thirteen hundred page report on Lehman's fall, press coverage immediately centered on a hitherto unknown pattern of transactions that Lehman employees dubbed "Repo 105."[85] These transactions provide a useful context for more carefully exploring the treatment of repos.

As we saw earlier, Lehman arranged a series of repos shortly before the close of each quarter.[86] The repos consisted of sales by Lehman of securities that Lehman would repurchase at a specified price after the end of the quarter. The 105 in "Repo 105" is a short-hand reference to the key feature of the accounting rule that spawned the transactions: so long as the securities used in the repo were worth at least 105% of the amount Lehman would pay for their return, the transaction could be booked as a sale rather than a loan.[87] Treating the Repo 105's as sales rather than as secured loans enabled Lehman to remove them from its balance sheet debt and thereby to reduce its apparent leverage ratio, with the result of making Lehman look less risky than it actually was.[88]

As the examiner pointed out, the accounting rule was entirely artificial. Regardless whether the securities were worth more or less than 105% of the required

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[85] As noted earlier, Ernst & Young has been charged with having known about the Repo 105 transactions and having acquiesced in them. See supra note 48.

[86] See supra notes 48-49 and accompanying text (describing use of repos to reduce Lehman's reported debt).

[87] Repos are ordinarily treated as loans for accounting purposes. But FASB's Statement of Financial Accounting Standards No. 140 ("SFAS 140"), Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, allows the repo seller to characterize a report as a sale if specified criteria are met, such as the requirement that the cash paid by the buyer be no more than 95% of the value of the securities conveyed. For discussion, see Valukas, supra note 48, at 754-57.

[88] According to the Lehman examiner, Lehman used $38.6 billion in Repo 105s at the end of the fourth quarter of 2007, $49.1 billion in first quarter 2008, and $50.38 billion in second quarter 2008. The transactions reduced its reported leverage from 17.8 to 16.1; from 17.3 to 15.4; and from 13.9 to 12.1 in the three quarters. Valukas Report, supra note 48, at 748.

payment, repos were functionally identical to an ordinary loan, with the securities as collateral. Under ordinary principles of secured transactions, the repos would be characterized as secured transactions.[89] We can state this conclusion with confidence because American commercial law—principally as reflected in the Uniform Commercial Code—has a deeply entrenched commitment to piercing through formal labels and defining transactions in terms of their actual form. A key gatekeeping provision of Article 9 explicitly states, for instance, that "a transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract" will be treated as a secured transaction.[90]

To be sure, it is not always obvious whether a transaction that takes on some of the attributes of a loan should be characterized as a secured transaction. In some cases, the drafters of the UCC have simplified the analysis by explicitly defining a transaction that takes the form of a sale as a secured transaction; in other cases, the termination has been left to judicial discretion. Sales of accounts under a "factoring" arrangement are the best known example of the first strategy;[91] and the caselaw addressing the question whether a debtor's sale of identified assets (such as credit card receivables or mortgages) as part of a securitization transaction should be deemed a true sale is the most important example of the second.[92]

The "true sale" cases put our analysis of repos into stark relief. The originators' objective in a securitization transaction is to ensure that the sale of assets will be treated as a true sale rather than a secured transaction, and thus is "bankruptcy remote" if the

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[89] For a nice analysis of this point, from early in the evolution of the repo market, see Gary Walters, Note, Repurchase Agreements and the Bankruptcy Code: The Need for Legislative Action, 52 Ford. L. Rev. 828 (1984). The leading article in this area takes the opposite view. It may be worth noting, however, that the author, a top commercial law scholar, starts from the premise that the "repo market is simply too enormous and too important" to run the risk that repos might be recharacterized as loans, and sets out to find a strong argument for this conclusion. Jeanne L. Schroeder, Repo Madness: The Characterization of Repurchase Agreements Under the Bankruptcy Code and the U.C.C., 46 Syracuse L. Rev. 999 (1996)(arguing that repos lack a tangible "res," and therefore do not qualify as secured transactions).

[90] U.C.C. § 9-109(a). In a much-discussed recent case, a bankruptcy judge determined that the characterization of repos should turn on the parties' "objective intent," and held that the repo in that case was a sale rather than a secured loan. In re Criimi Mae, Inc., 251 B.R. 796 (Bankr. D. Md. 2000).

[91] Sales of accounts are defined as secured transactions and brought within Article 9 by § 9-109(a)(3).

[92] For discussion of the key cases, see Kenneth C. Kettering, Securitization and Its Discontents: The Dynamics of Financial Product Development, 29 Cardozo L. Rev. 1553 (2008). See also Edward J. Janger, The Costs of Liquidity Enhancement: Transparency, Risk Alteration and Coordination Problems, 34 Brook J. Corp. Fin. & Comm'l L. 38, 43 (2010)("certainty that the assets have been subject to a true sale has been hard to come by").

debtor later files for bankruptcy. To achieve this result, the debtor is required to relinquish any interest in the assets that are sold. Repos, by contrast, have precisely the opposite intent. The parties fully contemplate that the debtor will reacquire the securities used in the repo transaction by tendering the specified price—which is functionally indistinguishable from a loan repayment.[93]

Leases and sale-leaseback arrangements complicate the analysis, but only a little. Although structured as a lease, or as a sale followed by a lease from the buyer back to the seller, these transactions often function like loan transactions. Article 2A of the Uniform Commercial Code provides extensive rules for leasing arrangements, but largely leaves the determination of whether the transaction is a "true" lease or a disguised secured loan to judicial decision.[94] Courts have tended to focus on factors such as whether the lessee/debtor is required to make more than a nominal payment if it wishes to purchase the assets at the end of the lease.[95]

Repos are far more like a secured loan than either a securitization or a sale-leaseback transaction. The repo seller is, for instance, fully expected to pay the specified amount and to reaquire the securities that are the subject matter of the transaction. The "haircut"—that is, the difference between the current value of the securities and the amount of credit extended to the debtor—is functionally equivalent to negotiations between a debtor and its lender over the amount of collateral collateralizing a loan. Moreover, if the repo seller fails to perform, and the repo buyer sells the securities, the repo buyer ordinarily must return any excess over the intended repurchase price to the repo seller.[96]

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[93] Many of the standard terms of repo contracts underscore this intention. The repo seller, rather than the buyer, is typically entitled to any interest payments or other proceeds of the securities during the pendency of the contract. See, e.g., Jeanne L. Schroeder, A Repo Opera: How Criimi Mae Got Repos Backwards, 76 Am. Bankr. L.J. 565, 571 (2002). The 2000 Global Master Repurchase Agreement, which is based on English law, is available at http://www.icmagroup.org/legal1/global.aspx.

[94] See, e.g., U.C.C. § 2A-103(j)(defining "lease" as "a transfer of the right to possession and use of goods for a term in return for consideration," but excluding without defining "a sale, including a sale on approval or a sale or return, or retention or creation of a security interest").

[95] A nominal repurchase price suggests that the transaction really is a loan. For a survey of cases, see Robert D. Strauss, Ellen B. Taylor, & Stephen T. Whelan, Statutory Developments—UCC Article 2A, 47 Bus. L. 1545 (1992)..

[96] Repo sellers like Lehman recognize that their repo transactions are loans and regularly treat them as such for accounting purposes. The Lehman examiner highlighted this fact in his criticism of Lehman's Repo 105 transactions. "Like other large investment banks," he reported, "Lehman engaged, on a daily basis, in tens of billions of dollars of repo transactions in its normal course of business for financing

The one feature of many repos that might seem to call our conclusion that they function as secured transactions into question is the repo buyer's option under many repo contracts to return either the original securities, or equivalent substitute securities.[97] This makes the ostensible collateral of the transaction more nebulous than with a traditional secured loan.[98] The fungibility concern only applies to repos that do not require return of the original collateral.[99] While the possibility that the repo buyer will return different (though comparable) collateral raises questions about the parties' respective entitlements that we consider in our discussion of rehypothecation below, it does not alter their status as loans rather than sales.

This reasoning reveals a striking irony in the accounting rule that spawned Lehman's Repo 105 transactions. Although repos of all kinds are essentially secured loans, a repo involving securities worth more than 105% of the amount of credit extended looks *even more* like a secured transaction than a sale. This is because the debtor has an even stronger incentive to reaquire the securities if they are much more than the cash advance, than if they are worth less. The repo buyer in such a transaction is like a heavily overcollateralized secured creditor. From this perspective, the accounting rule gets things precisely backwards.

2. Transaction Consistency for Repos

If repos were construed as loans by a bankruptcy court, and they were subject to the same core bankruptcy rules that apply to other secured transactions, how would they be treated in bankruptcy? The short answer, as we shall see, is that their treatment would change only in limited respects.

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purposes." In contrast with its Repo 105s, "Lehman accounted for these ordinary repo transactions as financing transactions." Valukas Report, supra note 48, at 751.

97 See, e.g., 2000 Global Master Repurchase Agreement, available at http://www.icmagroup.org/legal1/global.aspx.

98 The absence of clearly identifiable collateral is the central plank in Jeanne Schroeder's argument that repos are best treated as sales rather than secured loans. Schroeder, supra note 89.

99 See, e.g., In re Criimi Mae, Inc., 251 B.R. 796 (Bankr. D. Md. 2000)(concluding that it was not possible to determine whether the repo in that case was a sale or a secured transaction, and emphasizing that its requirement that the specific collateral be returned weighed in favor of treating it as a secured transaction).

The first thing to note, as mentioned earlier, is that repos would be automatically "breached" as of the filing of the petition in bankruptcy, and the claim and the value of the collateral would be determined as of that moment.[100] From that point forward, the debtor would have no further obligation to post collateral, but would need to provide adequate protection for the collateral's value as of the filing of the petition.[101] The counterparty could exercise recoupment rights, and would have rights of setoff, although it would need relief from the automatic stay in order to exercise the statutorily-recognized setoff right.[102]

With the possible exception of requiring the counterparty to gain court permission before exercising its setoff rights, we find this treatment unexceptional. To the extent the collateral was insufficient, the counterparty would be unsecured, and would need to stand in line with other unsecured creditors. The essential point is that the counterparty knows its situation as of the moment of bankruptcy, and can proceed accordingly.

We do think that, to the extent the repo buyer (or its agent) is in possession of collateral, it should be able to quickly realize on this collateral. In most cases, the collateral is either cash or cash-like, highly liquid, assets.[103] In those cases, there are few, if any, reasons, for delay. Valuation disputes are minimal to nonexistent when the collateral is cash or cash-like, and there is nothing "firm-specific" about the collateral, meaning that the ordinary justification for the automatic stay as applied to secured creditors simply does not exist.[104] Indeed, if done as a matter of recoupment—that is,

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[100] Kimberly Summe has argued that repos and derivatives would present insoluble valuation issues. Kimberly Anne Summe, Lessons Learned from the Lehman Bankruptcy, *in* Ending Bailouts as We Know Them 21 (Kenneth E. Scott, George P. Shultz, & John B. Taylor, eds., 2010)("[c]omplex derivatives such as credit default swaps on asset backed securities or collateralized debt obligations presented a major challenge for valuation when markets began to fall apart"). This, however, is a necessary part of *any* termination; Summe suggests it is a reason to reconsider whether complex derivatives are suitable for a mark-to-market model.

[101] Adequate protection is required by 11 U.S.C. § 362(d)(1) and defined by 11 U.S.C. § 361.

[102] 11 U.S.C. § 362(a)(7) (the filing of the petition operates as a stay of "the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor"). While the setoff is *stayed* (absent court permission), the *right* of setoff is expressly recognized, as tantamount to a secured claim, by 11 U.S.C. § 553. If the off-set arises out of the same transaction, it has been considered "recoupment," not "setoff," and thus not subject to the rules of 11 U.S.C. § 553 (or § 362(a)(7) as well). See In re Holyoke Nursing Home, Inc., 372 F.3d 1, 3 (1st Cir. 2004).

[103] This is particularly so in the wake of the 2008 crisis, which has prompted a shift back to cash-like collateral for derivatives, and sharply diminished repos based on mortgage-backed securities and other less liquidate collateral.

[104] The debtor's need for liquidity, particularly acute for a financial institution that hopes to reorganize, does not undermine this conclusion. Liquidity needs do not make cash or cash-like collateral "firm

closing out on a single repo contract itself—the Bankruptcy Code would allow the counterparty to proceed without first going to court.[105] For repo creditors that do not have a right of recoupment, there could either be an exception for such contracts from first needing court permission or there could be a presumption of a quick determination upon a motion being made. In either case, the "exceptions," if such they are, to current bankruptcy rules are, at most, minor.[106]

If our analysis is correct, it suggests the pernicious effects of bankruptcy's special treatment of repos are subtler than is often suggested. The special treatment did not radically alter a repo lender's incentive to monitor the debtor, for instance.[107] In the Bear Stearns and Lehman debacles, repo lenders (unlike swaps counterparties, as we have seen) monitored aggressively and indeed took advantage of their special status.

But the special treatment did encourage excessive use of repos, rather than more traditional forms of secured finance, in several ways. First, the special treatment removed the possibility of even a minor delay in exiting the contract, thus enhancing their attractiveness for financing as compared to less volatile sources of funding.[108] Second, the special treatment in bankruptcy may have invited the characterization of repos as sales for purposes such as Lehman's Repo 105 transactions.[109] In addition, although not

specific." Rather, liquidity needs should be addressed through debtor-in-possession financing. (While not the subject of this paper, we both are participants in a Hoover Institution working group that has formed a proposal for the bankruptcies of our largest financial institutions. Included in that proposal are various modifications to bankruptcy's standard rules and procedures for debtor-in-possession financing for such institutions. See http://media.hoover.org/sites/default/files/documents/chapter-14-proposal-20101116.pdf.)[hereinafter cited as Chapter 14 Proposal]. Requiring a counterparty in possession of cash or cash-like collateral to turn it over to the debtor is, as a matter of both principle and existing procedures, extremely dubious as a source of liquidity. There would need to be a hearing before the turn-over, 11 U.S.C. § 542, and/or before the collateral could be used by the debtor, 11 U.S.C. § 363(a), (c)(2). Moreover, upon turn-over, the counterparty would have to be given adequate protection, 11 U.S.C. § 361, which effectively is the requirement for senior-most debtor-in-possession financing, 11 U.S.C. § 364(d)—which, in every other situation, can only be used if "the trustee is unable to obtain such credit otherwise," 11 U.S.C. § 364(d)(A). For these reasons, we do not see liquidity needs of financial institutions as a reason to deviate from the idea that cash and cash-like collateral in the possession of a counterparty should not be subject to the automatic stay.

105 We discuss recoupment doctrine and its implications for repos and derivatives below. See Part II(D), infra.

106 Again, we discuss the application of preference law and other trustee avoiding powers later.

107 We thus part ways with the analysis of Mark Roe, whose fine article we are otherwise in full accord with, on this point. Roe, supra note 47.

108 See supra notes 35-44 and accompanying text.

109 See supra note 50 text accompanying notes 50-51.

directly linked to their special status in bankruptcy, repos enjoy automatic perfection, which removes the transaction costs of perfecting an ordinary secured loan.[110]

Reversing the special treatment of repos would reduce these distortions without dramatically changing the practical status of repos in bankruptcy.[111] To be sure, even a small change may have costs.[112] One cost is that the marginal reductions in benefits could induce repo lenders to insist on larger haircuts. The other is that even a tiny difference in a repo lender's ability to exercise its rights and sell its collateral in bankruptcy could increase the risk of runs on a financially precarious repo debtor.[113]

In our view, each of these costs would be well-addressed by our proposal to exempt repos that are collateralized by cash or cash-like collateral from the automatic stay. Allowing the lender to assert immediate control over cash collateral would protect the most important class of repos without jeopardizing collateral that the debtor needs for the Chapter 11 process.

3. *Rehypothecation*

Rather than simply hold or control the securities it receives in a repo transaction, the repo buyer frequently employs them in additional transactions. This widespread practice—which is the rehypothecation we referred to in the last section—adds a further wrinkle to the treatment of repo (and derivatives) transactions in bankruptcy.[114]

One might plausibly conclude that rehypothecation—or even the right of rehypothecation, whether or not it is exercised—transforms a repo from a lending transaction to a sale. In our view, however, jumping to this conclusion misconstrues the nature of the underlying transaction. Even if the securities are rehypothecated, the

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110 If a repo were recharacterized as a secured transaction, U.C.C. § 9-309(10) would provide automatic perfection.

111 It would not alter the ease of perfecting the security interest, because U.C.C. § 9-309(10) would continue to provide automatic perfection. For an argument that repos should be subject to a filing requirement if their special bankruptcy treatment is retained, see Enrico Perotti, Systemic Liquidity Risk and Bankruptcy Exceptions, Centre for Economic Policy Research Policy Insight, Oct. 2010, at 4, available at www.cepr.org.

112 As our friend and colleague Darrell Duffie has repeatedly reminded us.

113 See, e.g., Gary Gorton, supra note 64.

114 Kenneth Kettering's excellent book-length article on rehypothetication provides historical context and an analysis of current patterns. Kenneth C. Kettering, Repledge Deconstructed, 61 U. Pitt. L. Rev. 45 (1999).

transaction is still fundamentally a loan. While most secured transactions involve identifiable collateral that does not shift form, not all do. The collateral in an inventory loan is continuously shifting, for instance, and there is no limit on the number of subsequent parties who can take a property interest in the collateral in an ordinary loan.[115]

This last point takes us to the real issue with rehypothetication. The question is not whether rehypothecated securities cease to be loans. The real issue is the parties' respective entitlements if one or more fails to perform. If the debtor (the repo seller) consents to rehypothecation, it essentially relinquishes any rights against a subsequent buyer or recipient of a security interest in the securities from the lender (repo buyer), but the transaction is no less a loan. The conclusion that the debtor's only recourse is against its lender, the original buyer, under these circumstances is in fact entirely consistent with the current rules in Articles 8 and 9.[116] It is confusing only because of the multiple departures from transaction consistency in the characterization and treatment of repos.

C. How Would (and Should) Swaps and Other Derivatives be Treated?

Because of the range of functions they serve, the treatment of swaps under core bankruptcy principles would be more variegated than with repos. While most swaps would be characterized as ordinary executory contracts, swaps also are used for financing and different kinds of insurance purposes (in which case they would be insurance-like executory contracts in our typology).

Start with the use of swaps for financing, which is the least intuitive, least common, and most easily dealt with function of swaps. Although swaps are not ordinarily envisioned as financing instruments, they have this purpose in some transactions. Consider an unlikely swaps borrower: Italy. To spruce up its balance sheet as it prepared to join the European Union, Italy entered into a massive swap transaction

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[115] Schroeder uses the illustration of a security interest in grain, in which the secured creditor is not required to give back the same grain. Schroeder, supra note 89, at 1023. A standard repo contract with fungible securities—such as treasury bonds—is quite similar.

[116] See U.C.C. §§ 8-502, 8-510(a). See also Christian A. Johnson, Derivatives and Rehypothecation Failure: It's 3:00 P.M., Do You Know Where Your Collateral Is?, 39 Ariz. L. Rev. 949, 980 (1997)(concluding that any party that expressly permits rehypothecation "has in substance subordinated its rights in the posted collateral to the third party").

with JP Morgan Chase.[117] In form, the contract was a standard swap based on the relationship between the value of the lira and LIBOR.[118] By undervaluing the lira by 44%, however, the parties transformed it into a loan that Italy would be required to pay at the end of the contract term.[119]

While the size and purpose of the transaction were extraordinary, swaps also are sometimes used for more ordinary lending purposes. Contracts taking this form would be construed as "financial accommodations" in bankruptcy, and thus would be subject to the same treatment as repos.[120] Like repos or other loans, they would be automatically terminated when the debtor filed for bankruptcy, and the debtor would not be permitted to assume the contract. Our proposed amendment to this treatment also would stand for loan-like swaps. The automatic stay should apply to most collateral, but it should not interfere with sales of cash or cash-like collateral by the debtor's counterparty.

Most swaps would fall into the second category. Because they entail ongoing obligations by both sides, even the most exotic swap is simply an ordinary executory contract for bankruptcy purposes. The most troublesome feature of this result is that, as noted earlier, it may give a debtor time to speculate without consequence (if the hedge turns out to be "in the money," the debtor assumes; if the hedge turns out to be a bad deal, the debtor rejects). As we shall see when we turn to netting and setoff below, the risk of strategic assume-or-reject decisions is mitigated considerably if the debt and its counterparty have a master netting agreement, as they often will. But it does not disappear.

While strategic use of the debtor's executory contract powers is a conceptual concern with *all* classic executory contracts, it may have particular bite in transactions that are themselves designed, explicitly, as hedges rather than as the buying and selling of a good. The Bankruptcy Code is not wholly consistent in how it currently treats this

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[117] See, e.g., Benn Steil, Enron and Italy: Parallels between Rome's efforts to qualify for euro entry and the financial chicanery in Texas, Fin. Times, Feb. 21, 2002 (describing the transaction and comparing it to transactions used by Enron).
[118] LIBOR is the London Interbank Offered Rate, which is the interest rate at which banks lend to one another.
[119] There obviously was no guaranty that the swap would retain its value for J.P. Morgan, given the inevitable fluctuations in the value of the lira and LIBOR. But J.P. Morgan could—and apparently did—lock in the value by hedging against the fluctuations.
[120] 11 U.S.C. § 365(c)(2).

concern with respect to executory contracts in other contexts. For example, even though much of the undesirable nature of the delay option is mitigated by a requirement of compliance with the terms of the lease prior to assumption or rejection, Section 365(d) sets time limits on the debtor's decision in cases of unexpired leases of nonresidential real property where the debtor is the lessee.[121] Given the likely reality that the parties to swaps and derivatives are sophisticated players, and particularly with an assumption of court expertise, we think a short period in which to assume or reject is desirable. Whether it needs to be mandated in the Bankruptcy Code or left to court decisions based on the request of a counterparty—but with a presumption that the period should not be long—is an issue we will return to below.[122]

There are arguments that derivatives, unlike repos, have special reasons to be exempted from the automatic stay—in the sense of allowing the counterparty to terminate without waiting for an assumption or rejection decision of the debtor. Thus, in the words of one leading expert:

> The application of an automatic stay, while appearing to preserve the value of the "assets" of the failing entity, may be illusory as it relates to derivatives since derivative transactions and the collateral associated with those transactions are not really assets in the traditional sense and the preservation of value may rapidly change, particularly in a distressed market. . . . Highly liquid derivative transactions, such as interest rate and foreign exchange derivatives (which constitute eighty percent of the $600 trillion notional value over-the-counter derivative market), were terminated by many of Lehman Brothers' counterparties after the investment bank's failure, allowing those counterparties to reduce potential losses by entering into replacement transactions. The loss of an ability to hedge one's trading book because of the application of a stay would result in significant losses for qualified financial contract counterparties, causing a catastrophic decline in the activities of the financial markets.[123]

These arguments, however, have several weaknesses. First, derivatives certainly *can* have significant value—and hence are "assets"—of the debtor (precisely the reason behind permitting an assumption or rejection decision in the first place); the fact that their

[121] 120 days, under 11 U.S.C. § 365(d)(4). There are also time limits for such a decision on residential real property or personal property in Chapter 7, 11 U.S.C. § 365(d)(1).
[122] For a similar argument, see Thomas Jackson, Chapter 11F: A Proposal for the Use of Bankruptcy to Resolve (Restructure, Sell, or Liquidate) Financial Institutions, *in* Ending Bailouts, supra note 100.
[123] Summe, supra note 100.

value may change rapidly is a feature, not a reason to distinguish them from "assets in the traditional sense."[124] Second, an argument about the inability of a counterparty to hedge its books during the period before the debtor decides to assume or reject, even if true,[125] would have significant force only if there were systemic concerns, and thus would essentially focus on systemically important debtors, not all debtors. Third, even in these cases, some of these consequences might be mitigated either through the creative entering into of replacement transactions (themselves hedged) or requests for strict timetable on the assumption or rejection decision.[126] Finally, if the swap is collateralized, the counterparty would likely be entitled to payments to the extent the collateral declined in value after the bankruptcy petition was filed, as noted earlier.[127]

Still another argument for forgoing a stay centers on the "runability" of swaps. If swaps counterparties anticipate being treated less favorably inside than outside of bankruptcy, the reasoning goes, they will run as soon as they detect the prospect of bankruptcy. The counterparty to a swap may not seem to have as great a capacity to run as a bank depositor; a swap counterparty cannot simply cancel its contract and grab whatever it is owed at any time, any more than a bondholder or other creditor can. But the structure of the derivatives market makes it easy for counterparties to achieve the same effect.[128] Suppose, for instance, that Bank of America (BOA) and Goldman have a currency swap that requires BOA to deliver $1.3 million, and Goldman to deliver 1 million euros, in six months. If it catches wind of a possible BOA bankruptcy, Goldman could ask BOA to enter into a second, off-setting swap that calls for BOA to deliver 1

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[124] See Lubben, supra note 41. It is the case that interest rate swaps are, in fact, diminished in importance in bankruptcy, since (for the most part) debtors do not make interest payments, on pre-petition debt at least, during the bankruptcy case. Ayotte & Skeel, supra note 65, at 33 & n. 95. Even so, to the extent they have value, because of a hedge that is "in the money," it is an element bargained for by the debtor, and hence, analytically, a proper asset of the estate.

[125] Given that the original derivatives contract was a hedge, the probability (or risk) of an assumption or rejection would logically be directly related to the relative values of the currencies, interest rates, or other underlying factor on which the original derivatives contract was based. Because of that direct correlation, it would seem entirely possible to hedge against the possibility of either assumption or rejection (or both).

[126] See, e.g., Skeel, supra note 60, at 23 n. 87 (noting the concerns and suggesting: "None of these contentions are especially persuasive, however. The counterparty itself can minimize its risk through the simple expedient of limiting its exposure to any given debtor, for instance, and the counterparty often would be able to sell a duplicative hedge to a third party. Moreover, the uncertainty could be reduced under a rule that required the debtor to make prompt decisions on assumption, much as bank regulators do in a bank insolvency.").

[127] Supra note 101 and accompanying text.

[128] As pointed out to us in conversation by Darrell Duffie.

million euros and Goldman $1.3 million, on the same date as the original contract. In theory, BOA could simply decline to enter into the second contract. But in reality, the BOA has no choice, because other financial institutions will immediately cease dealing with a debtor that refuses to honor such a request. As soon as BOA agrees to the second swap, Goldman has eliminated its exposure to BOA. Widespread exit could cripple a financial institution that is not in fact insolvent, much as a bank run can cripple an otherwise healthy bank.

As noted earlier, we believe that the risk of runs is indeed the most serious concern with transaction consistency for financial contracts.[129] But here, too, the concerns do not seem great enough to justify complete insulation from core bankruptcy principles. A swaps counterparty can protect itself, and diminish its subsequent need to run, by the expedient of requiring adequate margin or collateral for the transaction, for instance. As we shall see, the percentage of adequately collateralized swaps should rise sharply when the clearing house requirements of the new reform legislation are fully implemented.[130] Moreover, for swaps counterparties that are not adequately collateralized, the special treatment may prevent one kind of run—mass exit from contracts before bankruptcy—but increases the risk of other kinds of runs. If large numbers of counterparties demand collateral at the same time, for instance, a debtor's liquidity may quickly dry up, as AIG found when Goldman and other banks ratcheted up their collateral demands. If the debtor did in fact file for bankruptcy, the filing could trigger massive, simultaneous cancellations of contracts and fire sales of the collateral securing the contracts.[131]

While the case for the current, blunderbuss elimination of the stay and other core bankruptcy policies is thus unpersuasive, the distinctive characteristics of swaps and other financial contracts do justify a more truncated automatic stay. The new reform legislation includes a one-plus day halt on termination (which will function similarly to a stay in this context) in resolution proceedings.[132] We believe that a similarly truncated stay—we would propose three business days-—should be workable in bankruptcy even

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129 Supra note 113 and accompanying text.
130 See Part III(A), infra.
131 See, e.g., Ayotte & Skeel, supra note 65, at 495 (discussing potential consequences of bankruptcy filing).
132 Dodd-Frank Act § 210(c)(10)(B).

in complex cases.[133] Although some might argue that three days is not enough time, it is important to recognize that the managers of a troubled financial institution will not begin thinking about which swaps to assume and which to reject for the first time the day they file for bankruptcy. Knowing that they only have three days to work with, a debtor's managers will have an incentive to plot their executory contract decisions long before they actually file. Moreover, the Dodd-Frank Act's requirement that systemically important financial institutions prepare
wind-down plans on a regular basis, even while they are healthy, will aid in the ability quickly to sort out which swaps to assume, as will the increased transparency the new regulation should bring to the derivatives markets.[134]

To summarize, the treatment of swaps under ordinary bankruptcy principles would prove more complex than with repos. Swaps fall into all three categories of bankruptcy contracts, and only the first—swaps that function as loans—would be automatically terminated and accelerated. Counterparties to other swaps would be subject to the automatic stay. The value of their collateral would, however, be protected and they would be compensated for the value of the insurance provided while the stay was in place.

D. Setoffs, Recoupment and Netting

Thus far, we have treated derivatives and repos as isolated contracts that the debtor is entitled to assume or reject on a contract by contract basis. While contacts between a dealer bank and an end user—a business that that uses derivatives for hedging—often take this form, the dealer banks that dominate the derivatives market

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[133] A proposal drafted by one of us (Jackson) for a working group coordinated by the Hoover Institution calls for a similar but shorter (one day) stay. See Bankruptcy Code Chapter 14, *available at* www.financialresolutionproject.com (outlining proposed new bankruptcy chapter for financial institutions). In addition to its temporary restriction on ipso facto clauses, the Dodd-Frank Act also invalidates "walkaway" clauses that permit a counterparty to cancel a contract without making any payment to the debtor, even if the debtor is in the money. Dodd-Frank Act § 210(c)(8)(F). Walkaway clauses should also be invalidated in bankruptcy.

[134] The Dodd-Frank requirement of wind-down plans ("living wills") is Dodd-Frank Act §167(d). As we explore infra, notes 161-170 and accompanying text, Dodd-Frank also pushes towards a regime in which most swaps would be traded on an exchange of "swap execution facility" and cleared on a clearing house. Such a move would almost certainly permit rapid valuations of swaps, again facilitating the ability to make decisions regarding such swaps within a three-day stay period.

have numerous transactions with one another.[135] These contracts are generally coordinated under a master agreement based on the standardized International Swaps and Derivatives Association (ISDA) master agreement.[136] Under current practice, which ISDA has successfully persuaded the U.S. and many other nations to enshrine in law, the parties are authorized to close out and net all of the contracts, not just an individual contract, in the event of a default.[137]

The derivatives industry has touted netting as a signal benefit of existing practice, dramatically reducing exposure and as a result increasing the potential scope of derivatives trading.[138] Although netting did not figure prominently in the early arguments for special treatment, the industry increasingly has pointed to netting as a reason why the current bankruptcy exclusions need to be protected. The loss of netting rights in the event derivatives were subject to a stay in bankruptcy and the debtor's ability to "cherry pick" among its contracts, the reasoning goes, would radically increase the riskiness of derivatives and force a constriction of the size of the derivatives markets.[139]

Once again, it is important to understand precisely how transaction consistency would and wouldn't affect the treatment of derivatives. Before turning to this analysis, we note in passing that one could question whether continued expansion of the derivatives market, which the industry treats as irrefutably desirable, is necessarily a good thing. In the aftermath of the crisis, evidence has mounted that the financial sector may have grown to too great a portion of the economy during the period of derivatives expansion.[140] Like the advocates of preserving special status for derivatives, however,

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[135] See, e.g., Duffie, supra note 52 (describing the interconnections).

[136] ISDA is the principal trade and lobbying group for the derivatives industry. See http://www.isda.org. It supplies the standard form contracts that are used (as customized by the parties) in most derivatives transactions. Examples of master agreements (culled from SEC filings) can be found at: http://www.sec.gov/Archives/edgar/data/1107694/000119312508091225/dex1032.htm

[137] See, e.g., 11 U.S.C. §§ 101(53B)(defining "swap agreement" to include a master agreement); 560 (exempting netting under swap agreement); 561 (exempting netting across multiple swap and other financial market contracts and master agreements).

[138] See, e.g., David Mengele, The Importance of Close-Out Netting, ISDA Research Notes (2010)(arguing interfering with netting rights would have deeply problematic effects). For a more equivocal assessment of the impact of netting, see Robert R. Bliss & George G. Kaufman, Derivatives and Systemic Risk: Netting, Collateral, and Closeout, 2 J. Fin. Stab. 55 (2006).

[139] Id.

[140] See, e.g., Patrick Bolton, Tano Santos, & Jose A. Scheinkman, Is the Financial Sector Too Big? (unpublished manuscript, May 28, 2010)(modeling factors that can produce excessive development of the financial sector).

we agree that a return to transaction consistency would be problematic if it destroyed all of the benefits of netting.

In reality, it wouldn't. The key bankruptcy doctrines here are creditors' right of setoff and recoupment. Under bankruptcy's setoff provision, a creditor is entitled to offset mutual obligations that it and the debtor owe to one another.[141] Because many and perhaps all of the obligations under a master agreement would be treated as mutual obligations, the debtor would not be able to pick and choose which derivatives to assume. The debtor would be required to either assume or reject all of the derivatives in a single master agreement.[142] The cherry picking fear is thus misguided as it relates to a single master agreement.

The principal difference between the current treatment of the contracts in a master agreement, on the one hand, and transaction consistency, on the other, is that a creditor cannot invoke ordinary setoff rights unilaterally, and it would be subject to the debtor's ability to assume all of the contracts if the debtor wishes to keep them in place. Setoff is subject to the automatic stay, and is not permitted until the bankruptcy judge authorizes it.[143] Under our proposed treatment of derivatives, this means that the counterparty's ability to set off the contracts in its master agreement would be delayed for up to three days. In our view, this is a sensible compromise between immediate setoff—or netting, in industry terminology—and the interest in facilitating an effective restructuring.

In some contexts, another key doctrine—recoupment—would enable derivatives counterparties to avoid even this limited delay. Recoupment is similar to a setoff, but a nondebtor with recoupment rights can exercise the rights immediately, without interference from the automatic stay.[144] The key to recoupment is that it is available only when the nondebtor and debtor have claims against one another that arise out of the same transaction. In the classic recoupment case, the nondebtor withholds excess payments that the debtor has previously made under a supply contract, and uses them to offset the

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141 11 U.S.C. § 553.

142 The Dodd-Frank Act's resolution regime takes this principle still further, requiring that the FDIC either assume or reject all of its derivatives with a single counterparty, regardless whether they are part of a single master agreement. Dodd-Frank Act § 210(c)(9).

143 11 U.S.C. § 362(a)(7)(stay applies to setoffs).

144 Recoupment is treated as an "equitable exception" to the automatic stay. See, e.g., Thompson v. Board of Trustees of the Fairfax County Police Officers Ret. Sys. (In re Thompson), 182 B.R. 140, 146 (Bankr. E.D. Va. 1995)(explaining the rationale and scope of the doctrine).

debtor's next batch of obligations under the contract.[145] Because the claims are so closely connected, the nondebtor is entitled to exercise recoupment rights.[146]

Any derivative or repo in which the parties owe cross-cutting obligations to one another would be a candidate for recoupment. If the debtor had made margin payments to the nondebtor under a swap, for instance, and values shifted so that the nondebtor had liability under the swap, recoupment would enable the nondebtor to use the excess margin to offset its obligations to the debtor.[147]

If a master agreement is treated as a single contract, recoupment could even apply to all of the obligations in the agreement. Although one line of cases has defined the mutuality requirement quite restrictively, the transactions in a single master agreement will ordinarily be so closely related that they should, in our view, be subject to recoupment rights.[148] This would not give the nondebtor the right to immediately terminate all of the derivatives in a master agreement. But the nondebtor could use its recoupment rights to offset any claims pressed by the debtor (such as requests for margin payments) during the period before the debtor made its decision whether to assume or reject.

In our view, the existing bankruptcy rules we have described need only be adjusted in one significant way. Under the analysis we have presented, a master agreement that included both derivatives and repos, as many do, would automatically be terminated, because repos could not be assumed. In theory, the parties could solve this problem by separating their derivatives contracts from their repos. But the leading dealers might continue to mix the treatment, either because they don't anticipate bankruptcy or in a deliberate effort to limit the benefits of bankruptcy. To prevent the artificial termination of all of the contracts in a master agreement due to the presence of a repo, we recommend that lawmakers amend the executory contract provision to make

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145 See, e.g., Ashland Petroleum Co. v. Appel (In re B&L Oil Co.), 783 F.2d 155 (10th Cir. 1986)(contract for oil).
146 Id. at 157.
147 For an argument that the nondebtor should have a right of setoff under similar circumstances, see Johnson, supra note 116, at 986.
148 See, e.g., Vance v. United States (In re Vance), 298 B.R. 262 (Bankr. E.D. Va. 2003) (describing the comparatively capacious "logical relationship" test, and contrasting a more restrictive approach requiring that the obligations must arise out a "single integrated transaction").

clear that termination or acceleration of a repo does not preclude assumption by the debtor of other, related contracts.[149]

Overall, then, concerns about the effect of transaction consistency are significantly overstated. With the limited exceptions we have noted, existing bankruptcy rules accommodate the concerns that transaction consistency would undermine the benefits of netting that are available under existing law.

E. Preference and Fraudulent Conveyance

In addition to insulation from the automatic stay, the other major protection for derivatives and repos in bankruptcy is that they are excluded from bankruptcy's preference and fraudulent conveyance provisions. With ordinary creditors, if an insolvent debtor makes payments or transfers collateral within ninety days of bankruptcy, the transfer can be avoided (and the creditor required to give the value back) as a preference.[150] Similarly, if an insolvent debtor enters into a transaction for which it does not receive reasonably equivalent value, the transaction can be reversed as a fraudulent conveyance.[151] These rules are waved off for repos, derivatives and other financial contracts.[152]

Once again, the industry concerns that are used to justify this exclusion are not nearly so serious as is generally assumed.[153] Even the legitimate worry of derivatives

[149] One final adjustment: we also would include language making clear that "walkaway" clauses are not enforceable in bankruptcy, just as they are invalidated in the new Dodd-Frank resolution regime. Dodd-Frank Act § 210(c)(8)(F).

[150] 11 U.S.C. § 547(b).

[151] 11 U.S.C. § 548.

[152] 11 U.S.C. § 546(e), (f), & (g).

[153] ISDA justifies this exception from preference law:

> this provision enables market participants to continue to trade with weakening parties immediately prior to any bankruptcy filing (subject to prohibitions against intentionally fraudulent transactions), so as to allow those weakening parties continued access to market accommodations that might help them survive. Without these safe harbor protections, market participants would be extremely reluctant to enter transactions with a weakening party in order to avoid receiving payments or taking collateral within the Code's suspect time periods relating to preferences and fraudulent conveyances.

ISDA, supra note 43, at 3. This argument, note, does not apply to *new* transactions with 'weakening parties" within the preference period, (as such new transactions would be for new value), but, rather, suggests that, prior to the preference period, such contracts won't be entered into as frequently because of the preference risk. Putting aside that this does not distinguish these transactions from any other transactions (all of which are subject to preference risk), the argument ultimately depends on the participants about the ongoing adjustments they make to the margin or collateral put up in connection with the contract being caught in a preference snare does not justify the current regime of wholesale exclusion of derivatives from preference law. With the swap described earlier, for instance, in which Bank of America promised to pay 1.3 million dollars in return for 1 million euros from Goldman in six months, the parties ordinarily would adjust their margin on a daily basis.[154] If the value of the euro increased, Bank of America would augment its margin, as would Goldman if the dollar went up. If preference law applied, and Bank of America filed for bankruptcy, each of the margin payments made or additional collateral posted by Bank of America during the ninety days before bankruptcy might be challenged as preferential. Not only would sorting out the sequence of transfers be mind-numbingly difficult, advocates of special treatment argue, but the payments really aren't preferential at all. They're simply ordinary adjustments, rather than special treatment.

If we focus on these ordinary adjustments, and set to one side pre-default grabs like Goldman's demands for collateral as AIG wobbled, this argument is compelling. But the plight of derivatives counterparties is not unique. Other credit arrangements have raised very similar issues in the past, and have been addressed in bankruptcy's preference provisions. Most closely analogous is the treatment of lenders who take security interests in inventory or the debtor's accounts receivable. Because inventory is sold and debtors collect accounts receivable, the lender's original collateral disappears and its security attaches to the new inventory the debtor acquires to replenish its stock, and to the debtor's new accounts.[155] Prior to the enactment of the 1978 Code, attachment of the debtor's security interest to the new collateral during the ninety days before bankruptcy could be challenged as preferential, even though it simply replaces the original collateral, because it is a transfer of a property interest to the creditor on the eve of bankruptcy.[156]

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assumption that "continued access to market accommodations" of "weakening parties" is a good thing. We believe a strong counter-argument—that "weakening parties" should be resolved, and financial players with the greatest expertise and monitoring ability are in the best position to stop inevitable delay—is as, or more, plausible. In any event, the ISDA argument runs counter to the overarching policy of preference law.

154 See text following note 128.

155 This assumes that the lender has an "after acquired" property clause in its security agreement, as inventory and receivable lenders invariably do. See U.C.C. § 9-204 (authorizing after acquired property clauses).

156 11 U.S.C. § 547(b).

Congress addressed this problem by including a special protection for inventory and receivable lenders in the preference provision.[157] Under this provision, known as the "two point net improvement" provision, collateral transfers can only be avoided to the extent they make the lender better off as of bankruptcy than the lender was ninety days before bankruptcy. If the lender is fully collateralized ninety days before bankruptcy, nothing can be avoided. If the lender is less undercollateralized at bankruptcy than it was at ninety days before bankruptcy, the difference—the amount by which the lender's position has improved—can be avoided, but only that amount.

We believe that the same principle should be extended to derivatives and repos. So long as the counterparty's position is not improved during the ninety days before bankruptcy, the trustee would not be permitted to avoid any of the margin and collateral adjustments as preferential. If the counterparty has strengthened its protections on the eve of bankruptcy, on the other hand, it would be required to give back the amount of the improvement. While the parties often will have made numerous adjustments during the ninety day period, this approach only requires two calculations—one for the beginning of the ninety day period, and one as of bankruptcy. Given that the parties calculate values continuously, determining whether there has been an improvement in position should be quite straightforward.[158]

The approach we propose would require an amendment to the preference provision, and we strongly advocate this amendment. But even in the absence of a formal amendment, courts might be able to achieve a similar result by applying the existing preference provision. If the parties' mutual adjustments were construed as substitutions of collateral, they might be protected, much as courts protected inventory and receivable lenders before the enactment of the current two-point net improvement test.[159]

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[157] 11 U.S.C. § 547(c)(5).

[158] This stands in notable contrast to current 547(c)(5), which can be difficult to apply because of the need to determine the value of the inventory or receivable collateral as of ninety days before bankruptcy.

[159] See, e.g., Grain Merchants of Indiana, Inc. v. Union Bank & Sav. Co., 408 F.2d 209 (7th Cir. 1969)(rejecting preference attack). Under current 11 U.S.C. § 547, courts might treat the adjustments as contemporaneous exchanges of new value, which are protected by 11 U.S.C. § 547(c)(1). The fit is not perfect, however, because the parties are not substituting new for old collateral, as inventory and receivable lenders do. Rather, they are adding or subtracting collateral as the values under the contract change.

In addition to collateral and margin adjustments, the other major prebankruptcy maneuver that could run aground of the preference provision is transactions that are designed to enable a counterparty to close out its relationship with the debtor. Recall from our earlier discussion, that Goldman could exit its relationship with Bank of America by proposing to offset their earlier transaction with a new swap, under which it promised to pay Bank of America 1.3 million dollars in return for 1 million euros. Should this transaction be treated as preferential? If Goldman owes Bank of America under the earlier swap, we believe the offsetting swap does indeed give Goldman an inappropriate benefit at the expense of Bank of America's other creditors, since the transaction reduces Goldman's (otherwise unsecured) exposure on the eve of bankruptcy.[160] In form, Goldman hasn't received a standard preference, because the new swap is not simply a payment or other transfer to Goldman. Instead, Goldman has created a setoff, which effectively ensures that its unsecured obligation will be paid in full. This, too, is anticipated by the bankruptcy laws. Under existing law, the creation of a setoff can be avoided to the extent it leaves the debtor's counterparty better off.[161]

III. Implications of the Dodd-Frank Act

While the Dodd-Frank Act borrows for its own use a number of bankruptcy provisions, it nonetheless leaves bankruptcy oddly untouched in terms of its statutory provisions. But while there are no direct statutory charges to bankruptcy law, there are important ways in which the Dodd-Frank Act affects bankruptcy indirectly. As we shall see, the reforms now require that most derivatives be traded on an exchange and be subject to clearing on a recognized clearing house. The Dodd-Frank Act's new clearing house and exchange requirements enhance the case for transaction consistency for derivatives in bankruptcy. The new resolution regime for large financial institutions

[160] If Goldman owes Bank of America, on the other hand, the new swap is not preferential because it simply has the effect of pre-paying an obligation that Goldman would otherwise be required to pay later.
[161] If a nondebtor incurs an obligation in order to create a right to set off the obligation against an unsecured claim, and effects the setoff prior to bankruptcy, 11 U.S.C. § 553(b) authorizes the trustee to retrieve the amount by which the nondebtor's position is improved. If the nondebtor does not invoke its setoff right until after the bankruptcy is filed, 11 U.S.C. § 553(a)(3) achieves the same effect.

creates a conflict between bankruptcy and resolution treatment of derivatives, sharply increasing the stakes of the decision whether to restore transaction consistency.

A. The New Clearing House and Exchange Requirements

The Dodd-Frank Act gives the CFTC and SEC the authority to require that every swap be cleared on a clearing house unless no clearing organization will accept the swap.[162] Swaps that are cleared must also be traded on an exchange or "swap execution facility," rather than negotiated privately between the two parties.[163] The new requirements dramatically increase the regulatory oversight of derivatives outside of bankruptcy, and they have important indirect implications for bankruptcy.

With swaps that are cleared, the clearing house interposes itself between the two counterparties to a swap and stands ready to make good on either side of the contract if one of the counterparties fails.[164] Because the clearing house is responsible for both sides' performance, it will require each to post margin or collateral on an ongoing basis and will monitor both sides. If Bank of America and Goldman Sachs enter into a swap requiring BOA to deliver \$1.3 million and Goldman to deliver 1 million euros, the clearing house would serve as guarantor of each side's performance, and would require each to meet specified margin requirements.

Closely linked with the clearing house innovation is a requirement that swaps be traded on exchanges (or executed on swap execution facilities),[165] rather than negotiated privately in the over-the-counter market, unless no exchange will have it. The objective here is transparency: swaps will need to be standardized if they are traded on exchanges like stock or bonds, which will make them easier to price and compare.

The initial question posed by this restructuring of the derivatives market is whether it moots the argument for transaction consistency. If Bank of America and Goldman Sachs are both fully protected by the presence of a clearing house, some might

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[162] Dodd-Frank Act § 723.
[163] Id.
[164] As Kimberly Summe has pointed out to us, the guaranty is somewhat qualified. The clearing house has the option of paying the defaulting party's obligation or obtaining a substitute contract. If the clearing house decides to pay, it is the one who determines the appropriate value.
[165] Dodd-Frank Act § 723.

say, there isn't much need for an automatic stay. But this misunderstands the intent of the automatic stay. If Bank of America were to file for bankruptcy, the presence of a clearing house would protect Goldman Sachs and thus diminish the risk that Goldman would be destabilized by BOA's default. But an important goal of the stay is to enable BOA to arrange an efficient disposition of its assets in bankruptcy. The clearing house arrangement has no effect on this function (other than to introduce the issue, discussed below, of whether the clearing house also should be subject to the stay), and does not eliminate its importance.[166]

The bottom line for exchange trading is the same. A swap that is exchange traded is more fungible than an OTC swap, which might seem to suggest that it need not be stayed. But exchange traded swaps are not like cash. The swap may be an important component of a debtor's portfolio of hedges or brokerage operations. Even if it would be simpler to replace than an OTC swap, its immediate termination could undermine a debtor's disposition of its assets.

Any case for exempting cleared, exchange traded swaps from transaction consistency would therefore need to rest on other grounds. We believe that the best, though ultimately unpersuasive argument for exemption is tied to the distinction between cleared and exchange traded and non-cleared and non-exchange traded swaps under the new legislation. Exempting cleared derivatives, but not noncleared derivatives, would create an incentive for counterparties to favor cleared derivatives.[167] While we too favor efforts to direct swaps toward clearing and exchanges, this does not seem to us to justify a departure from transaction consistency. The stay is essential to reduce the credit subsidy for derivatives, and to facilitate the efficient disposition of the assets of the debtor—BOA in our illustration.

The status of the clearing house itself is a more delicate matter. If the clearing house were solely a middleman, it would be a simple matter to conclude that the stay and other core bankruptcy policies should not apply. But the clearing house is far more than

[166] Under Dodd-Frank's resolution rules, clearing houses are not subject to any standstill. Dodd-Frank Act § 210(c)(8)(G). We think that this protection will not have much practical effect, because the FDIC will invariably protect all of the institution's derivatives contracts. As noted below, we do not believe that the clearing house should be insulated from the effect of the stay in bankruptcy.

[167] The rationale is that cleared derivatives would enjoy slightly superior treatment, because they would not be subject to the automatic stay in the event one of the counterparties later filed for bankruptcy. On the margin, this would encourage parties to use cleared rather than uncleared derivatives.

a conduit. It is not like the stockbrokers whose settlement and margin payments were protected by the original 1978 exemptions.[168] As guarantor of both sides' performance (indeed, technically a counterparty to each), and as the principal monitor, the clearing house is itself an integral player.

Because the clearing house is not simply a middleman, the presumption of transaction consistency should apply unless there other reasons that would justify protection from the stay and other bankruptcy policies. The most compelling argument we can imagine would stem from the new centrality of the clearing houses to the stability of American finance. Prior to the new legislation, large, interconnected institutions like Citigroup or AIG were the major source of systemic risk. With the new legislation, that risk will be shifted to the clearing houses. They are the new too big to fail entities, given their obligation to guarantee all cleared derivatives contracts.[169] We cannot afford, some might argue, for clearinghouses to be hampered in any way by bankruptcy provisions like the stay and the trustee's avoidance powers.

While we appreciate these concerns, we do not believe that that add up to a rationale for jettisoning transaction consistency. The first thing to note is that the clearing house could protect itself by requiring that swaps be fully collateralized. Moreover, the interference that we have proposed is quite limited— a three day stay and a preference reachback cabined by the two-point net improvement safe harbor.[170] The bite of transaction consistency would thus be very much at the margins, affecting undercollateralized swaps for a brief transition period.

The core difficulty with retaining the more sweeping current exemptions stems from the fact that the clearing houses will be stepping into the shoes of the major derivatives trading banks. The clearing house, rather than the counterparty, will now be a

[168] See supra notes 31-32 and accompanying text (describing arguments that brokers were simply conduits and should not be subject to preference and fraudulent conveyance rules).

[169] This point is made (sarcastically) in Editorial, Another Dodd-Frank Triumph, Wall St. J., Feb. 16, 2011, at A16.

[170] Somewhat ironically, exempting clearing houses from the three-day automatic stay we propose would undermine one of the key advantages clearing houses (and exchanges) provide. The ability to make three-day decisions regarding the assumption or rejection of swaps requires accurate valuation information that is virtually instantaneously available. Swaps cleared on clearing houses (and therefore traded on exchanges or swap execution facilities), would have precisely this attribute. If, however, clearing houses were exempted from the automatic stay, the swaps that would remain subject to the three-day stay we propose would likely be the ones without accurate and instantaneous pricing information. See infra note 133 and accompanying text.

debtor's principal monitor and creditor. The special treatment would, on the margins, diminish the clearing house's incentive to monitor the counterparties, and would preserve a credit subsidy for swaps as compared to other financial instruments.[171] In short, leaving the exemptions in place for clearing houses would thus replicate many of the distortions that exacerbated the 2008 crisis.

B. Resolution Authority

The new framework for large, systemically important financial institutions gives bank regulators the power to take over troubled bank holding companies, "systemically important" nonbank financial institutions, or other companies that are "predominantly engaged in financial activities."[172] Although the trigger is more complex—calling for U.S. Treasury initiation with the concurrence of the Federal Reserve and FDIC[173]—the new authority is designed to give the FDIC the same kinds of resolution powers it has with ordinary commercial banks.[174] The FDIC has a nearly unfettered right to sell or transfer assets or liabilities to third parties, as with ordinary banks.[175] With repos and derivatives, the FDIC is given a one-plus day period during which counterparties cannot terminate or net their contracts. During this time, the FDIC is permitted to decide which

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171 While the attention has been on whether clearing houses should be exempted from bankruptcy's automatic stay, our reasoning would be the same if the issue were whether clearing houses should be exempted from bankruptcy's preference rules (as adjusted pursuant to our analysis). Although incomplete, preference rules are bankruptcy law's most important effort to address a serious problem that leads bankruptcies systematically to start too late, by attempting to deny creditors who see bankruptcy coming gains from avoiding, rather than commencing, bankruptcy. See supra note 28 and accompanying text. For that reason, our monitoring argument for counter parties applies equally to their inclusion in our preference rules for swaps.

172 The resolution rules are set forth in Title II of the Dodd-Frank Act, entitled Orderly Resolution Authority (OLA). Interestingly, there is no requirement that a financial institution be designated as systemically important (a category that subjects it to extensive new regulation under Title I) prior to being taken over under the resolution rules. Instead, regulators need only find that it is a "covered company" because, among other things, its failure might cause systemic damage. Dodd-Frank Act § 202 (requirements for resolution petition).

173 Dodd-Frank Act § 203 (requiring recommendation by U.S. Treasury and approval by two-thirds of Federal Reserve Governors and FDIC Board).

174 The analogy between FDIC resolution and the Dodd-Frank resolution rules is criticized at length in David Skeel, The New Financial Deal: Understanding the Dodd-Frank Act and Its (Unintended Consequences) 117-27 (2011)(arguing that the arguments for FDIC resolution of small and medium sized banks do not apply to large financial institutions)..

175 Id. at 123-24.

contracts to transfer, subject to the stricture that the FDIC must transfer either all or none of the contracts with any given counterparty.

The relationship between the resolution framework and our transaction consistency analysis is initially counterintuitive. If one concluded that the stay is most essential for large, systemically important debtors—as one plausibly could[176]—the resolution framework might appear to make a bankruptcy stay unnecessary. The kinds of institutions that featured in the crisis—the AIGs and Lehmans—are covered by the FDIC's newly expanded powers, and these powers include a temporary stay. To the extent the key institutions taken care of, parallel reform of the bankruptcy laws may not seem so urgent.

In our view, transaction consistency should not be limited to large, systemically important financial institutions. But even if one wished to limit its scope to these institutions, the new resolution regime would not obviate the need for bankruptcy changes. The scope of the regime, broad as it is, is not exhaustive. Most financial institutions, even quite large ones, would be subject to the bankruptcy process, not the new resolution regime.[177] More importantly, even those institutions that clearly are covered—Bank of America, for instance—are not precluded from filing for bankruptcy. Only if the U.S. Treasury initiates the new regime prior to a bankruptcy filing, or removes the institution from bankruptcy after it has filed, will the new regime be employed with even the largest institutions.[178]

Even the most avid proponents of the regime have characterized its use as a last resort, with bankruptcy preferable except in extreme cases.[179] From this perspective, the resolution regime makes bankruptcy reform more urgent, rather than less. Under the present framework, with the resolution framework superimposed on the bankruptcy laws, there is little incentive for a large troubled financial institution to file for bankruptcy.

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[176] See, e.g., Skeel, supra note 60, at 19 (explaining possible benefits of stay only for systemically important institutions).

[177] Assistant Treasury Secretary Michael Barr, the Obama Administration's point person for the legislation, assured lawmakers that "bankruptcy proceedings will remain the dominant option for handing the failure of a non-bank financial institution, even very large ones." Assistant Secretary Michael S. Barr, Written Testimony Before the House Judiciary Committee Subcomm. on Comm'l and Adminst. Law 4 (Oct. 22, 2009); U.S. Department of the Treasure, Financial Regulatory Reform: A New Foundation (June 17, 2009), available at http://www.financial stability.gov/docs/regs/FinalReport_web.pdf, at 74-77 (same).

[178] See, e.g., Dodd-Frank § 208 (authorizing removal of case from bankruptcy to Dodd-Frank resolution).

[179] Supra, note 176.

From the managers' perspective, bankruptcy has many of the same downsides as resolution: they are likely to be displaced and their stock will be wiped out. And in the absence of a stay, derivatives counterparties' ability to cancel their contracts en masse would severely complicate the managers' efforts to arrange a sale or other resolution.[180] With no benefit to bankruptcy, the managers will stall, hoping for regulatory forbearance.[181]

If bankruptcy included a stay and other protections, by contrast, managers would have an incentive to prepare for and file for bankruptcy in the event of financial distress. From the managers' perspective, the prospect of a stay would be superior to resolution because it would give them a meaningful prospect of achieving an effective resolution. The stay would halt a run by the institution's derivatives counterparties long enough to facilitate a sale or other disposition of key assets. If AIG had had access to a bankruptcy stay, for instance, it could have resisted the collateral calls that hastened its decline by filing for bankruptcy.[182] Under the current regime, AIG had an irresistible incentive to do what it did: play for a bailout. The prospect that a stay might encourage the managers of a large financial institution to plan for bankruptcy in advance and then use the bankruptcy option strongly reinforces the case for transaction consistency with derivatives and other financial instruments in bankruptcy.

IV. Alternative Strategies for Reform

Given the effects of bankruptcy's departures from transaction consistency during the recent crisis, we strongly favor a return to thorough-going transaction consistency for repos and other financial instruments. But we also recognize that compromises and incomplete solutions are an inevitable part of the political process. We therefore begin by summarizing our ideal reforms, then introduce several more partial solutions.

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[180] See supra notes 56-59 (discussing this dilemma with AIG).

[181] Moreover, if any large troubled financial institution *did* start in bankruptcy, even with the extraordinarily rapid (and potentially unconstitutional) ability of the government to remove the institution from bankruptcy and place it within the orderly liquidation authority of Title II of Dodd-Frank, Dodd-Frank Act §202(a), see David Skeel, supra note 174, at 139, absent a brief stay on derivative counterparties *in bankruptcy*, the stay provided in the orderly liquidation authority of Dodd-Frank may prove to be illusory.

[182] Id.

Full transaction consistency would mean removing the existing exemptions from core bankruptcy policy for repos, swaps and other financial contracts, with several important wrinkles discussed earlier. The special provisions exempting these contracts from bankruptcy's anti-ipso facto rules would be deleted, in order to implement bankruptcy's standard limitation on ipso facto clauses.[183] We would reintroduce the automatic stay but—perhaps the most important wrinkle—limit its duration to three days, due to the volatility and short timeline of derivatives contracts.[184] Bankruptcy's preference and fraudulent conveyance rules also should be reintroduced for derivatives. Because of their similarity to accounts and inventory financing, we would protect collateral transfers that do not improve the counterparty's overall position, as bankruptcy does with accounts and inventory.[185] We would apply these adjustments to clearing houses as well as ordinary counterparties.[186]

The first alternative would entail simply deleting the exemptions for repos and derivatives from bankruptcy's anti-ipso facto provisions. This approach, which is the strategy lawmakers have employed for systemically important institutions under the Dodd-Frank Act's resolution rules,[187] is the most minimalist reform that would nudge these financial contracts toward transaction consistency and diminish the perverse incentives created by their special treatment. This most simple of reforms would prevent the kind of mass termination by counterparties that an AIG bankruptcy would have triggered. By preventing immediate exit by the debtor's counterparties, bankruptcy's anti-ipso facto provisions would give the debtor a short window of opportunity to arrange a sale or other disposition of its assets. Our principal concern with reintroducing bankruptcy's anti-ipso facto provisions, rather than providing a true stay, is the risk of

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183 Compare 11 U.S.C. § 541(c)(1)(B)(invalidating ipso facto clauses) with 11 U.S.C. § 559 (allowing ipso facto clauses in repos) and 11 U.S.C. § 560 (allowing ipso facto clauses in swaps).

184 See Part II(C) supra.

185 See Part II(E) supra.

186 See Part III(A) supra. In this ideal world, we would, of course, recommend that there be consistency between our proposals for repos and derivatives in bankruptcy and those in Title II of Dodd-Frank, preferably by having Title II of Dodd-Frank mirror the rules we would place in bankruptcy. This idea—consistency between bankruptcy and Title II of Dodd-Frank in the application of substantive rules—would likewise apply to our alternatives as well. We focus in text on alternatives to bankruptcy reform, however, believing that issues concerning re-opening Dodd-Frank for amendment raise a whole different level of political issues.

187 Dodd-Frank Act § 219(c)(9)(preventing invocation of ipso facto clause until 5 p.m. the day after the resolution petition is filed).

circumvention. Derivatives professionals could attempt to contract around the proscription, by for instance introducing a contractual provision that authorizes a counterparty to seize and sell collateral without formally terminating the contract.[188] The anti-ipso facto clause strategy would thus require vigilant judicial oversight, with bankruptcy courts construing the anti-ipso facto provisions broadly enough to foreclose circumventions.[189]

A second alternative to full transaction consistency would couple the minimalist strategy of reinstating the anti-ipso facto rules with an automatic stay that covered only swap transactions.[190] Because swaps are a large percentage of the overall derivatives market, imposing a stay on these derivatives but not other financial contacts would substantially increase transaction consistency. Repos, the other major component of the new finance, would retain their special status in bankruptcy. As we have seen, this status differs only in limited respects from the treatment repos would receive under true transaction consistency.[191] As financial accommodations, repos would be automatically terminated when the debtor filed for bankruptcy. Imposing a stay on repos is thus less crucial to restoring transaction consistency. A stay on swaps, by contrast, would remove an important distortion in existing finance, limit the risk of mass terminations and collateral sales, and facilitate an orderly disposition of assets.

Each of the alternatives to full transaction consistency could be adopted either by itself or together with our proposed reforms to the preference provision; the preference reforms are, in a sense, another distinct module. Lawmakers might choose to forgo the preference reform initially, in order to focus first on the largest source of distortion and to avoid the potential complexity of assessing a debtor's prebankruptcy transactions.

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188 If a stay were in place, these steps would be prohibited. But they would not be prevented if Congress reinstated bankruptcy's anti-ipso facto provisions while leaving counterparties' exemption from the stay in place.

189 The bankruptcy judge's handling of the Lehman case gives some comfort in this regard. The judge has held, for instance, the Lehman's counterparties who did not promptly exercise their right to terminate are deemed to have waived this right. In re Lehman Brothers Holdings (Metavante v. Lehman Brothers)(Sept. 15, 2009).

190 In addition to repealing 11 U.S.C. §§ 559, 560 and related provisions, this reform would entail modifications to § 362(b)(7) and §362(b)(17) reintroducing a three day stay.

191 See Part II(B)(1) supra.

We should reiterate that moving to full transaction consistency is much to be preferred to any of the more partial alternatives, but each step in this direction will improve on the special treatment that derivatives currently receive.

Conclusion

As the new finance emerged in the past thirty years, it seemed so innovative and different that it couldn't possibly be subject to the rules that applied to old fashioned lending arrangements. It was an entirely distinct, and so it was thought, self-regulating market.

In this Essay, we have sought to show that the instruments of contemporary finance are not quite so radically different as is conventionally thought. If we view them through the lens of the concept we call transaction consistency, it becomes increasingly clear that derivatives and repos should not simply be insulated from core bankruptcy rules such as the automatic stay and the prohibition of eve of bankruptcy preferences. If we have persuaded a few readers that derivatives and repos can be analyzed under the same framework that applies to other contracts, the Essay will have been a success.[192]

We do not claim that a currency swap is no different than a traditional equipment loan, and that a credit default swap is simply an insurance contract. Derivatives and repos do have distinctive qualities—such as the volatility of their value. But these are differences of degree, not differences in kind. Under the framework we propose, the stay would be limited to three days, and repos secured by cash-like securities would not be subject to the stay. We arrive at these adjustments by simply applying the concepts that underlie bankruptcy's treatment of ordinary contracts.

Our goals for this analysis are two: first, we hope that lawmakers will consider making the simple adjustments in the treatment of derivatives and repos that we have

[192] The issues are of far more than academic interest alone. The Dodd-Frank Act calls for two different reports on the efficacy of bankruptcy for handling financial institution failures. Dodd-Frank Act § 202(e) (study by Administrative Office and Comptroller); § 216 (study by Federal Reserve and Administrative Office). The treatment of repos and derivatives in bankruptcy will be central to the analysis of these studies. *See, e.g.,* Dodd-Frank Act § 216(a)(2)(D)(calling for analysis of whether the special treatment of qualified financial contracts—that is, derivatives—in bankruptcy should be amended).

proposed—or, alternatively, the more limited adjustments we have identified as providing most of the benefits of fully transaction consistency. Second, we hope that lawmakers will keep the transaction consistency principle in mind when the next wave of financial innovations arrives in the future, as it surely will.[193]

[193] Although our particular concern in this Essay has been repos and derivatives, deviations from transaction consistency have created distortions in other contexts as well. The most obvious is the special treatment of consumer mortgages. Unlike most other loans, which can be written down to the value of the collateral if the collateral is worth less than the debtor owes, Chapter 13 forbids the debtor from altering the terms of a mortgage on her primary residence. 11 U.S.C. § 1322(b)(2). The special treatment of mortgages may have contributed to the distortions in the mortgage market during the real estate bubble, and many commentators (including one of us) believe that removing the special treatment might have hastened homeowners' recovery from the recent economic crisis. See, e.g., David Skeel, Bankruptcy Phobia, 82 Temple L.J. 333 (2010)(describing the defeat of proposals for reform).