“Transaction Consistency and the New Finance in Bankruptcy” Penn Roundtable

Skeel/Jackson

25 July 2011

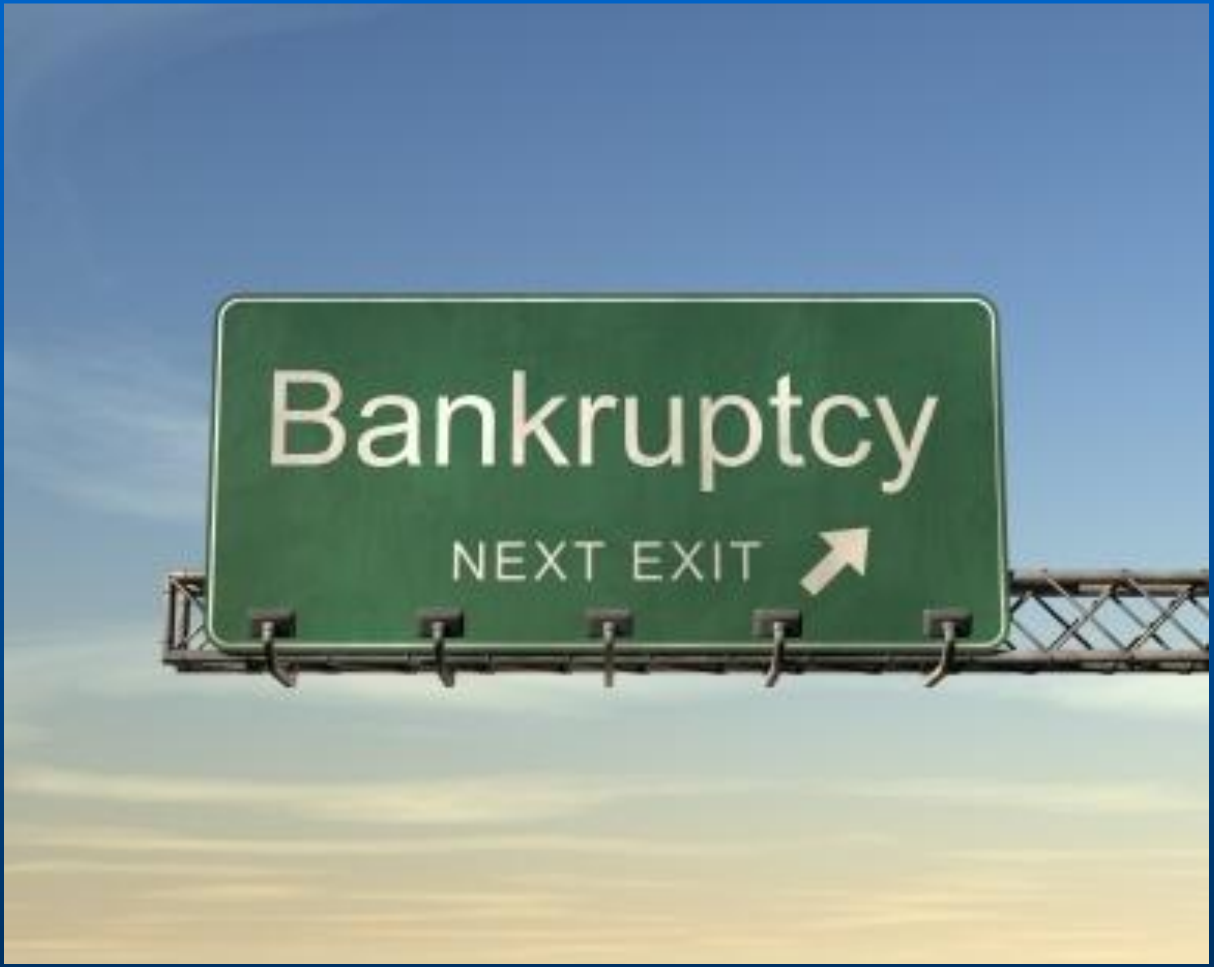
The Derivatives Irony

- Derivatives were largely unregulated before the crisis
- Outside: 2000 legislation prevented CFTC or SEC oversight
- Inside: protected from automatic stay, anti-ipso facto, preference, fraud conveyance

The Dodd-Frank Act

- Enacts new regime outside of BR
  - Clearing houses
  - Exchange trading requirement
- New resolution rules
- What changes in bankruptcy?
  - ….

*"Ladies and gentlemen,
is there a bankruptcy attorney on board?"*


Bankruptcy
NEXT EXIT

Roadmap

- 1) Is the omission grounds for concern?
- 2) What would restoring “transaction consistency” mean
- 3) Implications of the Dodd-Frank Act

1) Significance of the Omission?

- One answer: wise restraint
- David Mengele (ISDA): warned about the “radical suggestions, mostly from academic researchers in the United States, that derivatives be subject to normal bankruptcy procedures.”

Evidence from the Crisis

- Bear Stearns: major dependence on repo financing
- Lehman: J.P. Morgan froze $17B, demanded $5B
- AIG: collateral demands (Goldman etc) after downgrade

2) What Would Transaction Consistency Mean?

- The framework for executory contracts
- 1) loans/financial accommodations
- 2) classic executory contracts
- 3) insurance-like executory contracts

Implications for Repos

- Automatically terminated
- At most, limited delay
- Our proposal: no stay for cash-like collateral
- The question of rehypothecation
  - Doesn’t change the loan/sale analysis
  - Cf. a grain loan

Implications for swaps

- Swaps used for loans would be treated as “financial accommodation”
- Standard swaps should be subject to stay
- Concerns: volatility and runs
- Response: limited stay (3 days)

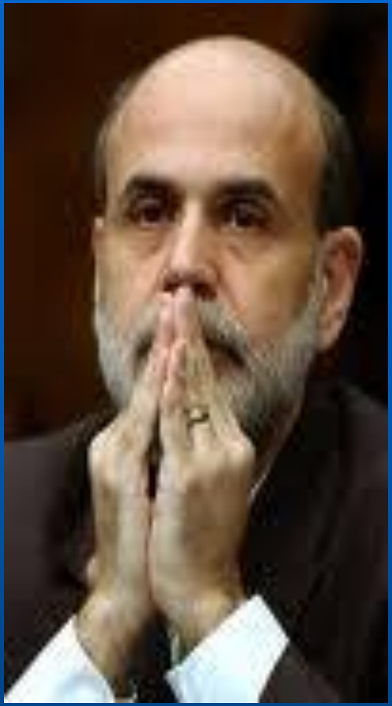
Netting of derivatives

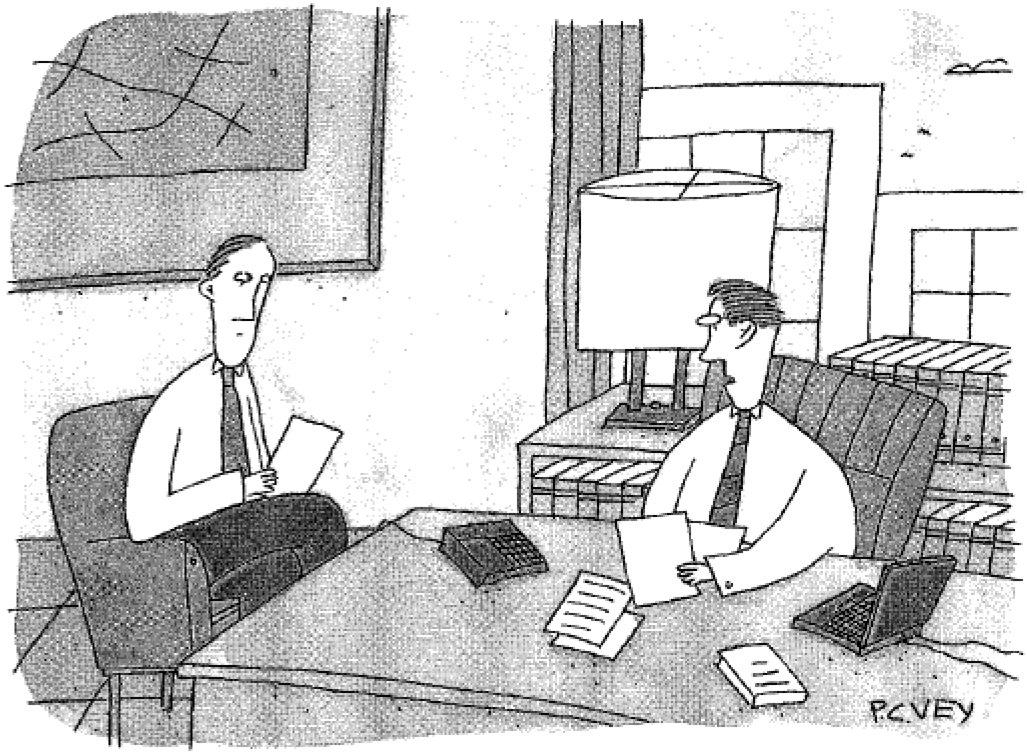
- Would be subject to stay
- But honored as setoff
- Result: master agreement treated as a single unit

Avoidance of Preferences

- Normal Rule
  - Transfers w/in 90 days are avoidable
- Concerns
  - Margin payments/collateral= exposed
- Response:
  - "two point net improvement" test
  - No avoidance unless improve position

3) Implications of Dodd-Frank





"These new regulations will fundamentally change the way we get around them."

Key innovations

- Derivatives
  - Clearing house requirement
  - Exchange trading requirement

- Title II Resolution Rules (OLA)

Do these make transaction consistency undesirable?

- Derivatives rules:
  - Make stay less problematic rather than more
- Resolution rules
  - Include 1-plus day “stay”
  - Effect will be pressure for bailout outside of resolution

Benefits of transaction consistency

- Managers have incentive to invoke without waiting for regulators
  - The AIG example
- Rule of law virtues of BR
- Makes resolution less important