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CHAPTER 11 - AT THE CROSSROADS:

DOES REORGANIZATION NEED REFORM?

"SYMPOSIUM ON THE PAST, PRESENT & FUTURE

OF CORPORATE RESTRUCTURING"

(Audio File 1003)

"Symposium on the Past, Present & Future
Of US Corporate Restructuring"
(Audio File 1003)

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(Inaudible) = Areas that could not be heard due to poor audio quality, background noise, quiet/stifled speaking, etc.

Bob Keach: We're going to jump right into our next program on safe harbors. I encourage you to pay attention closely to all of the panels over the next few days but frankly you really should pay attention to this panel. My personal views on safe harbors are sort of well known, at least to the people who talk to me. When the safe harbors originally came in, safe harbors being those provisions that exempt much of what happens with derivatives from the normal treatment of contracts under the bankruptcy code. When safe harbors first came in, pre 2005 I think the last panel talked about amendments that get made that we know a lot about or think we know a lot about that have unintended consequences. The safe harbor provisions I think were originally perceived to be niche amendments, very few people knew anything about what they meant and they had very much intended consequences, i.e. consequences intended by the derivatives and swaps industry and as we're going to talk about were expanded in 2005.

Arguably, and I'll leave this to the panel, we now have an exception big enough to drive a truck through in the bankruptcy code and we're going to be talking about exceptions that has real significance. Much of the debate over too big to fail and how to handle large financial companies in or out of bankruptcy is actually a discussion built around how one deals with derivatives. So this is a profoundly important question, I'm going to start off with a quote from Professor Lubben's papers which I think is interesting and then I'm going to turn it over to Shmuel Vasser who's going to talk to us a lot about what derivatives are, what the safe harbors are and sort of build the outline for us so that we can talk intelligently about this.

I circled and found one of profound Professor Lubben's quotes which was that Chapter 11 is designed around the notion of shared sacrifice and collective recovery where as granting exceptions to the process, even in the cases of hardship, undermines these twin goals.

One of the things I think we heard in the last two panels is that often the shared sacrifice and collective recovery is forced and it's not necessarily a Kumbaya moment, but the safe harbor issues I think are all about exceptions and what they do to the process. Having set the question up that way, let me first introduce our very distinguished panel. To my far right is Professor Stephen J. Lubben of Seaton Hall University. Steven has written extensively on derivatives and the safe harbor provisions. Next to Steven is the Honorable Christopher S. Sontchi of the US Bankruptcy Court for the District of Delaware. Judge Sontchi among other distinctions is the author of what I refer to as the American Home Mortgage Trilogy. Three cases that are very important in this area and in that sense Judge Sontchi has written as much of the literature here as anyone. Next to Judge Sontchi is Shmuel Vasser of Dechert LLP in New York. Shmuel has been in my experience one of the primary experts in this area and has written and spoken extensively in this area as well, often taking the position compatible with that of the swaps and derivatives industry. Next to Shmuel is Julia M. Whitehead of Whitehall, Miller Advisors and Julia has also written some very provocative recent articles on the safe harbors and what they do and don't do with respect to the reorganization process.

With that introduction let me start with Shmuel. Give us a, it's almost ridiculous to use the word basic here, give us a basic explanation of derivatives and the other instruments and agreements covered by the safe harbors, how the safe harbors operate currently.

Shmuel Vasser: Sure. I'm actually going to try to do it in a short order because if I don't you guys are all going to be sound asleep when we're going to have the more interesting discussion on what should be done and whether what we have is appropriate or not. Basically these provisions started in about the first of those became effective in 1982 when congress added the exemption the various special treatment to these instruments dealing with securities contracts, commodities contracts and forward contracts. In 1984 as a result actually of an (inaudible) 1982 decision of the bankruptcy court in the (inaudible) District in the bankruptcy of Longberg Wall Congress amended these provisions by adding a safe harbor treatment for repos. Again just interesting to see August '82 a bankruptcy court decision in 1984 to basically address one bad decision so you can see how long the legislative forces works to address these issues. Then in 1990 the provisions were expanded to add safe harbor treatment to swaps, that was mainly as a result of the (inaudible) work of a vilified organization called ISDA, the International Swap Dealer Association in which have been receiving the brunt of the criticism with respect to this safe harbor in the last few years.

The basic rational for the safe harbor deals with essentially two points. One is the volatility of the underlying instrument securities or commodities essentially the underlying assets that are on which those derivatives are written and the other one is either call it the daisy chain effect or the interconnectedness of these instruments or more appropriately the dealers that deal with these type of instruments. They used to be smaller, they're more now but the markets in these industries are very connected, very strong connections in the nature of back to back agreements across markets and now internationally in fact these are not limited to a specific geographic country or region. When you add to that the amount of money involved when you look at the legislative history and you see the amounts that were talked about at the repo market at the time, I don't remember what it was, maybe it was 25 billion. Notionally at the time these amounts seems like small change in comparison to the amounts that these instruments cover now days. These three when you add them together are essentially the rationale that legislation dealing with these provisions. Shall I talk about what the instruments are?

Bob Keach: Sure, briefly.

Shmuel Vasser: Okay briefly securities contracts are what you would think about agreements to buy, sell or transfer securities and I think it was intended and I think you'll see the legislative history intend to cover what's called the public securities. You'll be surprised to know, as I am and I was when I found it, that it's actually not clear what public securities are. So that's a real problem and that's an issue that prevails the litigation of a security contract of safe harbor because there's a division in the courts. Some courts are saying you have to cover public securities, some courts are saying it doesn't matter what the statute says, in fact it doesn't matter what the legislative history says, when the statute is clear you follow the statute and you're not going to ask me to comment about that debate.

The commodities and forward contracts essentially designed to cover the entire universe of the markets that deals with, call them commodities. The difference is commodities contracts are generally viewed as the futures contract, i.e. the contracts that are traded on the Chicago Mercantile Exchange, on the IMEX, on exchanges where these types of agreements are traded. Forward contracts are essentially privately negotiated contracts with a maturity date in the future to deliver pork belly or whatever it is.
When you look at the case law and there's a 60 page very dense presentation in your material that you know will put you to sleep very quickly, as I said, but even that distinction has been at question recently because a lot of the forward

contracts, which traditionally were supposed to cover actual delivery now (inaudible) the fact that they're just financial hedges. They're not traded, they're not futures but they do not contemplate many times actual delivery.

Then you have the repos basically the purchase agreements at the time of Longberg Wall what caused the shock in the market, those were all repos on government securities, they were overnight repos and when Longberg Wall failed this entire market froze and the concern was that how is the government going to continue fund itself when this market can freeze as a result of a failure or forbid dealer in these securities.

Bob Keach: Well and let's just freeze there for a second because I want to focus the issue a little bit. Again, just to frame the issue normally under the bankruptcy code the automatic stay prevents a creditor from moving on collateral opposed bankruptcy. Also under Section 365, if I am a counter party to a contract my other counter party files bankruptcy I'm unable to terminate that agreement so those are basic rules. The issue with classifying something as one of the protected derivatives is that those protections don't apply and to go to your original justification argument this is the original '82 problem.

The original concept as I understand it and the experts on the panel will correct me if I'm wrong, was that let's take that sort of open closed repo scenario. You had a middle person in the market who had a contract to sell securities to a third party. On the other side of the transaction it had a contract to buy securities from a party and the original contemplated problem was that if one of the two counter parties, either the buy or sell position filed for bankruptcy then the middle party is unable to acquire the securities that it intended to sell on the other side of it's position. So we created a safe harbor essentially to not let that happen. They would be able to go ahead and sell and not withstand the automatic stay, they'd be able to go terminate that contract, not withstanding 365. That was the original construct to prevent what you called market seizure correct?

Shmuel Vasser: Yes, correct and in fact those were really two of the main safe harbors plus one. The two main safe harbor which you mentioned generally speaking the exception from the automatic stay, both for termination of the contract and for sale of whatever that means they will issue, whether that means actual foreclosure on the collateral or not, but essentially, clearly you could terminate the contract and apply sell off. The other one is that IPSO factor closes as a coalary to that the 365 provision was fine and if the IPSO factor closes were enforceable to huge changes from the ordinary lease contract, anything else that we bankruptcy lawyer used to deal with. The third, important item although may be less important to the immediate functioning of the financial system was the protections from avoidance borrows, recovery of preferences and forging transfer is not permitted with the exception of actual (inaudible).

Bob Keach: Right, so to continue that point, not only could I terminate, not withstanding the usual operation of 365, I could terminate just because of the bankruptcy in that scenario?

Shmuel Vasser: Correct.

Bob Keach: If I had done all of this pre bankruptcy I'm also not at risk that any of my transactions will be subject to examination under the avoidance powers?

Shmuel Vasser: Correct.
Bob Keach: That's sort of the original idea. I want to talk a little bit about forward contracts just to illustrate the point and have you comment Shmuel. The other issue with forward contracts is forward contracts is generally a contract to sell a commodity into the future. So like electricity, I'm selling electricity to

somebody else who may be reselling it, I may be hedging my position in terms of who I'm buying my electricity from and again the idea was that I would be able to terminate that contract if bankruptcy filed so that I wouldn't be stuck with my hedging position behind with somebody not buying ahead. The problem as forwards as I understand to define the issue is how to distinguish them from typical supply contracts, correct?

Shmuel Vasser: Yes.

Bob Keach: Do you want to talk about that a bit?

Shmuel Vasser: Yes, that's a huge issue and I've been blamed, there's people blame me for many horrible things but I don't always take the industry point of view. I do think that, and I've been saying it publicly that the forward contract exception is actually very problematic. It's problematic because it's very, very poorly drafted. By the way as many of the other safe harbor position, as anybody will ever try to give advice to a client about them knows the forwards is so poorly drafted that in fact if a lot of people actually knew about that and that's by the way a question to why are we simulcasting this. It can actually be used to the exchange judges who let that happen and to eliminate a large portion of a bankruptcy code. Honestly it's very, very hard to distinguish between forward contract and a supply contract. It covers everything that is a commodity. Now it's another piece of lobbying trivia, everything in the US is a commodity except for onions. Apparently 1907...

Bob Keach: The onion law.

Shmuel Vasser: Yes when the Commodities Exchange Act was passed the onion growers did not want onions to be a commodity I have no idea why. Maybe Steve will write a paper about that? So everything is a commodity and as far as the duration of a forward contract the future delivery has to be just two days or more. So anybody in the audience who can basically write a laundry lease as a forward contract should probably leave the room right now.

Bob Keach: And I can see Steven just chomping at the bit but I want to set this up just a little bit more. Just to sort of illustrate the...

Shmuel Vasser: One point to go to you which is absolutely interesting because I think you mention it and then I'll let you speak I promise is that when you talk about power which is an issue you raised, it creates another issue that is just starting to filter in the courts very, very little but when you take these provisions in conjunction with the deregulation of the electricity industry in the late '80's or early '90's many corporate buyers are buying electricity based on what's called PSA, Power Supply Agreements. They're off the grid, they're not the same type that I have an agreement with Conrad or whatever supplies it's governed by, regulated by the PUC state and federal and has all the tariffs. It's a bilateral negotiate agreements and now when you file for bankruptcy these power suppliers come in and say terminate, 366 doesn't apply. Now way it can protect you.

Bob Keach: And it tells you something about the strength of the exception that enhanced 366 was considered inferior but being treated as a forward contract counterparty who could simply just terminate and that in fact happened. So that sets that part up and then one quick thing because I do want to set up what happened in Judge Sontchi's cases. Master repurchase agreements in the mortgage, particularly in the subprime mortgage industry, the way as I understand that that worked, and maybe this is a question for the Judge and for Shmuel as well, is that essentially what happened with the warehouse lenders and subprime lending who provided the money to essentially originate the loans, package them and sell them back was rather than setting that up as a simple secured transaction, I'll lend you some money, I'll take mortgage pools as collateral, what actually happened was they structured it as an arrangement as the mortgage pools were sold essentially to the warehouse lenders, was structured as a sale, i.e. with the debtor having the ability and I'm oversimplifying obviously but with the debtors having the ability to buy back what we might have considered in a different structure collateral, is that how I understand it?

Professor Stephen Lubben: Yes that's right. American Home for instance was in the business of originating mortgages and having originated them of course selling them, either as securitizations or as whole loan portfolios. To get the money for that they were given money or lent money if you will by the lenders. The loan was actually a sale so in the old days they would lend money and they would get a security interest on the originated mortgage. Now under a purchase agreement they sold the originated mortgages to the lender and the lender held it for up to 180 days and got a per diem interest rate. Once American Home was able to figure out how to package the deal, either to keep it or to securitize it or sell it as a whole loan they would buy back the mortgages from the repo lender and sell them and get cash and continue the cycle, so that was the change.

Bob Keach: And the benefit of setting it up as a repurchase agreement, one of these instruments within the safe harbors was that in the event of a default...

Professor Stephen Lubben: Right in the event of a default if the repo lender is holding it and declares it a fault the repo lender first they have to put it to the debtor and say you need to buy it back now. Well no debtor has the money to do that and the alternative I can liquidate it or I can take possession of it because in American Home for instance, most lenders didn't liquidate because the market was at such a low they decided to hold in hopes that it would go up in price. But the stay would not apply all the provisions that Shmuel talked about.

Bob Keach: So in bankruptcy terms the collateral just gets taken away, no benefit of the automatic stay, no benefit of the anti IPSO Facto provisions of the bankruptcy code. And Julia I want you to comment on this, but also I'll throw the question to you. This got worse in 2005 in some peoples minds, better if you're on the ISDA side of the table but I want in addition to commenting on what was just said why don't we talk a little bit about what happened in '05 to blossom this issue.

Julia Whitehead: I think the fact that this passed in 2005 is critical to what happened and there wasn't a lot of discussion about this, as the earlier panel said this was largely a consumer bill but I don't know if we had a lot of discussion at that time it really would have made a whole of difference. The reason was 2005 financial markets were great, innovation was fantastic. It would have been much more difficult to bring some of the arguments I feel that are out there today and repos are one of them.

So the whole genesis for the financial services part of this in the safe harbors really came from 1998 in long term capital management which as many of you may remember was a, at the time, large hedge fund with a lot of leverage positions across a lot of products and it was a lot of concern for the market what the effects of a failure of a larger counter party would do. Now in the case of long term capital management the major counter parties actually took over the firm, put in a lot of capital, sat through a year to wait for the positions to right themselves because when long term capital got in trouble a lot of people were suddenly against and in fact they did right themselves and the people who put in the money got their money back in a return.

That said, the industry as a whole was very concerned about the situation and was just waiting and waiting and waiting and lobbying and lobbying and lobbying to expand safe harbors because they wanted to be able to be in position to take their positions, take the marbles and go hope and BAPCPA presented that opportunity and what it was, was a very expansive act. I think you said this before there are maybe five categories within BAPCPA of products that are covered and each of those are expanded and I just want to talk about two of them.

One of them is repurchase agreements and as Shmuel eluded to the earliest problem with the repurchase market was in Longberg Wall and it was the treasury market, the government securities market. That for much of our history in financial services that was the repurchase markets, an incredibly important market. Most banks, most financial institutions they financed their government purchases through repurchase agreements, they may finance their balance sheets through that and it's important to the government as well. The federal reserve manages the money supply in part through repurchase agreements. So it's critical that market functions well.

The other thing that's important about the government securities market it is a huge market, it's very broad, it's very deep, it is very transparent and for a creditor to be on the other side of safe harbor position provision looking at these repurchase agreements being taken outside of the bankruptcy court, there's little concern that some value somehow is going to leach out of the estate because they're settled outside because the prices are available everywhere for everyone to see.

Extending that however in 2005 to things like mortgage related securities, maybe it seemed like a good idea at the time because again this was 2005, mortgages were good, mortgage backs were good, we hadn't really thought about most of us alt A and subprime let alone mortgage related by the way includes repos backed by CDO's and CDO squared and synthetic securities. Many of you may not know what those are but I know all of you know that there is a taint to a lot of those names right now, for a good reason.

These were new products that came out, many of them weren't tested, the structures weren't good, the assumptions were good and more importantly theses were very unlike the government securities market. These do not trade frequently, some of them don't trade at all, they're custom, they're designed by model, the assumptions that go into those models certainly have changed from the time that many of these were put together and it begs a lot of questions as to how a safe harbor that was originally designed for things like treasury securities works for collateral and for instruments that there may be a lot of disagreement on what the value is.

Bob Keach: So the big issue in '05 and then I'm going to hand this off to Judge Sontchi was we had an expansion of the numbers of transactions and the types of counter parties that were within these safe harbors, a massive expansion correct?

Julia Whitehead: Wholesale, yes.

Bob Keach: All right. And Judge Sontchi I want you to talk a little bit about American Home and what expanding this to the mortgage industry meant on the ground in most cases.

Judge Christopher Sontchi: What it meant was American Home was dead on arrival when it came into bankruptcy because it had lost completely all of its liquidity and they fired virtually everybody on August 3rd, they really started to get default notices like crazy on August 1st and by August 6th they were in bankruptcy. The only thing they really had, well they had some things that they actually owned, their biggest asset being the servicing portfolio or the servicing business. I think that's one of the things by the way that really distinguishes mortgages being used in a repo situation as opposed to treasuries or other type of securities which is mortgages you need somebody to service them. You need somebody to collect the mortgage payments, principle and interest, make sure the taxes get paid, make sure the place has hazard insurance, etcetera and then spit the money out to the various people who own the mortgage. That proved to be a very serious complication in American Home and I think ultimately what it does is it almost eliminates the whole point of the repo, which is liquidity because the old warehouse lenders don't have the liquidity that they thought they had anyway because they only way to actually get through the system is either to liquidate or excuse me, is either to litigate up front or take your risks and litigate on the back side. Calum Bank litigated on the front and Lehman litigated on the back and it's a bit of a difficult choice.

Bob Keach: But the effect in those cases was essentially with the activity up front, but just move the assets essentially outside the court except for arguments about peripheral issues like services.

Judge Christopher Sontchi: Yes and I would make the argument or pose a question as to whether it really matters. It comes down to a timing issue and it comes down to who controls the collateral, whether the debtor controls the collateral or whether the lender controls the collateral. Ultimately if the collateral goes down in value the unsecured claim of the lender goes up. If it goes up in value they get the benefit, in a lending situation they'd actually get some sort of adequate protection payment, maybe replacement liens. Interestingly they don't get that in a repo situation but of course they control whether to buy or sell.

Bob Keach: Okay Stephen I want to throw this to you, we've heard Shmuel talk about daisy chains and ripples in markets and these are things that are designed to make sure that markets did not freeze. You authored a paper for this panel at my request, thank you very much, that has a pretty simple title which is that the Safe Harbor Should be Repealed. Are we going to have daisy chain problems and market issues and so forth if that happens?

Professor Stephen Lubben: I'm glad I've been writing a long list here of things to talk about, but I think the most fundamental one is Shmuel talked about volatility and the daisy chain, those are the two core issues for the safe harbors but they're only relevant to the extent they effect systemic risk. The safe harbors as they're currently drafted are so much broader than you need to address systemic risk, systemic risk being the long term capital management fear that the world will end if a financial firm enters bankruptcy. The safe harbors also don't distinguish between hedging and speculation in swaps or any derivatives, they don't really distinguish between the user of the swaps or the airline who files for Chapter 11 with a bunch of fuel hedges loses all those fuel hedges, even though the airline should not have any systemic effects whatsoever obviously if it files for Chapter 11, yet those kind of contracts are subject to the safe harbor. So on the one hand they're too broad and then the other issue which I think Shmuel and I can go back and forth on a long time is whether if they were limited to financial firms do the safe harbors actually do anything to help with systemic risk.

I think there's an argument to be made, and I'm not the only one to make it a lot of academics have that actually the safe harbor increase systemic risk because you're basically telling everybody to run out and immediately close out their position and buy new positions upon a bankruptcy filing when it might be actually better to have that breathing room provided by the automatic stay.

Professor Stephen Lubben: I can say that I have a new case Capmark and what I was informed, I don't have any other information other than that on the first day of the case when I asked the question about whether derivatives or repos were involved is that they liquidated it was a planned filing, they in effect liquidated all their derivatives in the time leading up to the filing in order to avoid the whole problem of immediately losing all their liquidity. You and I had a conversation about that and that might not be the right thing to do because the pricing may not be good.

Judge Christopher Sontchi: Yes I mean if this were any other asset would we want to encourage the debtor to immediately go out and conduct a fire sale on the eve of bankruptcy right of any other asset. Now I know the counter to that is well this isn't any other asset. The question is, is there a narrower, more targeted way to address the systemic issues rather than have the safe harbors. In the paper for example I make the argument that on the volatility front rather than have safe harbors isn't the issue really one of adequate protection? If the collateral is extremely volatile what we need to do is update adequate protection to make it relevant to this kind of collateral, which means changing the bankruptcy code. So you're right to point out the title of my paper is Repeal the Safe Harbors but I'm going to avoid the fallacy that the first panel pointed out where you just make one legislative change and then act as though you don't have to do anything else at that point in time. I think what you need to do is repeal the safe harbors, along with a series of related changes to the best of your knowledge code.

Julia Whitehead: Just on that point about whether BAPCPA reduced systemic risk because of the extension of safe harbors, clearly it did not. I mean if anything I'm not a believer that Lehman was a single biggest factor in the credit crisis but it certainly didn't help. On top of the points that you mentioned I think this clear incentive to get collateral out of an estate before somebody files contributed to a lot of Lehman's liquidity drain and both Bear Stearns and Lehman I do believe they're executives were truly shocked by how fast that liquidity went out. But if you read the code and these are very concentrated markets and I thin BAPCPA had something to do with that.

The large players clearly read the code, clearly drafted their contract, in fact there were some new contracts really close to when Lehman filed before Lehman filed that sort of extended some of the abilities of the counter party to get their assets out of the estate under the master netting agreement. This agreement now that's part of the code where you can take all your exposures across all these protected products with a counterparty or even related counterparties and take them out of the estate and that definitely was an impact on Lehman and the value in terms of what went out of the estate, what was appropriate. You mentioned whether timing matters, it absolutely matters when you're dealing with a liquid market because Lehman's demise caused a lot of products to go down in price or in value against price and value are a little bit different things...

Judge Christopher Sontchi: I'm sorry to interrupt but my point on timing is it's not going to make any difference because the debtor isn't going to be in a position to recognize value unless the contract somehow gets above par, right?

Julia Whitehead: Well it depends, you've got contracts that are difficult to value, you've collateral that's difficult to value. Somewhere in that equation you know when you're valuing everything at the lowest point which is what happened with some of the collateral. They take some of the bad collateral and say it's I think in your case, they valued a low amount in their arguments whether that collateral should be valued higher or lower. But it's at a point in time if you wait a week, I don't know if you remember the Enron case at all, now that wasn't a bankruptcy but it was a hedge fund that traded in a lot of natural gas instruments and it went under and JP Morgan took over it's positions and 10 days later realized a three quarter of a billion dollar gain, which was great for JP Morgan, it bailed out their quarter.

You know if you have a little bit more time in bankruptcy you don't have the stress on the market, the concerns, the rumors, the ability to play against the party and I don't think any of that was considered in the code.

Judge Christopher Sontchi: Yes and just to be illustrative because it's not always exotic instruments like securities derivatives but let's take an example of a relatively straight forward contractual arrangement. If you talk about this in terms of subprime mortgages it's easy to say that markets collapsed and therefore it doesn't make any difference, but we had a fairly simple, middle market case involving fixed price, long term natural gas contracts being supplied to a cogen facility, so this is a major asset of the facility, they get to buy all this gas at fixed prices. Market prices going up tremendously, using the gas therefore to make electricity was a really bad idea so our end user stops using the gas and starts reselling the gas into the marketplace, thus capturing the margin between its fixed price and the market price on the gas.

We went from a supply agreement arguably to something that doesn't look so much like a supply agreement begins to look a little bit more like a forward at that point. We had litigation in that case whether this was a forward contract or not, and of course the battle there was were the counterparties going to get the benefit of the spread by cancelling the contract as a forward or was the estate going to get the benefit of the spread by keeping the contract as an executory contract. We won that one and we actually got a ruling in a Canadian court that it was not, I think Canada's term is eligible financial contract but rather than forward. That's sort of the battle isn't it, who get's the spread? I mean if we're in a market where there's no spread we could barely care, again if we're not just legislating for today but for tomorrow we're talking about who gets the spread. Isn't that what isn't that what this comes down to?

Shmuel Vasser: That's where we are now, question is whether we are where we should be. I think that goes to what Steve said and I totally agree with that, shockingly, is that I think we have...

Judge Christopher Sontchi: It's going to be boring if you guys just agree with each other all the time.

Shmuel Vasser: There are different areas that we need to talk about or the public discussion should be about. One is which is a valid point, I know where I come on it is whether or not safe harbor should be repealed, I think that's a separate issue assuming you have them what should they say and I think even Steve and I think it kind of changes his view in response to my paper but he doesn't say that. Steve came out with Repeal the Safe Harbor but when you read his papers, at least the way I read his paper, I don't think he really believes in repealing them. I think he believes that they are way too broad, as I do, and that they are not well drafted, as I do. I think we need to take it one step at a time and the first thing is do the safe harbor in a vacuum play an important role? I say yes, I can't prove it. I think I said it in my paper that there's no mathematical if you will or evidentially proof one way or another. The people are talking a daisy chain case...

Judge Christopher Sontchi: You mean about the market impact and having them or not having them?

Shmuel Vasser: Correct. The daisy chain camp says daisy chain, daisy chain, we have no empirical evidence to support it. The people who are against it say no daisy chain impact and they have no empirical evidence to support it so we don't know. Assuming that some people know what they're doing some of the time I assume that the FDIC, the various economic advisors to the President of the United States over time and SEC, various regulators, CFDC they all take the view that there is systemic risk. Okay I having absolutely no ability to judge that accept that. I think it also makes sense. If you really know how these markets work, which I don't, I kind of know but not really know you see the systemic risk embedded in the back to back nature of this transaction concentrated for the most part among few large intuitions. So there is a systemic risk.

Question is what do you need to protect this part of the systemic risk? I believe that your supply contract in that case should not be protected because it dose not pose systemic risk. I think when you protect a private LBO when two shareholders will (inaudible) but it's a security under the definition of the bankruptcy code, then there's no fraudulent transfer when the company fails a year later, although it was an LBO and if it was not subject to the safe harbor it would clearly be a fraudulent transfer. Now you see a transaction that has absolutely no impact on the market being protected. I think the real subject of discussion should be what do we protect?

Professor Stephen Lubben: I have to disagree, I don't think it's about who gets the spread and I can only speak with any experience in the mortgage repurchase arena but the issue if the alternative is a security position in the loans that are sitting at the debtor or a repurchase where you are holding the loans there will be a timing issue because of the automatic stay. But the debtor is not able to capture the upside of that arrangement because of the security interest. The spread will go to the party who owns the security, excuse me the party with the lien until that party is going to get paid in full. Indeed the risk you could argue, and I said this just a few moments ago that the secured party is better off because there's some protections if the collateral goes down in value that they would get other than them holding it. When we're talking about value...

Bob Keach: (Inaudible) adequate protection, you could adequately protect the downside movement in bankruptcy in ways that wouldn't happen outside.

Professor Stephen Lubben: My specific proposal in the paper is that maybe we should allow market to market collateral arrangements to continue through bankruptcy and put the burden on the debtor like we do with cash collateral to go to court and change them if those aren't appropriate and that's one way to have a narrowly tailored kind of solution the systemic risk issue.

To focus on Shmuel's point more specifically I think I agree with Julia that up until Lehman Brothers there was a sense of trust us we're experts and a great difference I think on the systemic risk issue to the FDIC and to ISDA and to other people. Now if you step back and think about it a little bit how could it be that it reduces systemic risk by basically forcing everybody to immediately jump out of a position and get into new positions upon a bankruptcy filing. I agree also that we're never going to be able to test this empirically so it's just a matter of ones intuitions, which is the more plausible story. It just seems heavily implausible that everybody jumping out of a position and then buying new positions upon a bankruptcy could have any positive benefits on the systemic side.

Another issue too is the bankruptcy code the right place to be addressing these systemic risk issues? Essentially what it seems like is we're providing an excuse for poor risk management in a lot of these safe harbors right? This gets back to kind of Rich's points in the morning panel. I'm sure every creditor would like to have some opt out of bankruptcy so that they don't have to deal with the consequences of what happens when somebody files for bankruptcy. Why I think we need to focus in more specifically why these contracts specifically, not just because they like it and it sounds like a nice idea, everybody would like to be out of bankruptcy if they could but then of course if you do that for everybody then you destroy the entire process.

Judge Christopher Sontchi: You were talking about liquidating the position, this goes back to a different issue but what was the alternative in a case, again I'm sorry about such as American Home if there had not been the liquidation of any of those repos on day one of that case, that case is still dead because American Home couldn't originate any new mortgages, American Home couldn't sell the mortgages they originated. Nobody was going to give them further credit to go out and originate mortgages their business is over. So why not turn over what value there may be, which is the pending mortgages to the people who will ultimately get the benefit of them anyway?

Professor Stephen Lubben: I don't think the case is dead right, the debtor I'll concede the debtor is dead. Same with Lehman Brothers right, investment banks probably can't operate after they file for bankruptcy because so much of their business is their reputation right and they destroyed that by filing for bankruptcy. The question is and maybe this goes back to who gets the spread or who gets the upside question. The question is who should get the value and the answer that I propose is usually you get more value out of keeping the debtor intact and selling it so I'm kind of proposing a 363 model.

Lehman Brothers would have gotten more value for its assets if it had a full derivatives portfolio to sell along with it's other assets. Same with American Home, if it could have sold its mortgage portfolio intact shortly after filing instead of just basically having the creditors pulling it apart. So the question is I think the 363 Sale model and then distributing the gains to everybody is more consistent with the idea of bankruptcy as opposed to basically allowing individual creditors to pull value out of the estate.

Julia Whitehead: I'm not so sure that financial firms can't be reorganized, I don't know if the reputation intact is as big as you say because I don't think they have such great reputations to start with. When you look at some of the things that happened since 2005 one of the things that BAPCPA did in the safe harbor is it actually promotes market, it promotes the growth of certain products because you're reducing your risk implicitly. People believe your risk is reduced if you've got the safe harbor provision. For example when CDO's came into safe harbor Bear Sterns financed half it's balance sheet with CDO's which turned out to be a very bad idea.

Similarly a lot of these liquid instruments that counter parties think they have this protection, they can grab it and take care of themselves, I think it does what you say. I think it sort of took the onus's of credit assessment, risk management and that's something we've really gotten away from and that's not something the code should be doing. It shouldn't be changing markets.

Bob Keach: Let's talk a little bit about distortive effects because I also want to talk about how this distorts things, not necessarily in financial institutions cases. I think one of the points I took out of the American Home mortgage trilogy is that essentially what had happened in the warehouse lending is they changed their loan documents to make them into master repurchase agreements arguably. These could have been collateralized transactions. Do we have a problem when the safe harbors are now driving the deal lawyers in non systemic risk cases to draft supply agreements as forwards and loan transactions as master repos. I mean doesn't that kind of distortive conduct suggest some level of over breath?

Shmuel Vasser: Absolutely. I mean a theme that I've taken from the prior panels and I actually thought it would be more interesting for us to comment on the earlier panels rather than even do this panel.

Bob Keach: You can do that too.

Shmuel Vasser: I think we're in a different environment now, not just because of the credit crunch but over the last decade or so, maybe more market participants became very sophisticated in bankruptcy and bankruptcy now is a money driven business. People actually make money by structuring products that get this treatment in bankruptcy or this treatment in bankruptcy. There's a whole industry whether it's Wall Street or beyond I think it's well beyond Wall Street where very smart people are coming out of business school and looking at how you can make money or make more money by using bankruptcy tool to impact or structure a transaction or impact your transaction.

So that should go back to legislation and regulation because that can't be these 1978 days where we dealt with a few big banks and secured lenders and everybody was like bankruptcy is a terrible thing if we get stuck in it we'll take our lumps but everything will be fine at the end of the day. Now people make money out of it, it's like the tax shelter industry where people actually read the code, they read the provisions and they think about what do we do now that we can do differently using that and as a result make more money?

Professor Stephen Lubben: Do you think that's a socially useful thing for people to be doing?

Judge Christopher Sontchi: But it's no different in bankruptcy than any other law.

Shmuel Vasser: Absolutely but I think we need to recognize that when we approach legislation and regulation we need to recognize that we're dealing with these sophisticated people and making money and therefore pay lobbyist to go to Congress and make sure that Congress preserves their way of life. So it's not as simple as arbitrage but it's really the focus that's on arbitrage and how much money people make out of it.

It started before, there are various decisions out there that a lot of people did not just pay attention to. There's a trilogy again of decisions in the 9th Circuit called Thrifty Oil. It's in the late '90's where if I summarize the facts for you, it's really undisputed that it was a loan. It was really undisputed. But the lender said you know what I can't syndicate this loan the way it is, I've got to document it as a swap and I said fine, do it as a swap. It doesn't matter we get the same terms do it as a swap. The document swapped, there was testimony before the bankruptcy judge that it was both intended as a loan but it was document swap. The bankruptcy court, the district court and the 9th Circuit Court of Appeal said sophisticated parties, that's the document to use safe harbor transaction.

So these issues are out there and it's part of our society. It's not just we can legislate it we need to recognize that it's out there in the way we approach how we treat these things.

Julia Whitehead: Yes, but I think one of the differences is you point out that there are very smart people who read the code and are able to profit from it, but that's not everybody. I work with a pension fund that has Lehman bonds and they had no clue what was going to come down, and neither apparently did the rating agencies because they were holding those bonds because of the ratings that were on them up until the very day they filed, or close to it.

What I think happened here was that this was such a massive expansion of the safe harbor provision without thought to what had changed the markets. And again as I said at the time 2005 I don't know you have a lot of people arguing against it but we certainly know now that some of these markets are very different than what we thought, they operate in different ways than the ones we were used to in 1978 and there are impacts that the safe harbor provisions have themselves on the market and how people play that are very dramatic. By the way you said that you don't think that there's any empirical evidence about how this effects systemic risk one way or the other. That may be true but for sure Morgan Stanley was going to go down, Meryl Lynch was going to go down and Goldman Sachs was going to go down and it's only because Meryl Lynch was bought and Morgan Stanly and Goldman Sachs became banks that they didn't.

Professor Stephen Lubben: And AIG really couldn't use Chapter 11 because of the safe harbor too right?

Julia Whitehead: Right.

Professor Stephen Lubben: It's antidotal evidence, right? We don't know what the alternate universe would have been with a different setup. I think ultimately the question is there's several issues here right? One is the over breath and we seem to be in agreement on that the safe harbors are too broad. And the question is what do you do with the systemically important group of companies that still, and there we debate whether or not the safe harbors help or hurt actually on the systemic issue.

Again I think it's an issue of is this something that should be addressed at the bankruptcy level. By the time the company collapses into bankruptcy usually the bankruptcy is just the realization event of something that went terribly wrong a lot earlier and people blame the financial crisis on the Lehman bankruptcy. Obviously by the time Lehman filed that Chapter 11 petition the damage had already been done. It didn't really matter whether they filed Chapter 11 or not at that point.

Bob Keach: You talk about the systemic risk issue and I don't want to steal thunder from tomorrows program on too big to fail but it's kind of interesting to me that in the Resolution Authority Bill introduced by the administration there's a reinstitution at least on a very short term basis on a stay against derivative provisions. In other words there's a small provision to the safe harbors I think there's a one day stay essentially. We could argue if that's enough but there's at least some recognition that maybe the safe harbors shouldn't operate even in the case of too big to fail financially.

Professor Stephen Lubben: Ironically it does nothing to address the issue of the current safe harbor of being too broad so that they encompass non systemically important debtors. I'm not a big fan of the resolution authority idea either just because again without getting too much in the other panel it seems to me like a lot of reinventing the wheel. It seems like to me again the issues with Chapter 11 are things like the safe harbors and if you actually address those then you wouldn't need to create a whole new separate authority.

Bob Keach: Let's take the time we have left and I'm going to ask the $64,000 question that we're asking all our panels more or less. You've got a free hand to write the legislation starting with Julia and going that way, what would you do with these things? If you could tell Congress what to do what would you do?

Judge Christopher Sontchi: Raise judicial salaries.

Bob Keach: Wait, you went out of order.

Julia Whitehead: I think he just wanted to make sure that I have my priorities straight.

Bob Keach: Within this topic what would you do?

Julia Whitehead: I think there is a use for safe harbors, I think for repos and government securities and that very narrow but very big example it makes a lot of sense. I think one of the problems with all the legislation was that it wasn't well thought out and so to say it should all be rolled back, knowing that a lot contracts and a lot of behavior has gone on since then just because of this it's a little bit scary for me, but maybe I'm just a cautious person. I certainly, and I think pretty much everybody here agrees, would want to see limitations and certainly some of the extensions repealed and at a minimum I would be looking at almost anything that was a liquid and trying to make sure we understood why we should have a safe harbor and what the consequences of safe harbor treatment meant to both the counterparties on both sides and to the actions of those markets as a whole.

Shmuel Vasser: Just in case I'm before a judge in the future, I support Judge Sontchi's idea. I think what needs to be done and probably can't be done but I'll say it anyway, I think Congress first needs to hire people who are unaffiliated and actually understand how the markets function. It doesn't help that you have the heads of Morgan Stanly and Goldman Sachs testify because these people are biased. They need to get sophisticated advice on how the markets actually work because if you don't understand how they work you'll never be able to deal with them.

When you've done that I think you need to look at the type of institutions that should be protected. For example, broker dealers are not eligible for Chapter 11, they can file only for Chapter 7 so when people talk about Lehman Brothers focus on the fact that their main unit, LBI Lehman Brothers Inc not eligible for Chapter 11, you can't reorganize it and there's a reason for that. So you need to focus on the type of institutions that should be protected, the type of behavior in which they engage that should be protected and narrow the markets in which protection should be extended to.

Judge Christopher Sontchi: Being cautious, I think Steve really hit a real key issue here which is the way the code is currently drafted it encourages a race to the assets by creditors. Generally the whole point of Chapter 11 and the automatic stay is to avoid that. I think one of the things you have to do if you're thinking about changing the law is think about the economic problem you're trying to solve and how does it fit into what we're trying to do and what we're not trying to do under the bankruptcy code. Ultimately in a liquidation it may not matter, it depends and I think you raised a good point about the ability to sell Lehman with it's portfolio or American Home with its portfolio as opposed to without its portfolio.

The problem of course is generally when these issues arise it's because of just huge market problems, perhaps even dysfunctional markets. I'm not sure there's anything you can do and I would be cautious about changing the law to address a problem which hopefully is a once in a generational problem.

The only other thing I'd say is I think the continued expansion of safe harbor to other types of contracts, other types of securities is a mistake. They become very difficult to figure, to reconcile with the statute and in fact, because of that they defeat the entire purpose, which is to preserve liquidity.

Professor Stephen Lubben: To some extent I've already stated what my idea is but I think the fundamental problem is that we moved from in the early days the safe harbors protected a situation where we had some sort of counter party in the middle of a transaction that needed to be protected. Somehow we slipped away from that and got to the point where now we're protecting what looked like regular bilateral contracts right from the effects of the bankruptcy code.

And the definitions are so broad, we haven't really touched on it we talked about specific definitions but there's a question about whether you even need the definition of forward contract just like swap covers everything now right? So the breadth of the definitions cover the original justification with systemic risk but now we have a breadth of definitions that's so broad it covers essentially every debtor, even if they're not systemically important. Again at the very least you need to narrow the definitions in a different paper I took a more modest argument and basically argued that we should not apply safe harbors anymore to non financial firms, because in those cases the derivative contracts are usually part of going concern value because they're hedges in most cases.

In this paper I'm a little more aggressive because I was asked to be a little more aggressive but I think it's really true that the safe harbors, even as applied to financial firms are overbroad, what we need to do is go back and look at the specific issues, like issues of adequate protection. Maybe allow market to market collateral to go forward and maybe 507B is not sufficient for current lending purposes because it's not enough left to pay that kind of a priority anymore these days with all the DIP lending that goes on, but have more targeted specific things rather than just saying you're out of the bankruptcy code you don't have to worry about it anymore.

Bob Keach: Quickly with the time we have left, any questions from the audience? I will ask if you do have a question just step down to the mic so that we can benefit those people who are on the webcast. Seeing none, hungry crowd. Let me first thank the panel very much, appreciate it. Your free lunch is directly across the street, there is a free lunch, even in this town at the Washington Court Hotel. We'd ask you to go directly there, we'll have lunch and then we'll have the rare opportunity to listen to Harvey Miller talk about the issues we're all facing in this panel. See you at lunch, thank you.

END OF TRANSCRIPT

"Symposium on the Past, Present & Future
Of US Corporate Restructuring"
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ABI

CHAPTER 11 - AT THE CROSSROADS:

DOES REORGANIZATION NEED REFORM?

"SYMPOSIUM ON THE PAST, PRESENT & FUTURE

OF CORPORATE RESTRUCTURING"

(Audio File 1004)

"Symposium on the Past, Present & Future
Of US Corporate Restructuring"
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MODERATOR: **Robert Keach, President, ABI**

KEYNOTE SPEAKER: **Harvey Miller, Weil, Gotshal & Manges**

(Inaudible) = Areas that could not be heard due to poor audio quality, background noise, quiet/stifled speaking, etc.

Bob Keach: Our next speaker I think provides a unique opportunity for all of us. Our special speaker needs almost no introduction beyond simply referring to him as the most prominent bankruptcy professional of our time. Harvey Miller is, as we all know a partner at Weil, Gotshal & Manges in New York where he's been a member of the firms management committee for over 25 years and he created and developed the firm's Business Finance and Restructuring Department, specializing in reorganizing distressed business entities.

For years when the major US corporations have considered bankruptcy as an option their next thought has been to make sure that Harvey was available. Regardless of the industry, whether it's manufacturing, retail, technology, energy, airlines, you name it, companies have sought Harvey's counsel on the path ahead and a way out of bankruptcy.

He is in fact the debtors counsel for many of the matters we have been talking about today and we'll talk about today and tomorrow including General Motors and Lehman Brothers. The breadth and depth of Harvey's lifetime of experiences in this business make him uniquely suited to assess the past, present and future of corporate restructuring in America and without any further delay it's my great pleasure to introduce Harvey Miller.

Harvey Miller: Thank you very much Bob, and good afternoon. It's a great pleasure for me and a privilege to have the opportunity to speak to you this afternoon. Being a keynote speaker, especially post luncheon is not the easiest position to occupy, particularly after listening to the last two panels. I sort of feel like Elizabeth Taylor's seventh husband on the first night of their honeymoon, I know what I have to do, but can I make it interesting. Don't take that literally.

Indeed as I look out on this audience I commiserate with you. It reminds me of a dinner I attended several years ago in the city at which a large group of persons were being honored. As is sometimes normal in the Capital there was a substantial amount of drinking as people appeared to be bracing themselves for sitting through the speech of the keynote speaker. The podium was set on the table, to the right of the podium was a very respected president of the organization sponsoring the dinner. The keynote speaker was introduced and he began his speech. As he droned on in a almost monotone on the state of frogs as an endangered species it became clear that the sponsor was distraught and was working his way through a bottle of vodka.

Things weren't going well and a sponsor in the audience became more agitated as the speaker went on. Finally the sponsor picked up the vodka bottle, waved it around his head and threw it at the speaker, he missed. The bottle hit the chairman of the dinner who was sitting on the other side of the podium. The chairman went down with blood streaming above his right eye. The sponsor dropped to the floor to assist the chairman and express his deep apologies. The dazed chairman looked up and mumbled to his assailant please do it again, I can still hear the son of a bitch.

Fortunately I'm told it was a non alcoholic lunch so I will move forward without fear with my address. First a caveat, whatever I may say in the next 20 minutes is not quotable. If the occasion should arise I will deny I said it. When I was a young attorney I wrote a law review article, a year or so later I was arguing a case in the court of appeals and after I finished my argument my adversary, a very good friend, got up and said to the court frankly your honors, I don't understand how Mr. Miller can make these arguments in light of his recent law review article.

I immediately thought of something I had learned listening to an appellate argument in the 2nd Circuit. It was a securities case, the plaintiff was represented by Professor Lewis Loss, then the outstanding securities law expert from the Harvard Law School. The presiding judge was Henry Friendly, a graduate of Harvard Law School and a great friend of Professor Loss. After listening to Professor Loss's argument Judge Friendly looked down from the bench and said Professor Loss you have me at a loss. Everything you have argued is diametrically opposed and contrary to everything you said in your most recent law review article. Professor Loss looked up and said Judge Friendly I want you to know that I think much more clearly when I get paid for it. Frankly, I did not have the audacity to say that to the court and I struggled through but the rule now prevails, I am speaking freely.

Second there was no assigned topic and I have groped for an appropriate subject. I thought it might be interesting to say a few words about what I call the panic of 2008 and a aspect of its consequences. In that connection I read the other day that when asked by a Congressional committee to explain what caused the collapse of the financial work M&N Bank had testified that banks were too ready to loan, too ready to meet the competition of their neighbors, too willing to cut down their margins to the point of encouraging excessive barging and borrowing. That testimony was given in the early 1930's by the then CEO of First National City Bank, which thereafter became Citibank and then Citigroup. It demonstrates that the more things change the more they remain the same. As Yogi Barrera said, it's déjà vue all over again.

So was the panic of 2008 clearly predictable? During much of the 18 years that Alan Greenspan was the chairman of the Federal Reserve Bank we lived in the world of Ayn Rand. The free market was the ideal, all of the regulatory reforms that were adopted after the Great Depression of the 1930's were denigrated and contracted. The underlying philosophy was that a free market is a perfect market and that in a self governing market one may rely upon the self interest of financial institutions and their managements to regulate excessiveness and to provide sufficient resiliency that in turn would provide sufficient liquidity for the market.

Mr. Greenspan endorsed that concept, that the management of financial institutions was asked an essential moral integrity that safeguarded the public interest. I guess he meant that the financial compensation and perks management awarded itself demonstrated a higher public responsibility, a rather panglossian view of the world. In any event at the speech at the end of his reign as fed chairman at a conference in this building Mr. Greenspan boldly stated that in his 18 years as chairman there were no recessions and that peytonly confirmed the validity of it's economic theories.

I am not quite sure what 18 years Mr. Greenspan was referring to, for I have a vivid memory of a number of recessions which occurred during the period 1987 to 2006. But then again, considering the events over the last three years can you rely upon anything an economist states as an absolute fact, after all they predicted nine of the last four recessions.

Of course we all remember Mr. Greenspan's congressional testimony in October of 2008 when he stated the events of September shocked him and it made him realize that what he had been preaching for all those years seemed to be wrong. So putting Ayn Rand aside, the moral integrity of financial institutions and their managements did not prevent the evils described by Mr. Greenspan or provide the requisite resiliency to avoid a market collapse. Rather non bank financial holding companies were allowed to achieve leverage ratios of 30:1. Long term investments were fueled with short term credit on the premise that easy credit would be a constant. Money was cheap and no cav or cav like financing prevailed. Trading the proprietary positions became the rasion detra of the giant investment firms. Risk analysis virtually disappeared as the institutions bought into the theory that if they didn't like the particular position they could always sell it in an ever resilient market. In other words, there would always be a greater fool out there.

Unfortunately in the spring of 2008 they found out the market really wasn't so resilient and worse, if the position was sold at a distressed price they would be caught in the web of market to market requirements that could and might exacerbate their capital positions.

It became clear that it might be better to hold the position, value them internally and not reveal the weakness of the portfolio. And so cracks in the bubble began to form, but that can't go on forever and finally the credit boom bubble burst and now we are trying to deal with the consequences, as well as to devise a means to deal with similar situations, should they arise in the future.

As we sit here today in the halls of Congress consideration is ongoing as to the construction of a new resolution regime. The word regime, there's something going on in this government about czars and regimes. Allegedly to deal with this systemically dangerous circumstances that might result in the distress and failure of a non bank financial holding company it is entitled the resolution authority, the Large Interconnected Financial Companies Act of 2009. The activities in Congress precipitated by the panic of 2008 have been aggravated by the views of certain parties in groups resulting from the bail outs of Bear Stearns, AIG, Washington Mutual and others as well as the conservatorships of Fannie May and Freddy Mack which have cost federal taxpayers billions and billions of dollars.

Likewise, the bankruptcy of Lehman Brothers and the joyful rides of GM and Chrysler through the bankruptcy court have generated substantial discussion and some degree of criticism.

Although the financial debacle of 2008 was clearly predictable and should have been recognized by the regulators, as late as April 2008 the chairman of the Federal Reserve Bank was attempting to console the market by announcing that the subprime crisis was fully contained. It wasn't, it was growing it was effecting the entire globe. Air was leaking out of the bubble and it all came home to roost with the argument of moral hazard being applied to Lehman Brothers. Remember the Treasury had taken a high level of criticism with the bailout of Bear Stearns, which Secretary Paulson initially opposed and against his economic views he approved the conservatorships of Fannie May and Freddie Mack on or about September 6th, 2008.

Just about a week later while Mr. Paulson was feeling extremely sensitive Lehman grew into a gigantic problem, a problem for which he had little empathy. As a result the decision was made to let Lehman go. In fact the Treasury, the Federal Reserve Bank and the SEC basically directed Lehman to immediately initiate a bankruptcy case before 12:00 midnight on September 14, 2008. It was sort of an impossible idit, there wasn't a single piece of paper prepared as of 2:00 in the afternoon on September 14. it wasn't until 2:00 A.M. that the worlds largest bankruptcy case was filed on a set of the most minimal papers you could imagine.

The regulators failed, or perhaps refused to acknowledge the dire consequences to the economy that wouldn't be precipitated by a Lehman failure. I guess they bought into Shum Peter's economic theory of creative destruction as a basic element of capitalism. In other words they may have thought that the failure of

Lehman would soon be forgotten as other entities rush into the space vacated by Lehman.

I can think of no greater misjudgment than the decision that was made by those regulators as to Lehman. I could go on on this subject for quite some time, but I understand there's a wedding scheduled for this room tonight. That was (inaudible) the luncheon, so I'll move on.

What I want to talk about is the resolution regime. After Lehman's foray into bankruptcy the Treasury Secretary claimed the government did not have the tools to deal with Lehman. Curiously he found no problem the following day to pour 85 billion dollars into AIG, a good portion of which went to Goldman Sachs. Be that as it may, the actions of the Treasury Department and the Federal Reserve during that period of time and Treasury's subsequent demand of Congress for the unqualified right to access and use 800 billion dollars, without any accountability as framed in a two and a half page proposed statute that was defeated by Congress but had the effect of substantially infuriating Congress as led to the consideration of a new resolution regime. This is being considered by the House Committee on Financial Services, the Judiciary Subcommittee on Commercial and Administrative Law and the Senate Banking Committee.

In a statement dated October 1, 2009 submitted to the Committee on Financial Services, Chairman Bernanke in support of the proposed resolution regime for failing systemically important financial firm stated in most cases the federal bankruptcy laws provide an appropriate framework for the resolution of non bank financial institutions. However the bankruptcy code does not sufficiently protect the public strong interest in insuring the orderly resolution of a non bank financial firm who's failure would pose substantial risks to the financial system and the economy.

Indeed after the Lehman Brothers and AIG experiences there was little doubt that we need a third option between the choices of bankruptcy and bailout for such firms. Chairman Bernanke and the Treasury Department to the best of my knowledge have not elaborated on the experiences referred to in his submission that has led to the conclusion that the financial distress of a non bank financial holding company presents only two options, bankruptcy or bailout both of which are inadequate and I guess unacceptable.

Chairman Bernanke does not define what is a non bank financial holding company. Would GM or Chrysler fit within that definition? He doesn't define which entities would be identified as posing potential systemic risks. He fails to recognize that bailout is a noun that has many meanings and does not necessarily encompass the satisfaction of the claims of all creditors and equity interest holders.

It is a major underpinning of the proposed legislation that creditors and equity holders must bear the cost of any failure of the entity. Obviously the Treasury Department bears scars from the bailout of Bear Stearns and others. Congress intent that bailouts with the use of federal taxpayer money never happens again. The sentiment is that there it is necessary to establish that there is no such thing as too big to fail. I would just note at this point in connection with Lehman Brothers there is not one dollar of federal money being used in any way in the Lehman case.

The issue that should be of interest to this audience is the conclusion to the new resolution regime proponents that the bankruptcy code and the bankruptcy court can not handle the failure of a large, non bank financial holding company. The version of the legislation I reviewed I believe incorporates two concepts. First a regulatory scheme that would have a responsibility of overseeing organizations that could precipitate dangerous systemic consequences if they failed. However there is nothing in the statute that defines how to determine whether a particular entity is a systemically dangerous operation.

I assume that the objective of the new regulatory scheme is the overhaul of competing regulators and filling in the gaps in such regulations to enhance early detection of distress and the potentiality of failure. Authority to take action would be vested in a proposed Financial Services Oversight Council. The membership of the council would include one, the Secretary of the Treasury who shall serve as Chairman; two, the Chairman of the Board of Governors of the Federal Reserve System; three, the Director of the National Banks Supervisor, a newly created federal government agency that will be responsible for fraudential supervision and regulation of all federally charted depository institutions and all federal branches and agencies of foreign banks. Four, the Director of the Consumer Finical Protection Agency a newly created agency; five, the Chairman of Obscurities and Exchange Commission; six, the Chairman of the Commodities Trading Commission; seven, the Chairman of the Federal Deposit Insurance Corporation; and eight, the Director of the Federal Housing Finance Agency. Just imagine the debates within that council, and they don't even have an odd number.

The staff of the New Resolution Regime would be housed in Treasury. I'm not sure how the council would operate but I doubt it would be easy to reach consensus with such high powered persons. This aspect of the proposal the clean up regulation require higher capital reserves and early detection are all good and desirable.

The second aspect of the proposed legislation is intended to deal with the administration of the failure of the systemically challenging entity once it occurs. It is substantially flawed. It contemplates that such administration would not be in the bankruptcy court but rather conducted by the FDIC either as a conservator or as a receiver. The choice would be made by the council with any kind of judicial oversight or transparency. At the time that council determines that failure is imminent the FDIC much like a predatory bird would be authorized to swoop in and take full control of the entity. The FDIC would be vested with the most comprehensive and complete powers that may be imagined, it would be the dictator in possession. There would be no public hearings and no required transparency. The FDIC in its discretion would decide on all issues relating to the administration and disposition of the debtors assets and liabilities without any required hearings or public access. Assumption and rejection of contracts including in many instances structured investment vehicles or derivatives and litigations of all kind would be in the complete discretion of the FDIC as receiver.

The proposal is predicated on the supposed expertise of the FDIC and its allegedly brilliant history in dealing with distressed banks. I believe the record after the performance of the FDIC is not demonstrative of a good history. For a good portion of its history the FDIC was largely passive. In those years when it was not especially passive it's activities were mostly limited to dealing with small and medium sized banks to protect the beneficiaries of its insurance program, the banks depositors.

How does that experience convert into the administration of a complex global business such as that which Lehman conducted prior to September 15th, 2008? The FDIC recording in the banking crisis that engulfed Texas in the early 1990's is not stellar, the results were mixed.

The FDIC acts more like an insurance company, anxious to deny coverage whenever possible so as to preserve its insurance fund. That may not be the right mindset in connection with the debtor whose failure might trigger a panic. Transferring depositor accounts over a weekend to another FDIC insured bank is not the same as dealing with billions of dollars of global transactions represented by esoteric securities as well as the investments that are peculiar to a non bank financial holding company.

Non bank financial holding companies engage in many different and complicated lines of business. I am fairly certain that the FDIC never had to deal with the issue of unwinding esoteric derivatives contracts. In the case of Lehman there were over 930,000 derivative contracts in existence at the time of the commencement of the bankruptcy case. Within 24 hours Lehman was swamped by counterparties serving notices of default and notices of termination under the prevailing ISDA contracts. Because of the safe harbor provisions in the bankruptcy code Lehman was the hostage of the counterparties.

The swing in values may range from 40 to 70 billion dollars. Lehman and the bankruptcy court were helpless in the face of the counterparties onslaught. Under the proposed resolution regime concept as I understand it and it may be changing as the proposal winds its way through Congress, the FDIC as receiver may suspend the effect of the safe harbor provisions for a short period of time, 24 hours to three days. How will the FDIC deal with those derivatives in the face of its total lack of experience.

Likewise the FDIC has no experience in international insolvency situations. Absent of global agreement how would the FDIC deal with the commencement of the insolvency proceedings all over the globe, given its insular experience?

Lehman has generated 80 insolvency proceedings in jurisdictions throughout the world. Yes the FDIC could hire additional personnel and the services of turn around services, just like the bankruptcy court approves but we have a system in place that is experienced, capable and adequate. It has demonstrated competence, resiliency and the necessary flexibility to meet the needs of the particular situation within the framework of the bankruptcy code in the bright glare of full transparency.

So what is wrong about the bankruptcy code and the bankruptcy courts and why would they be inadequate to deal with the failure and collapse of a non bank holding company? The bankruptcy code has been in effect for over 30 years. Bankruptcy courts have demonstrated a facility and exceptional ability to deal with the most difficult and complex issues that may arise in the world of finance, commercial law, financial distress, insolvency and liquidation. How a bankruptcy court regularly deals with situations which were not contemplated in connection with the adoption of the bankruptcy reform act of 1978. Indeed mass tort cases were not within the contemplation of Congress in 1978, that did not stop the bankruptcy court from applying its expertise, perseverance and dedication to finding the ways and the means to deal with the consequence of mega tort cases.

We are all fortunate in having bankruptcy judges with outstanding ability and intellectual powers to construe the bankruptcy code to meet the demands of an ever changing world to best serve the general interest of the economic stake holders and the interest of the nation. The bankruptcy court is the people's court. More people attend hearings in the bankruptcy court than in all other federal courts. It is an accessible court for all and a court in which all proceedings are public and transparent. It represents an enormous contrast to what is proposed under the resolution regime legislation.

The only complaint about the bankruptcy code and courts that I have heard from the Treasury and the FDIC is the bankruptcy process is too slow, laborious and procedurally demanding and it involves too many parties and interests. Frankly I'm somewhat astounded by the accusation of the inability on the part of the bankruptcy court to act expeditiously and decisively to deal with imperative issues.

Let us look at three examples of how bankruptcy courts reacted to categorically imperative situations. Lehman had a traditional holding company structure. One of its primary divisions was Lehman Brothers Inc. a registered broker dealer. LBI as a broker dealer with public customers was not qualified to commence a Chapter 11 case, it's alternatives were Chapter 7 or a proceeding under the Securities Investor Protection Act. However a good portion of Lehman's assets in its customer accounts were in LBI. During the morning of September 15 and for a day there after Lehman negotiated a sale of it's North American capital markets business, essentially the business of LBI to Barclay's Capital Inc. One of the major problems was how to effect the transfer of the broker dealers assets to Barclay's which was the foundation piece of the sale. LBI was still functioning on Monday, September 15th pursuant to an understanding with a New York Federal Reserve Bank.

To effectuate the negotiated sale we had to figure out how to include the broker dealers assets in the sale as Barclay's would not agree to any sale without protection against potential fraudulent transfer litigation. As a financial organization the business of Lehman and it's broker dealer subsidiary were extremely sensitive to market forces and potentially a severe and sharp meltdown. Barclay's was very concerned about time, Lehman's customers were concerned about time. Barclay's required a sale approval within five days.

On Tuesday, September 16th a motion was filed with the bankruptcy court to approve sale procedures and set a sale approval hearing for Friday, September 19th. Despite objections and taking into account the urgency and sensitivity of the situation the bankruptcy court reacted expeditiously and set the sale procedure hearing for Wednesday, September 17th.

Again the avalanche of objections could have been deemed overwhelming. The hearing to consider the sale procedures commenced in mid afternoon of September 17th and went on until almost 9:00 P.M. that night essentially without a break. At the end of the hearing the bankruptcy court approved the sale procedures as necessary and because the only alternative was a complete meltdown.

The sale approval hearing started on Friday, September 19th at approximately 4:00 P.M. Once again the avalanche of objections both oral and in writing continued until the opening of the hearing and indeed after the commencement of the hearing.

Judge Peck kept the hearing in session through midnight of that day, again without a break. Bankruptcy judges don't seem to eat. All objectors were given the opportunity to present their objections and after the close of the evidentiary hearing and closing arguments at approximately 12:01 A.M. Judge Peck issued his decision approving the sale. I can not really describe the emotion in the courtroom. There were three packed courtrooms, no one left the courtrooms during all of that time. At the conclusion of the reading of his decision and for the first time in my career, which has been rather wrong, the entire courtroom audience rose up and applauded the judge as he stepped down from the bench, it was like a Broadway show.

What had happened in the space of less than one week, a bankruptcy court acted with expedition, extraordinary skill and dedication to meet the needs that had to be served. The cases of Chrysler and GM, likewise, have demonstrated the inherent ability of bankruptcy courts to deal with extraordinary situations and decide them within the constraints imposed. Chrysler took 43 days and GM 40 days.

In the circumstances that prevailed the need for speed was recognized by the court and was demonstrated over and over again. All objectors were given full opportunity to present their cases. In each of Chrysler and GM there were extended evidentiary hearings on an expedited basis with full access to the public. How can anyone say the bankruptcy court is too slow to take effective action to resolve critical problems? Why isn't the current process and proposed pre arranged Chapter 11 case of CIT Group Inc, a template demonstrating the effective way to use the bankruptcy court and the code to deal with the potential collapse of a financial organization?

While there may be many complaints about Lehman, General Motors and Chrysler those proceedings and the sales approved in those cases were accomplished in the full light of day, with complete transparency, transparency insisted upon by the bankruptcy court. There was full access for the public and the economic stakeholders, there was a full right of judicial review and indeed such review was taken right up to a motion for a stay in the Supreme Court of the United States, all within 90 days.

Compare that to the non public executory decisions that can only be challenged under the regime under the Administrative Procedures Act or in a (inaudible) action in the District Court. When all of these issues concerning the administration and failure under the proposed Resolution Regime Legislation are presented to the Treasury and the FDIC they are dismissive. Basically the answer that comes back is we know what we are doing, trust us. I have to say that's a bit hard to take. Trust was given through 2008, what did it lead to? It was Armageddon. It brought this country to the edge of a capital D depression. There may be many complaints about the current administrations in dealing with the economy but I believe that the great preponderants of knowledgeable people believe that without the stimulus program we would now be in a depression equal too or greater than the so called Great Depression of the 1930's.

There has been no case made that the bankruptcy court is inadequate to deal with the failure of any entity including non bank financial holding companies. To discard a court that has demonstrated extreme competence and ability and create another bureaucracy in the executive department from my perspective is sheer madness.

Of course the bankruptcy court is not perfect, few things in this world are. However with a few amendments to deal with the safe harbor provisions that primarily were included in the 2005 amendments and some of the clawbacks of debtor protections that were part of the amendments of the code going back to 1984 we can improve the code so that it can provide the means to more comprehensively serve the national interest. In that connection there must be an effort to restore to the bankruptcy court the discretion to deal with particular issues and problems that it must resolve. No statute can cover every probably situation. Bankruptcy and reorganization cases are very often fact driven.
To paraphrase Leonard Hand the bankruptcy code should not be a document to embalm the habits of 1978, it should not be a straight jacket of rigid rules, but rather a charter to deal with ever changing economic and human situations with appropriate discretion invested in the court to implement the philosophy and objectives of the law.

It's time to conclude. I will leave you with two thoughts that appear applicable to what is going on. One, there is always and easy, simple solution for every problem. Neat, plausible and wrong. To transfer business failures from the administration by bankruptcy courts to the regime is just wrong. Finally, as John Adams said, I have come to the conclusion that one useless man is a disgrace, two are a law firm and three are called Congress. Thank you for your attention.

Bob Keach: That concludes our luncheon remarks, we're going to transition directly to our labor panel so give us about two minutes and we'll get started. Thank you very much.

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CHAPTER 11 - AT THE CROSSROADS:

DOES REORGANIZATION NEED REFORM?

"SYMPOSIUM ON THE PAST, PRESENT & FUTURE

OF CORPORATE RESTRUCTURING"

(Audio File 1006b)

"Symposium on the Past, Present & Future
Of US Corporate Restructuring"
(Audio File 1006b)

MODERATOR: **Melissa Kibler Knoll, Senior Managing Director, Mesirow Financial Consulting**

PANEL:
Jack Butler, Partner, Skadden, Arps, Slate, Meagher & Flom
Steven Golick, Partner, Osler, Hoskin & Harcourt
Charles Tabb, Professor, University of Illinois College of Law
Clifford White, Director, Executive Office for U.S. Trustees
Bettina Whyte, Chairman of the Advisory Board, Bridge Associates

(Inaudible) = Areas that could not be heard due to poor audio quality, background noise, quiet/stifled speaking, etc.

Melissa Kibler Knoll: In order to keep things moving, we're going to start now. Let me go through a couple of administrative matters, briefly. Excuse me. We're going to start now. Thank you.

Administrative matters, briefly. We do have a reception this evening, immediately following this program. We hope you'll join us for that. That's out in the foyer as soon as we finish the panel. Also, tomorrow morning, we hope you will join us for the second half-day of this program. We start at 8:45 tomorrow morning. There's continental breakfast at 8:00.

So now, moving on to our last panel of the day, this panel is, "Who Should Run the Chapter 11? The Future of the DIP Model, CROs, Trustees, Monitors, Committees and Beyond," all in one hour.

Actually, I'm going to stop myself from making Bob's mistake, and I will introduce our panelists. To my immediate right, Jack Butler, from Skadden, Arps, Slate, Meagher & Flom in Chicago. To his right, Steven Golick, with Osler, Hoskin & Harcourt in Toronto. Professor Charles Tabb from the University of Illinois College of Law in Champaign. Then, to his right, Clifford White, Director of the

Executive Office for U.S. Trustees in Washington, D.C. And finally, Bettina Whyte from Bridge Associates in New York.

We've heard from a lot of panels today that Chapter 11 has changed a lot since the enactment of the 1978 code. The financial markets have changed. The players have changed. We've had a proliferation of distressed investing and claims trading, radical changes in the composition of secured lending syndicates, including their dominance by hedge funds and other non-traditional investors, evolution in the composition of statutory committees, and constantly changing capital structures fueled by complex financial products.

Bankruptcy has also become more transactional, moving from a bootstrap, stand-alone reorganization process to one in which sales of substantially all assets outside of a plan of reorganization have become commonplace. One can turn on the news and hear the terms 363 sale or pre-PAC. And our bankruptcy law has evolved and adapted through these changes. Or has it?

The question we're going to explore in this panel is whether our current debtor in possession model is truly serving the needs of today's constituents, or whether we should look either to past models, new models, or even other countries, in order to devise a bankruptcy process that is better suited to meet tomorrow's challenges.

The 1978 Code was built on the model of a reorganization being pursued by a debtor in possession, balanced by a vibrant, well-represented creditor's committee consisting of present and presumably future creditors who have an interest in seeing the debtor reorganize, either to have a customer to sell to or to liquidate otherwise illiquid claims.

Given the changes in the market, though, Jack, can you address, does this model still have functionality?

<u>Jack Butler:</u> I think it does. And in fact, I think the question, when you talk about who should operate a Chapter 11 case, I think you have to figure out what fiduciary do you want to do it? That's really what the subject's about.

And from my perspective, using traditional state law fiduciaries that are governed by state law, that are schooled in and responsible for carrying out the fiduciary responsibilities imposed by applicable state law is, in fact, the right cornerstone to the system, provided there are checks and balances.

And the whole point of a code, and the amendments that have been made since 1978, has been to provide those check and balances. So whether it's statutory committees or oversight from the U.S. Trustee, the powers given to the Bankruptcy Judge, herself, in connection with 105 and case management, the ability to bring motions for Examiners or Trustees, and a whole series of others, checks and balances, there are many opportunities in a Chapter 11 case to either curtail or remove the state law fiduciary if that's the right thing to do.

But we shouldn't forget that it's a state law fiduciary that's in place. Opponents to the current system talk about entrenched management. What you really have here are the appropriate representatives of a company based under applicable state law. Delaware, New York, whatever the state law that may be prevailing.

And just as bankruptcy judges look to a state law for contract law, they look to state law for how to interpret secured financing arrangements and the law of collateral, in many cases, for fraudulent conveyance law, and a whole series of other kinds of state law.

So do they and should they be holding people up to the standards under applicable state law as it relates to fiduciary?

So I am a proponent and believe in a system where officers and directors, at the first instance, with appropriate oversight are, in fact, governing the Chapter 11 case.

Melissa Kibler Knoll: Jack, as we walk through the Chapter 11 process, though, doesn't it at some points in time, and particularly when you get to the plan process, does the debtor in possession wear too many hats? One might argue that when you're trying to maximize assets and preserve assets, that they can balance that fiduciary duty.

But particularly when you're negotiating a plan, some would say there's really an inherent conflict where they can't act as a fiduciary for all of the various parties that they're dealing with.

You work with debtors a lot. Do boards, if properly advised, balance and navigate this properly and well? Or is it something that's just inherently a conflict they have trouble reconciling?

Jack Butler: There are problems with every system, so I'm not about to say that every Chapter 11 operates perfectly or fiduciaries always do their jobs.

But I will tell you that I believe that officers and directors who are trying to fulfill their fiduciary duties to maximize business enterprise value, to take that seriously and apply it.

Harvey talked about it earlier in the last panel that just because a lender tells him to do something doesn't mean he'd necessarily do it. That's really an exercise of a fiduciary responsibility.

I'm not going to do what everybody says we should do. And sometimes you have to say no. Saying no is the exercise of a fiduciary responsibility. And oftentimes it is the debtor in possession who actually is able to forge consensus by bringing everybody to, if you will, if not the center of the table, somewhere in the middle from the positions that they had.

And I happen to think that they can do it well. And if they fail in those duties, there are many, many opportunities for people in the system to step in and make a change.

Bettina Whyte: Let me, because I do sit on corporate New York Stock Exchange boards, make a comment to that. And, of course, I've advised many, many creditors and debtors in the process. In taking over as a Chief Executive Officer, or Trustee, CRO, but done all these roles, I think that one thing that's very important from a board's perspective is to truly understand what the bankruptcy process is.

And I think that the boards that do not do as good a job as they could when they're serving as fiduciaries in a bankruptcy is when they haven't been made to understand what their role is, and that it hasn't really changed, who their responsibility lies to. And a priority perspective has changed. And that's the difference.

So they're going to make the same types of decisions that they will under any other circumstance. But who they have to focus on has to change. And that still means maximization of the estate.

I think a couple things that do happen, however, clearly when they get into this issue, is, in many cases they feel denuded. If they decide they want to sell an asset, not necessarily the company, but an asset, a major division or something, and they think it's in the best interest of the company and will maximize value, and they see the Creditors Committee or the secured lender, of course, they're used to dealing with a secured lender, but not so much the Creditors Committee, or any other constituency and party and interest objecting and the judge then ruling. And if they rule against the board, they do feel denuded.

That's part of life. They get over that if they're good and are a responsible board. But it is a peculiar position to be in. I will say that. But I don't think just because of a peculiar position to be in that they don't actively take a role that is what they should take. And that's to provide the best value for the constituents.

Clifford White: At the last panel, Harvey Miller said we need more Chapter 11 trustees, so I should probably just rest my case right there...

Bettina Whyte: I figured you were going to do that.

Clifford White: And finish that. But the question that you posed gets to a number of sub-issues, of course . But, essentially you're saying, is the modern economic circumstance we find ourselves in, does the code speak to it? And my suggested response to that is maybe let's try it, and then we'll see.

Because what we're seeing, increasingly, is with the use of CROs who are not always, by no stretch of the imagination, always a negative in a case, but CROs who are used to defeat a Trustee when a Trustee is otherwise needed. Or where an Examiner is needed under the provisions of the code and entitlement under the code, the scope is narrowed so that the statutory purpose is eliminated or reduced, that's the problem we've got. So perhaps we should try the statutory structure a bit more faithfully.

And one of the roles of the U.S. Trustee, the primary role, we've got to try to police those boundaries when the parties go to those boundaries. And why is it important, in our view at least, that we need to do that? Because when those boundaries are exceeded what happens is it means that not all stakeholders are given the protections of the code. Either it's one, entrenched management is given too much power or two, a select group of creditors are given too much power.

Whereas the code has a provision that allows for all stakeholders to be protected. And I think we're sometimes losing a bit of sight of that with the way cases sometimes proceed.

Bettina Whyte: Cliff, let me ask you a question. I would agree to some extent with what you say. I've been a Trustee, so why am I going to argue you shouldn't have them. In many, many cases I've also been a Chief Restructuring Officer. As I said, in more cases, probably.

But having said that, I guess what I don't understand, other than where there's massive fraud and you can claim that the board was involved in that fraud, or should have known, it's hard to know about fraud until after the fact. Let's face it, that's why it's called fraud.
But the point I would make is don't be blamed by association. You may have some bad apples in a company. Clearly you did, under the circumstance. That doesn't mean that everyone should be disposed of, nor that they were part of the bad acts.

One thing that was in, I think, your paper that was written said that management actually reports to the board. Well, that's not true. And it said the board manages the company. I guarantee you the board does not manage a company, nor should it (inaudible)...

Clifford White: Management controls under ordinary corporate governance principles so the board is in charge. The problem you've got is if you try to set up some other structure where there's some party that unaccountable to the board.

But I'd agree there needs to be great restraint exercised with regard to ousting management and putting in an independent Trustee. It's a mechanism and it ought to be used with some restraint.

But I don't think we've got any evidence that trustees are overused whatsoever. Frankly, the burden of proof is proof is probably too high. It's clear and convincing in the Second and Third Circuits. At least there, where you've got the Circuits that have spoken to it. In our view, it's not based in the code. We take a different position.

So we're just suggesting that there ought to be a better balance. I would also suggest that in the 2005 law, the amendments were, in part, to try to give a better balance. Because whether it be in the issue of CRRUPS (sp?), whether it be an issue of 1104(e) where we're now bound where there's merely a reasonable suspicion of fraud or other bad acts to file a motion for a Trustee, provisions with regard to exclusivity, all of that at least suggests to us Congress was saying that there needs to be a better balance struck. That balance has, in the past, gone too much in favor of entrenched management.

And I would suggest, though, that if we use the trustee examiner mechanism as intended, we're also protecting all the weaker stakeholders in the case, as well.

Because as some of the papers presented for this panel say that while the CRO is often put in by some powerful creditor. Well, that's not a proper purpose, either.

Bettina Whyte: By the way, the day that I work for some creditor as a CRO will be the day I quit my job. I mean that very strongly. And Becky would say the exact same thing.

Jack Butler: Cliff, and I, with all due respect, there's absolutely nothing in the legislative record from 2005 to support your interpretation that those provisions were intended to dilute the traditional state law of fiduciaries from operating a Chapter 11 case.

Clifford White: That's not what I said. But if you look at the three provisions I just cited, they weren't exactly giving managers more goodies.

Steven Golick: This is a fascinating debate. Coming outside of the U.S., I can try to bring some perspective here.

Across the whole world, and in most of the developing countries, and certainly developed countries, people have been looking for the last five or 10 or maybe even 15 years at the Chapter 11 model, at the debt-end possession model and saying gee, that's very interesting and it makes a lot of sense. And saying, we should start to adopt that.

And a lot of countries have been doing that over the years. Canada's had it for many, many years back from the depression days. But they're looking at it and saying, gee this makes sense because our real alternative is liquidation, in most of these other countries.

And yet, this is the very time, in the middle of one of the deepest recessions we've had in our memories, that the U.S. is debating, should we get rid of this or should we tinker with it and adopt another model.

I think that the model actually works. I think it's a good model. I think it does need a little bit more input into the checks and balances. Because I think the code, as it was in '78 and the dynamics of the different structures and the players, are very different than what is today. And I think you do need to take that into account and see what other checks and balances can be brought into the system. But the system is not broken.

Bettina Whyte: Right.

Steven Golick: It just needs tinkering.

Melissa Kibler Knoll: I want to revisit that issue and the checks and balances in just a minute when we talk about monitors. I don't want to lose a point on CROs for a moment.

Bettina, CROs has been a relatively recent phenomenon in addition to our DIP model that Steven was describing before, traditionally. Talk for me a little bit about the increase in the use of CROs over the last, let's say, 10 to 15 years. Is it a positive development in terms of furthering the goals of reorganization?

Bettina Whyte: We didn't used to be called Chief Restructuring Officers. But we did exist. I've been doing this for 30 years now, almost. So we did exist.

Now there are more of us, because we've been given a formal title, among other things. And I think it's become a more acceptable concept. There's more people trained in doing it.

To Cliff's point and to some others, yes, we usually are recommended. Almost always are recommended by a group of creditors. Not necessarily secured, I might add. But a group. Usually because the company needs more money or an amendment, or is having some type of difficulty. We're not only used in bankruptcies. In fact, often we're brought in before a bankruptcy to try to prevent it.

But I think there's a couple of important issues. Number one, we are fiduciaries. We are officers of the company. We are fiduciary. So when I say I don't work for any creditor, you better believe it, and they all know it, trust me. And that's why I don't get referred in some cases. I'll be very blunt.

Second of all, there's an interview process that the board and management goes through when they pick a Chief Restructuring Officer. And while they may have a list of three or four or five, they don't always choose from it. But after you've talked to three or four or five Crisis Managers and Chief Restructuring Officers, you have a darn good idea who you want and why. And they're going to be working for management and the board. And with a good company, they aren't going to be chosen unless they're acceptable.
And that's true of their fees, as well. Because when they're negotiating, they're negotiating hard on fees, albeit I will say that in many cases, a company will sometimes pull back because the Creditors Committee, if it's bankruptcy, anyway, will have a second bite at that apple. And everybody knows it. And so they'll rely a little bit on the Creditors Committee.

But the point is we are independent. We do bring knowledge of crisis situations typically, although not always, more typically today since CROs have become more common. It wasn't true years ago. They're brought in to help the restructuring aspects of the bankruptcy moreso than the operational day-to-day.

And that leaves management free, again. Not management that has any kind of...

Unidentified Male Speaker: Sure.

Bettina Whyte: Taint on them, other than maybe they didn't pull the right plug a the right time. Or do something they should have that could have helped the company. But a lot of these companies who, really, are in bankruptcy or close to bankruptcy because of industry issues and things that...

Unidentified Male Speaker: Right.

Bettina Whyte: They could have prevented, perhaps, but not completely.

But anyway, so they actually do serve a purpose because they can negotiate and help on the financial end some of the operational issues, as well, with vendors, suppliers, et cetera, and serve as a buffer.

Most importantly, Chief Restructuring Officers, and I think there is this difference between CROs and trustees in this case. Not in every case. But I can say, overall, my feeling is that CROs are brought in and they tend to, if they're good CROs, not to bring in an army of people.

Now, if you have a huge, massive case, you're going to need an army of people. If it's all over the world and it's a gigantic company. Because you've got to have your hands in every pie.

But the point of a CRO is to use management itself and the teams of people that they've developed, again, assuming you're not worried about fraud, to do what they can do best. You handle the things that are bankruptcy related or restructuring related and augment that team that already exists with a few of your own people who are used to crisis and used to doing the kinds of things that need to be done.

And therefore, you're more accepted, very often, I would say, than a Trustee is who comes in and comes in with the name Trustee, which scares the living daylights out of a lot of employees and others. Now, that's not to say everybody embraces a Chief Restructuring Officer. Don't misunderstand. Because that's not true. But...

Unidentified Male Speaker: So maybe we just need to give the trustee an acronym.

Bettina Whyte: And what would you call that?

Unidentified Male Speaker: Call them a Monitor.

Jack Butler: Bettina, that's one thing I think I would quibble you about a little bit. You said earlier that the CRO is independent. And the CRO is not independent.

Bettina Whyte: No, they're an advocate of the company.

Jack Butler: They're independent in the sense that they're independent from the company prior to their being hired.

Bettina Whyte: Right.

Jack Butler: But once they're hired, as you said earlier, you're a fiduciary along with all the rest of the officers and directors.

Bettina Whyte: And when I said independent, I mean independent of any of the parties that may have been asking you to come in.

You are absolutely an officer of the company. And you absolute represent the company. And that's all you represent. And so therefore, if a creditor who brought you in, and believe me, this has happened in many a case, doesn't like what you're doing, you can't worry about whether they like you or not. You don't go to work to be liked. You go to work to get respect. And hopefully, you get the job done.

Clifford White: May I stipulate to two points? Every time Bettina is retained in a case, it's because she has peculiar expertise to help the restructuring so the management can go ahead and make a better widget. And number two, there's an independent board to oversee.

When you have those two factors present, you don't usually see, as long it's not a tainted board, you don't see the U.S. Trustee trying to get in the way. It doesn't always happen. I'll stipulate that with regard to you. I cannot stipulate that with regard to every CRO we see coming down the pike.

Bettina Whyte: I agree, Cliff.

Melissa Kibler Knoll: Let's move along our continuum here. We've started with Jack and the current debtor in passion model. We've talked a little about some of the recent developments with Bettina in CROs. And I want to give Professor Tabb an opportunity. He's going to be at the other end of our spectrum, which is talking about mandatory appointments of Trustees.

Let's talk a little bit for a moment, though, about a hybrid. And you can work from there.

In recent cases where there was going to be a sale to an insider group or a lender. The debtor or some other constituency might have sought the appointment of an examiner to oversee a sale. Would you say that there might be certain circumstances where a trustee should be appointed automatically when a debtor announces, or it becomes obvious the debtor's going to be selling substantially all of its assets? Or should other things happen relative to exclusivity termination?

Charles Tabb: Absolutely. I think we need to perhaps reframe the debate. Listening to this it reminds me of the advantage that I have in class when I can ask the questions of the students and raise them. And it's been very interesting.

It's interesting to listen to Jack. It sounded like I was in a 1979 CLE program talking about the wonderful new model.

But I think the assumptions he makes in terms of the debtor as debtor in possession being an independent force, I agree with Cliff. When Harvey said we need a trustee as an independent force, I rest. If he feels that way, then I think the point is fairly made.

And this is a very natural segue panel from the one before where much of what was being talked about was how the debtor as a DIP is not an effective counterweight at all to the controlling lender.

There's been a lot of discussion. David Skeel's article, Bob Rasmussen (sp?) taking about it. And we all know this. How the senior lender creditors control cases. It's a new world. It's not a DIP-controlled world anymore.

So for us to start from the presumption that we should have the DIP and that we have an effective checks and balances system, I used to teach that. I agreed with that until it was proven demonstrably false, I believe, in many cases.

So we really need to reassess where are we, given the fact that how things play out, we don't have a DIP as an effective counterweight.

Perhaps one way we could address this would be to have the idea of a presumptive Trustee. Because one thing that's happened is, Cliff was talking about this, you now have a situation where courts almost never will appoint a Trustee. It's such an extraordinary remedy, but clear and convincing evidence, even in cases where it would clearly seem appropriate if you had a situation where it was presumptive.
But there were grounds, perhaps on a closely held case if a CRO had been appointed shortly the bankruptcy, well, there's no reason to throw out the good new turnaround management we just brought in. Situations like that. Then perhaps you could rebut it.

So I would suggest that we reframe the debate and say why not? Why are we going to defer to these debtors who were, the management was elected by what's now an out-of-the-money constituency. Why not have a trustee?

Jack Butler: Charles, the problem, of course, with that analysis is you'd like to ignore the entire history that occurred prior to the code. Trustees didn't do so well when they were running the show as the federal fiduciary.

Because what you're really talking about and debating about is should you use state law fiduciaries or federal fiduciaries to run the case. And back under the acts, Article X was not a particularly effective article, right? Fewer than one in five people of those companies ever reorganized, either.

It is, I don't think (inaudible)...

Charles Tabb: Of course, you're talking about reorganization. We don't do reorganizations anymore, Jack. We do 363 sales.

Jack Butler: Having just finished a reorganization last month, I guess we do them now and then. How's that? And the fact is, reorganizations can be done. And by the way, to pave the opportunity, sales can be done as part of reorganizations if, in fact, you're going to deliver value to the broadest set of constituencies.

And one of the debates I think we're going to be having over the next few years as capital markets hopefully improve are the circumstances under which we have sales as part of reorganizations or deal with plans.

It's a little difficult, I think, in a case of complete melting ice cubes to be talking about reorganization plans. And so I think we're in extraordinary headwaters right now.

But I just want to go back to your statement that the current system's effectiveness is demonstrably false. Because I just don't see the evidence for that.

And the reality is, statistically, in Chapter 11 cases of $100 million and more, how many times do stakeholders, hundreds of thousands of stakeholders, ask for a Trustee? How many times do they ask for it, and how many times is it denied as a percentage of Chapter 11 cases? The incident rate's remarkably low because people don't seek out the remedy. And they don't choose to do that.

And it seems to me, when you talk about this, I tend to agree with some things Cliff said earlier and Steve mentioned in his comments. I think there are some tweakings about standard of proof. I'm an advocate of using state law, but we don't have shareholder meetings particularly very often after you file Chapter 11. So what's the standard for review of how long the board stays in place? I think there's tweaking around the system that needs to be discussed.

But I don't believe that there's really a proof here, as you suggest, that it's been proven demonstrably false.

Charles Tabb: So you think the DIP is an effective counterweight in resisting DIP financing orders?

Jack Butler: There doesn't appear to be a party in the case. You somehow suggest to me that a federal Trustee is going to be able to, the judge won't do it, the (inaudible)...

Charles Tabb: But they talked in the last session, the judge isn't...

Jack Butler: The (inaudible) won't do it.

Charles Tabb: The process makes the judge essentially unable to do it. I think they're dead-on in that point.

Unidentified Male Speaker: No, I think what happens is that if, in fact, you're facing, at the end of the day, aside from Congress intervening, I don't think you're going to see a situation where trustees are going to have a bravado that says, yes I'll liquidate the company instead of having an opportunity to provide capital to move the company forward in a positive way.

Bettina Whyte: I don't really see that a Trustee has any more leverage in negotiating a DIP loan than anyone else, to be honest with you. At least I never did. Maybe others are more successful as a trustee than I was. But there's only so many DIP lenders out there today.

And I think we need to also focus on the markets that we have today. None of us know how long they're going to last. If you're a broker, you think we're already back in heaven, and if you're not, it's a different issue.

But to be honest with you, I don't think you can look at changing a code or an act or any of these provisos just because it's something that occurs today. I think you've got to look at it as a process. We are in, as we've talked about, the worst markets that most of us have ever seen in our lives. And I don't think you necessarily assume that these markets are going to continue. Because if they do, I need to go call my broker again.

Clifford White: Let me just make an observation, though, with regard to what we often see in a case is opposition to a trustee or even an examiner. The most vociferous opposition comes, of course, from the debtor in possession. But a close second are the institutional lenders and the committees.

So a question might be, if they won't have more leverage, what is it that creditors and other powerful interests in the case are so afraid of? Could it be the independence of the Trustee and the fact that the Trustee will look out for all stakeholder interests? That's query. I don't know the answer.

Bettina Whyte: I don't know the answer, either, Cliff. I thought about that, based on the paper that you wrote.

But I think there's a couple of issues that come to mind. Number one, Trustees have not historically, and I say historically, worked. They haven't provided any form of reorganization in the sense that most cases, you're going to yell at me, most cases that have Chapter 11...

Clifford White: We never yell in the U.S. Trustees.

Unidentified Male Speaker: Don't need to.

Clifford White: It's against the (inaudible).

Bettina Whyte: Most Chapter 11 cases that have Trustees in them, the majority, I'll say, I won't say all, have not turned into successful reorganizations unless you consider, which by the way, I do, a successful 363 sale of the company where the employees remain intact. Where the customers remain intact. Where the creditors actually would get some money. And even in a couple of mine, we've been able to get some return, albeit it small, for unsecured creditors.

So if you're talking about that situation being a reorganization which, again, I'm willing to call it that because I believe it is, then I would agree. But I...

Charles Tabb: One of the problems, Bettina, I think, is the premise that you have Trustees are only brought in in the truly extraordinary cases. So the run of the mill reorganization case, there's no obvious reason why they couldn't retain the same managers who'll make the same business decisions and, as Cliff said, actually be independent, though. I mean we haven't...

Bettina Whyte: (Inaudible).

Charles Tabb: Tried the trustee model. And Jack was talking about, well, it didn't used to work either. No one would ever pick it because they had a choice and they were trying to save their own jobs. So they're going to file under old XI instead of X. Of course.

Bettina Whyte: Unfortunately, I was still around during those days, too. But I guess I don't see the benefit of keeping all of the old management who are going to help in the decisions aids in anything. Then you're really back to the Monitor, as best I can tell in that situation.

Steven Golick: My question for Charles was going to be, what would see the role of a trustee or mandatory trustee or some new trustee model? What do you see them wanting to do, or having to do? What's the scope of their authority and duties?

Charles Tabb: The same duties that would be exercised by the DIPs supposedly, except they actually would be independent.

Steven Golick: Do they report to someone? Do they have some taskmaster?

Charles Tabb: Yes. They have to report to court. They have fiduciary duties in regards maximizing the value of the estate.

Steven Golick: So it's really not a new check and balance. It's really just new management going in (inaudible)...

Jack Butler: Charles, what, I'm sorry Steve.

Steven Golick: Okay, go ahead.

Jack Butler: What makes a federal trustee that Cliff picks presumptively better than, assuming no fraud or gross mismanagement, than the state court directors that the stakeholders have picked?

Charles Tabb: They're not stakeholders. They were picked by people who are no longer the stakeholders.

Jack Butler: What, they disappeared?

Charles Tabb: Most companies are insolvent, Jack. All right?

Jack Butler: (Inaudible).

Charles Tabb: Yes, there's a handful. But the people that selected them are out of the money. Why should their chosen party be the one to get to make the calls?

Jack Butler: But state law would say, if in fact it's actually insolvent, an issue that's litigated very frequently in cases that might appear to us to be insolvent, but no one seems to be willing to concede them, in that case, state law tells directors what to do.

I'm just trying ask what makes the man or woman that Cliff picks presumptively better than anybody else associated with the company?

Steven Golick: Well, isn't that the fundamental question, is what is in the best interest of all the stakeholders? What will maximize value for all the stakeholders? And you've asked the right question. Is it the people who have experience in running the company? And maybe they're good management, maybe they're bad management. Or is it a third party coming in just completely independent and knows nothing about the company? It's a philosophical question.

Clifford White: Let me go back to an earlier question. How do we know unless we try it? Because I ask you...

Steven Golick: Yes.

Clifford White: Name a megacase in the last five years with a Trustee. Now, two weeks ago in Thornburg Mortgage, we moved for a Trustee and succeeded after a three-day evidentiary hearing. It's probably the largest case in the last few years. Maybe I'm just not thinking of one right now.

But name one megacase in the last few years that's had a Trustee. And name one Trustee that the U.S. Trustee has appointed since '78. I think Jack's original indictment of the trustee system was prior to the establishment of the U.S. Trustee Program, I might add. But name a trustee...

Jack Butler: (Inaudible).

Charles Tabb: Who blew up a case in the last several years.

Bettina Whyte: Not you, but didn't a Trustee get named in DBSI recently?

Charles Tabb: Is that a trustee, or I'm now looking up as a DBSI, yes, yes.

Bettina Whyte: Yes, well, Chapter 11.

Melissa Kibler Knoll: And let me expand. Cliff, you didn't bite on my earlier suggestion of expanding beyond the appointment of a Trustee in the case of fraud, gross mismanagement to something like a sale situation or whatever.

Do you think that we should go beyond where we currently are? Since you're not satisfied with the implementation of the current law, should that law go farther in terms of other situations where a Trustee should be appointed?

Clifford White: Well, I wouldn't be in favor of a per se rule. I'd again go back to what is the code. And I think sometimes we forget, certainly when you see the hearings, what the litigants argue when there's a Trustee motion.

A Trustee is mandatory when? When there's cause. Cause generally being where there's egregious mismanagement, or where there's some semblance of fraud and there's no balancing. But the parties always argue balancing.

Bettina started to say, a few minutes ago, as well, look at all of the costs. My goodness. Look at what the costs are in these cases. I just don't find it to be an argument with much force, with regard to a Trustee or an Examiner for that matter, that they're adding great cost to a case that are going to have any adverse impact on the case.

So I would suggest, again, that really what we need to do is just take a look again at the code provisions and follow those. And that will be, perhaps, a sufficient answer.

Bettina Whyte: But the one...

Jack Butler: And on that point...

Melissa Kibler Knoll: Hold on here.

Jack Butler: You and I would agree. I mean, if what you just said, if I had it right, Cliff, was that we should follow the code provisions, then you and I have a basis on agreement. Because I actually...

Clifford White: Right.
Jack Butler: Think, as you know, that the Office of the U.S. Trustee Program plays an important role in the system. And I think, in fact, that the code has the checks and balances to be able to step in and address issues that require intervention.

Bettina Whyte: Maybe I misunderstand, but at least it sounds like the Professor is suggesting that that that code ought to be expanded to make it easier or then...

Charles Tabb: Well, the concern I have, Bettina, if the courts applied 1104 as I believe it was intended. I wouldn't have a problem. But it's not. And so perhaps the way to test it is simply to flip the presumption, if you will, and permit the rebuttal of the presumption the other way. And then courts would be disinclined, I think, to say I'm doing something extraordinary.

I mean, it's difficult to read an opinion where they talk about appointing a trustee where they don't use the word extraordinary.

Bettina Whyte: I don't disagree with that. I do disagree with your premise about...

Charles Tabb: Right.

Bettina Whyte: It to be flipped. But I don't...

Charles Tabb: Right.

Bettina Whyte: Disagree with the fact that there aren't been many.

I do want to make a comment, though, about Examiners. Because I've been becoming very concerned about the code as it stands today, and Examiners. I don't think it's a logical requirement that a creditor, et cetera, that an Examiner be appointed.

And I think what we've seen because of the way it's written, and I'm not sure what it was intended to do, but the way it's written, you have two situations which judges are faced with. They have to appoint someone, although sometimes, like in Asarco, it can take almost a year before somebody's appointed.

And what I have noticed, and again, I'm not a lawyer. I don't go flipping through all the legal documents of appointments of Examiners. But what I have noticed in many cases is two things. Number one, the judge doesn't want to appoint an Examiner, doesn't see the need for an Examiner. So therefore, he or she decides that that Examiner will have a very small scope, which may be the proper scope, will be paid almost nothing. So they can't do, in some cases, what the scope is, and have such a short time period that it's a useless amount of money being spent for nothing.

Now, having said that, that may be, and the judge's prerogative, that there shouldn't have been an Examiner, in which case maybe it's okay if you can even find anybody to do the case.

The flipside of that is that in many courts, I have seen Examiners appointed, and most of these are cases where there's fraud, et cetera, they have done perhaps an okay job, hopefully. But it has cost the estate a huge amount of money.

And in that case, again, it's not the appointment of the Examiner that's the issue. It's the allowance of what that person is supposed to do, and having not set up the proper parameters ahead of time for what the costs should be, can be, etcetera.

Let me give you some examples. DBSI, I believe the Examiner has charged, he and his professionals, approximately $3 million. He hasn't been paid all of that because there isn't enough money in that case yet to pay him. A Trustee has been appointed. But the Trustee, who interviewed several people for a financial advisor, basically came back and said we can't afford most of you. We don't have any money to run the case. So that's a problem.

If you take a look at SemGroup, where I have been appointed the litigation Trustee, $5.1 million was spent on the Examiner report. It's a fairly narrow report in the sense that it doesn't show all of the potential litigation that's out there. And that was $5.1 million, as I said. And the litigation Trustee to fight all of the litigation has been given $15 million.

Now, there's a lot of litigation in that case and it's very convoluted. And unsecured creditors have also hire their own consultants. It goes on and on.

And by the way, these are not necessarily comments about the Examiner, themselves. I'm not saying they didn't do a good job. I'm just talking about what it left.

And then you look at New Century, with a $12.1 million cost. And the Trustee hired 40 people from his own law firm. And in some of these cases, by the way, you don't even get the benefit of the documents which the examiner used or saw or reviewed. You don't get the benefit of the depositions because the judge has allowed them to be kept private.

I think there's got to be some regulations set around this.

Clifford White: Can I respond to just some of those points, at least? Because...

Bettina Whyte: Go ahead.

Clifford White: One, I want to thank you for reminding me about DBSI, before Roberta kills for it. Because in the case there, you had an Examiner filing an unscheduled emergency report to the court that led us within a day or two to file a motion for a Trustee, because of what he uncovered.

Bettina Whyte: Right (inaudible).

Clifford White: So all your concerns about costs notwithstanding, that's exactly one of the primary roles of an Examiner.

Second. Go ahead.

Bettina Whyte: I just really...

Clifford White: Right.

Bettina Whyte: Want to say in my defense...

Clifford White: Right.

Bettina Whyte: Again, I'm not objecting to the concept of the...

Clifford White: Yes.

Bettina Whyte: Trustee, I'm just saying it's becoming a difficult issue.

Clifford White: Well, and you also raised the issue of costs. The only time I every have a professional at our doorstep complaining about costs is when we've put in an independent fiduciary. That's simply a fact. That's the only time cost becomes a concern of the professionals in a case (inaudible).

Bettina Whyte: But wait a minute. (Inaudible).

Clifford White: Let me keep going. You had so many marvelous examples. I'd love this.

Melissa Kibler Knoll: Should I step in, Bettina?

Clifford White: Can you win the reception?

Bettina Whyte: Yes.

Clifford White: You know, one of our problems is, when you get to scope, we have to fight tooth and nail on scope. And let's deal with New Century, since that's basically all facts in the record disposed of.

In the New Century case, we go and we file for a Trustee in the case within two weeks after there was admission of inaccurate financial statements with the SEC. And we filed, in part, of 1104(e). Reasonable suspicion, but we have a heavier burden to carry, which we pled in the pleading. But it was early in the case. The judge says you don't have enough evidence at this point.

But we had also pled an Examiner in the alternative. So we got the Examiner. Then we have to fight tooth and nail forever for the Examiner. A similar thing in many, many other cases, SemGroup, as well. When you complain that the report is too narrow, well, you know a lot of negotiation goes into the scope of it. But that was actually an outstanding report.

And New Century, by the way, was viewed, at least by *The New York Times*, as the most authoritative account of the subprime meltdown that was put into the public domain. And it does serve an important public policy purpose. When you have the story being told, in these cases, of either corporate fraud or other kinds of economic calamities, they may not be taking depositions sometimes in the same way.

But they also will, because of the way they can do their work, they should be able to preempt the field, and they should be able to draw the road map for causes of action while the committee goes about other things such as negotiating.

And one of the reasons costs are driven up is because the professionals don't want to give up any of their turf.

Bettina Whyte: That's correct. I don't disagree with a word you have said, by the way.

(Transcriptionist's Note: At this point there is a simultaneous conversation that is inaudible and undistinguishable as to who is speaking, and therefore, was not transcribed; approximately 3 seconds.)

Bettina Whyte: All I'm saying is you can't have an Examiner...

Clifford White: We're very nervous if no one disagrees with us in the U.S. Trustee.

Jack Butler: To some extent, Cliff, I think you're making the point. The one thing I do think, on Examiners, is that the statute ought to be changed that it shouldn't be of right if anyone files a motion. I think that's ridiculous.

But the concept that the U.S. Trustee ought to be able to seek an Examiner, or that parties ought to be able to go in and seek it, I think ought to be in place. It's one of the checks and balances that ought to occur. I totally agree with that.

And my premise is that the U.S. Trustee, in my experience, exercises judgment and restraint in making these motions. And when you go in, you go in, and you're in a contested hearing, and you either win or you lose. But you do your job.

My premise is the U.S. Trustee, in fact, does their job and exercises judgment and restraint. And that is a positive check and balance in the system. It's part of the check and balance in state law fiduciaries. It shouldn't displace them or replace them unless the court chooses otherwise.

Melissa Kibler Knoll: Yes. And I'd like to use this point now to segue from Examiners into Monitors. And I'd like to ask Steven to take the floor for a minute and talk a little bit about the functions of Monitors.

Because, I think as we start to look at it more closely, sometimes they play a role in your Canadian that's more similar to an Examiner. Sometimes they're a little bit more of what we might even see a CRO being. They're definitely a hybrid.

So talk a little bit about how that system compares to what we use here.

Steven Golick: Thanks, Melissa. Let me start off by saying a disclaimer the way Harvey had a disclaimer. I don't act for the Canadian government on this panel. And therefore, my comments should not be seen as their comments.

And secondly, my comments should not be seen as a shill for the Canadian system. I love the U.S. system.

The way it works in Canada, we have something called the Companies' Creditors Arrangement Act. It's the equivalent of Chapter 11, but it's a very small statute, so it's all of about 10 or 15 pages. And it dates back from the Depression Era, and it's been amended a number of times, as recently as September 18th of this year.

About 15 years ago, we codified the appointment of Monitors, which were starting happen in practice, anyways. And what it does is the Monitor is a unique animal. It's generally a large accounting firm, but it can be anyone, as long as they have a Trustee in bankruptcy license.

And they hold three hats. Their first, most important hat, is they're an officer of the court. And they owe their duty to the court to make sure that they are the eyes and ears of the court.

Their second and most important duty is to make sure that they assist the debtor in the conduct of the case. Everything from looking at the cash flows, looking at the financial plan, assisting in developing the plan, assisting in communicating with the creditors. We even go so far as having the monitor set up a website where all of the pleadings are dumped because we don't have a PACER system like you have in the U.S.

And the third, and rather unique thing, is that they also hold a brief for all of the creditors, both secured and unsecured. And they're supposed to be there to assist the creditors in everything as mundane as filing claims to assisting in the negotiations, and arranging for compromises. Getting documents out to them, getting information flow going. And going to court if they see some material adverse change and saying, wait a minute. There's something strange going on here. We think the creditors need to be informed and involved.

I'm sure it comes as a bit of an unusual position to say that one person can wear those three hats. Although maybe Robin would agree, because he can wear multiple hats.

But it actually works. And the reason it works is because there's checks and balances. And we have different checks and balances in Canada. It's not what you have in the U.S. We don't have an Unsecured Creditors Committee. So that there's nobody there speaking for the body of creditors unless the creditors happen to band together and form an ad hoc committee. And they may not get funding, and usually don't get funding from the court. So it's very hard to ask unsecured creditors to get together, and start banding together, and hiring counsel, and hiring financial advisors when there really is no funding for it.

We don't have any other official committees as you can, in the U.S., have the court appoint committees. Our courts have occasionally done it, but only on the extremely large cases and unique circumstances.

So at least there's someone there who's being funded by the assets in the estate who will go to the court and say, here is my independent view of it. And, of course, being a court officer, the court really listens to this person. The court says, wait a minute. I know everybody else here has an axe to grind. But when the Monitor comes in and says, this is what I think the valuation is, or this is what I think should happen on the motion, or these are the dynamics of what's going on, the court knows that that person is completely independent, but trying to be fair to all of the different stakeholders, employees, creditors, suppliers, customers, and so on.

I don't know that that would necessarily work in the U.S. because you have different checks and balances. But you could adopt, if you were interested in it, certain aspects of it to have an independent person come in and wear multiple hats without actually taking control of the business. I know the Trustee really takes control of the business. The Examiner does not.

But there's a middle ground. And it can be someone who is there to say, here is someone just as a friend to the court, who has no axe to grind, and says here's what's really going on, judge. And goes to the stakeholders and says, I know you really want this, but it's not going to work here. And here's why it's not going to work here. And you can trust me, because I'm not there for the debtor. And I'm not there for the secured creditor. And I'm not there for the suppliers.

Bettina Whyte: Don't we really have that? Not, again, being a lawyer, I don't want to step on anybody. But don't we have a bankruptcy rule that allows the judge to hire his own expert or her own expert if they so choose? I know that that's been done.

Steven Golick: That was just done in one case.
Bettina Whyte: Yes, I know. So it seems to me that there's a vehicle, anyway, although it's very seldom. As you say, it's been done in one case that I'm aware of.

Jack Butler: But to Steve's point, I there is, Steve. There's elements of what you talk about that have real merit. And the question, really, in my mind is are there elements of the Monitor system? Because, as you pointed out, I'm not sure the weights put in Canada exactly work.

But if you were to, for example, replace the Examiner function or supplement it with a Monitor so that the court had available to, that wasn't one of right, but someone could file a motion on its own could not presumptively have one, but has the ability to add that to the arsenal. I could see facts and circumstances where that would be helpful.

Steven Golick: I think you're right, Jack. One of the dynamics that happens in Canada, and I've seen it happen in other jurisdictions, although they don't have monitors, is when you have that independent court officer coming in, somehow people start to play nicer in the sandbox. And the reason they do that is because they know if they take positions that are just outrageous, that when they get to court, the judge is going to say, well, what does my independent officer think? And he or she is more likely to run with the view of the independent officer.

That doesn't mean that it's still not an adversarial system. It doesn't mean that people still don't put their positions forward. But I think it speeds up the process of the case and it makes it less expensive in the long run for everyone.

Jack Butler: I think one of the points we made in our paper is, I think in the last 10 years in particular, you have seen a growing trend in the U.S. system where courts have used alternative dispute resolution, and have put in place an arbitrator or a mediator.

And I think, in some of these cases, a mediator in a U.S. case can act an awful lot like the Monitors I've worked with in the Canadian cases. And their roles are very, very, very similar, at least in terms of bringing people together.

And there are a lot of cases these days who are getting mediators, and in some cases, arbitrators. Where judges are stepping in, to reduce costs, to promote alternative dispute resolution.

Steven Golick: Most of the work we do across the board is U.S.-Canada. And we have found, usually, the Canadian case has to slow down to meet the timelines of the U.S. case. And whether it ends up with a 363, or whether it's a full reorg, it still is a slowing down. Even on a pre-pack, there's a slower process in the U.S. than there is in Canada.

And I think you're quite right that if there would be some expanded rule for whether it's mediators, examiners or something, I think you will find the cases will speed up. And I think you'll find that the cases will have less adversarial litigation.

Now that's just one person's view. And I'm not suggesting that you should adopt the Canadian model. I don't think it works in the U.S. But by expansion of some roles, I think you will find some benefits to it. And I encourage people to consider it.

Melissa Kibler Knoll: Well, let me ask Professor Whyte and the U.S. Trustee to weigh in on that. Do you see some sort of model where there is some position akin to a Monitor, either through using the already-existing law that is out there that enables the court to appoint an individual? Is there still utility to a Creditors Committee and an individual that would play some sort of a role, like a Monitor, in that situation?

Bettina Whyte: The concept of a monitor, again, it's a little fuzzy. Because, as I was reading your paper, I'm putting down Financial Advisor, CRO, Trustee, Examiner.

Jack Butler: It's a lot of hats.

Bettina Whyte: I had a really difficult time trying to figure out what this person does. But I do think that it's not a bad concept. To me, the biggest benefit of that concept is you don't have an Unsecured Creditors Committee in your situation.

And I do think that, while we have lots of parties and interests in our cases, the costs continue to go up because of all those parties and interests. And if you could really find a person who is good in the Monitor position, all this comes down to, whether it's a Trustee, or a CRO, or management or a Monitor...

Steven Golick: It's the person.

Bettina Whyte: How good is the person? How much of a fair deal, really, are they, and the like? So I think it could have some benefits, especially from moving the system along.

Clifford White: Well, the key to longevity in the federal government is you don't comment on potential legislative proposals unless you're under oath before a committee. So I won't answer your question directly.

But let me just say, with regard to committees, because it is an important point, and in Jack's paper, he talked about Unsecured Creditors Committees as co-fiduciaries. There are certain limitations with regard to what a committee can do. The most basic limitation is the fact that it is constituted as a fiduciary for the creditor class, not for the broader stakeholders beyond that class.

And second, as earlier panels talked about, the multiplicity of interests that you see, even on a Creditors Committee, is so much greater now than in past years, which presents quite a challenge for us.

For example, an appointing committee, the hedging, the trading, guarantees on loans, what's the real exposure of the creditor? So it's very difficult to get a representative committee, even as an Unsecured Creditors Committee, to say nothing of trying to appoint a committee that would have broader responsibilities than otherwise are discharged.

Melissa Kibler Knoll: Right. Do you find, though, given all those difficulties, are you starting to feel like the committee model is broken? Is it too difficult to...

Clifford White: I wouldn't say it's broken. It is more difficult. And especially since Blue River where the SEC found evidence that a member had misrepresented his position in a case in order to gain membership on a committee, we have gone to many greater lengths in the last several years than in history.

The program would traditionally go to, in terms of vetting committee members so that we know what the real exposure is. And then we ask for regular updates on what the trading is, and that sort of thing. And that there be an order, if there's going to be trading, and so on and so forth.
Which is why I'll give a plug to what happened in the Lehman Brothers case to show that it does still sometimes work. In the Lehman case, of course, on day one, case is filed, with a pivotal hearing to be on day five. So we put out a notice almost immediately to whatever creditors Lehman could help us identify that there'd be an organizational meeting.

The next day, commencing in the evening, there was a creditors organizational meeting where we conducted the usual business, including vetting creditors individually. So by day three, there was an appointment.

Now, it was great for me, because I remember talking to the U.S. Trustee, Diana Adams in the evening. She was identifying some of those issues she had to deal with. I went to bed and woke up in the morning, and found out how she solved it.

But that's the way you have to do it these days. It's a harder job, but it still is being done. And I'm not willing to say, at all, that the committees are broken. It's just that it is very difficult to expand their duties, because it is much more difficult to monitor committees than in the past.

Melissa Kibler Knoll: Yes. And let me ask that final question to the panel. I don't want to let you all down without having all of you, with the exception of Cliff, have the opportunity to comment that if you were rewriting the legislation, what things do you think need to be changed relative to our current DIP model? Jack, go ahead.

Jack Butler: I would look at burdens of proof and standards in connection with the appointment of Trustees, Examiners and Monitors. I think, as you've heard me say, I don't believe that Examiners should be of right. I think that that's kind of turned the system on its head. I think, in fact, there should be more thought into where that's appropriate and not. I would not, obviously, make them presumptive.

I also think there needs to be a mechanism to think about, in the case of directors, at least in publicly held companies. But I would argue, in all companies, that how you compensate for the lack of shareholder meetings, or require shareholder meetings, or sort out how those interface with creditors' rights to the point that I think Charles made earlier, sometimes interests have moved. So you can kind of think through those issues, as well.

There are some boards that are viewed as being entrenched for a long period of time. But on the other hand, the experience I've had is that when stakeholders are dissatisfied, those boards change. And when they're not dissatisfied, they continue.

I think the fact that there's a very clear, informal system that's worked, in certainly a lot of the larger cases, where there have been changes to who those state court fiduciaries are, imposed by the stakeholders when they weren't satisfied with the conduct of the case. And they haven't felt a need to go in and file a motion...

Melissa Kibler Knoll: Right.

Jack Butler: For a Trustee or an Examiner.

Steven Golick: I like Bill Brandt's comments from this morning that the 78 Code was all about getting people in the room to build consensus. And I think the system, as it currently exists, doesn't encourage enough consensus building. And I think if you have a little bit more independence of some people coming in who are, I'm not saying a full monitor, but people coming in who can help build that consensus, and you treat the checks and balances a little bit, I think it'll fix whatever is broken. And I don't think it's very broken right now.

Melissa Kibler Knoll: Right. Professor Tab?

Charles Tabb: I would suggest the Presumptive Trustee, subject to rebuttal. At the same time, I'll say that if we don't fix the problems that the last panel addressed on DIP financing, I'm not sure it's going to matter much.

Melissa Kibler Knoll: All right. Bettina? Oh, I forgot, we're skipping you.

Bettina Whyte: I agree with Jack and what he said. I also would make one other comment. While I agree that most boards of directors who remain on in a debtor in possession situation are fair and honest, I really do believe that those boards ought to change their makeup.

And I think that, not necessarily every director should be removed or should leave. Although a lot of them do anyway of their own volition.

But I do think the creditors ought to have a position on those boards. And I think that is one way to provide some oversight and some different type of review of what is going on, and insurance of independence, and that all the constituents are being really represented.

Melissa Kibler Knoll: I would like to thank all of our panelists and all of you. Please join us outside for the reception. Thank you very much.

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SYMPOSIUM/PANEL DISCUSSION

HOSTED BY

ABI

CHAPTER 11 - AT THE CROSSROADS:

DOES REORGANIZATION NEED REFORM?

"SYMPOSIUM ON THE PAST, PRESENT & FUTURE

OF CORPORATE RESTRUCTURING"

(Audio File 1007)

"Symposium on the Past, Present & Future
Of US Corporate Restructuring"
(Audio File 1007)

MODERATOR: **Robert Keach, President, ABI**

PANEL:
Daniel M. Flores, House Judiciary Committee
David Gray Carlson, Professor, Yeshiva University, Cardozo Law School
Kevin J. Carey, Judge, U.S. Bankruptcy Court, District of Delaware
Adam Levitin, Professor, Georgetown University Law Center
George W. Kuney, Professor, University of Tennessee School of Law

(Inaudible) = Areas that could not be heard due to poor audio quality, background noise, quiet/stifled speaking, etc.

Bob Keach: (Audio begins) the first time, I'm Bob Keach, President of the ABI. I want to welcome you to day 2 of our Legislative Symposium, which, as we said yesterday, our modest goal is to examine the past, present and future of corporate restructuring in the United States. Does Chapter 11 need reform? And if so, what forms would that reform take?

We have two, I think, very important panels today. And our first panel is literally plucked from the front pages. This is an issue that is currently being debated on Capitol Hill as we speak.

One of the challenges, frankly, of preparing for this panel was the fact that every other day, something new arrives. And I think two days before we were about to depart to Washington, Senator Dodd dropped his 1,100-page version of Resolution Authority into the mix.

So we have lots to talk about. Let me start by introducing our panel of experts on this subject. And they continue what has been an unbelievably high quality of our panelists and speakers for this conference.

Starting on my immediate right is Daniel M. Flores from The House Judiciary Committee. Next to him, Professor David Gray Carlson. Next to David is the Honorable Kevin J. Carey from the Bankruptcy Court in the District of Delaware. Next to Judge Carey is our scholar-in-residence, Professor Adam Levitin from Georgetown University Law Center. And on the far right, Professor George W. Kuney from the University of Tennessee School of Law.

Thank you to all of our panelists this morning.

Let me start with a question for David, to kick this off. There are a number of proposals in circulation, David, but they have a common theme. And that is they appear to think that Chapter 11 is not up to the task of handling the Too Big to Fail institutions. And we should talk about who they are. But at least some of them consist of non-bank financial holding companies, insurance holding companies, and the like.

What exactly seems to be the shortfall in Chapter 11 that everybody is concerned about?

David Gray Carlson: Okay, well, thank you. Before I respond, I want to say thank you for this magnificent conference. Thank you for putting me on a panel where law professors are finally in the majority.

I have to say, I am so intimidated by bankruptcy practitioners. And yesterday we heard from practitioners who said, well, yesterday Judge So-And-So in Delaware signed Such-And-Such an order. There'd be a gasp from the crowd and people would run to the phone, call their clients and you know, with all...

Adam Levitin: You have to actually see the order to determine whether that was true.

David Gray Carlson: Well, with law professors, it's rather different. And I'm speaking only for myself. I read the Appellate Opinions. And it takes three years for an issue to get to the Appellate level. It takes me a year to find the case, two years to write up the article, three years for *The Law Review* to publish it, two or three years for another human being to read it.

What I really want to talk about today is the Y2K bug, and its affect on Chapter 11 reorganization. And I want to say it's a once in a lifetime catastrophe, and I think we need legislation. So the exact question posed to me, what does Secretary Geithner hate about Chapter 11? I think with questions like this, the ultimate political question is always where does the virtue reside? Who has good faith?

This was never put better than by George Orwell, who wrote, "Four legs good, two legs bad". Secretary Geithner thinks he's got four legs, and he thinks the bankruptcy judges have two legs. But what is Secretary Geithner seeing when he looks at Chapter 11? That's the question.

And I'd point out a couple of things that disturb him. One would be that, basically, the debtor has to file a voluntary petition. It's debtor-initiated. And so the first thing that has to happen for Chapter 11 to do its job in this crisis is for the management of the Too Big to Fail company has to be on board.

Now, so far, we've actually seen that. Lehman Brothers was ordered to file for bankruptcy, and so they did. Chrysler and GM were instructed to file for bankruptcy, and they did. But that's an issue as to what happens if we get a debtor that just won't do what the Secretary says?

Daniel M. Flores: Well, given the magnitude of the government involvement, at least in the two auto companies that you mentioned, ultimately what choice is there? Look at what happened, specially with the GM CEO who swore, months before, they would never file a bankruptcy. Sure enough, there it came. And there he went, right?

David Gray Carlson: And that's a good point. Who rationally would stand up to Secretary Paulson? But from Geithner's standpoint, why not just get rid of that possibility? And I think that's what this bill achieves, right?

Adam Levitin: Well, David, I think it's not just whether they file for bankruptcy. It's also the timing. And if you're the Treasury Secretary, you want control over the process. You don't want to have to defer it to management. And beyond that, you don't want to have to defer to a bankruptcy judge, of all people.

So I think there's a huge control element that's in this. But also, why would Secretary Geithner care about control? Well, okay, power likes power. There's maybe kind of the control freak aspect.

But I think there's more than that driving this. Ultimately, any kind of insolvency is about distribution. The core problem is there's not enough money to pay everyone in full on time. And someone's going to have to take their lumps. And we know in bankruptcy we can kind of look down the road, and if it's bankruptcy, we know who's going to be taking their lumps.

And sometimes we're fine with that. But sometimes we don't like the distributions that come out of bankruptcy. We don't like that Goldman Sachs might take a loss. Or we don't like that Union employees might lose their pension.

Bob Keach: We never like it if Goldman Sachs takes a loss.

Unidentified Male Speaker: They never do.

Bob Keach: And by God, they haven't.

David Gray Carlson: But I would point out, you're putting your finger on something, here. Basically, the one and only test in bankruptcy is best interest of the creditors. But I don't think Secretary Geithner cares about the best interest of the creditors. He's talking about saving the republic.

Harvey Miller put it that Secretary Geithner wants to be a dictator in possession, as he put it. And dang that Hitler and Stalin, they've given these dictators bad names. And so I'm sure Mr. Miller meant that in the pejorative.

But the dictator was a noble position from the Roman Republic. Cincinnatus, who drops the plow to defend the Roman Republic at the bridge. The dictator was a person designed to save the Republic. So I think that's what Secretary Geithner has in mind. But he needs to suppress (inaudible)...

Bob Keach: Well, in fact, and Dan, I'll let you pick this up. But isn't that, in fact, sort of in the Bill? Essentially, it seems to me, in the run-up to the Resolution Authority Bill, and we'll get to the specifics on that in a second, one of the things they overtly said was bankruptcy, unfortunately, is all about distribution to the actual stakeholders in the case.
We actually care about the creditors. And we don't take into account things like systemic risk. And therefore, they don't want a program that focuses on mere distribution, but rather looks at bigger issues.

Isn't that, David, part of what's going on here?

Daniel M. Flores: Actually, if I could jump...

Bob Keach: Sure, Dan. Go ahead.

Daniel M. Flores: I'm glad a lot of the points so far have been raised. I'm going to go back to Sam's initial comments. I want to politely correct one thing, which is there actually is a proposal that's on the table that is a bankruptcy proposal, not a Too Big to Fail, or not a non-bankruptcy proposal.

It's been out since July. It's the Republican proposal, being Title I of H.R. 3310. This is a bankruptcy proposal that, to my knowledge, has actually received very good reviews from bankruptcy experts, including Harvey Miller, and actually nicely resolves some of the issues that have just been talked about.

I think, in terms of the issues of where the administration Frank-Dodd Proposals, Geithner Proposal are coming from, a lot of it does come down to, not necessarily what works the best or what could work the best, but who gets blamed and who gets gamed under the structure that is put in place.

Obviously, under an agency-controlled process, agencies have control. Therefore, they get to best assure that they don't get blamed for making a mistake by kicking in their risk-adverse instincts and erring in favor of their reputations. The don't get gamed in that debtors who know that agencies have bailout authority cannot play chicken with them over the grave consequences that will happen if the agency makes the wrong decision and lets somebody go into bankruptcy, instead of giving them a bailout.

And I think a lot of what's going on with the non-bankruptcy proposals comes out of that set of unstated premises.

H.R. 3310, I think, very nicely resolves some of these issues because it leaves the resolution of non-bank financial institutions to the Bankruptcy Court, but provides a very strong role for agencies and government expertise that can account for systemic risk, and help the Bankruptcy Court account for systemic risk in the process.

Bob Keach: Daniel, just for the people who may not be familiar with the bill number, that's the so-called Chapter 14 Proposal, correct?

Daniel M. Flores: That is right. We might have called it Chapter 10. We called it Chapter 14. But it's a special chapter for all non-bank financial institutions. And it provides a fairly simple but, I think, effective set of reforms that will allow us to handle the bankruptcies, the insolvencies, of very large, very interconnected firms that perhaps could pose systemic risk, and at the same time, process the insolvencies of small companies or smaller companies, less interconnected companies, that don't pose that kind of risk.

The way it's structured is we create a pre-filing opportunity. Very fast-moving, very contained, to allow the relevant federal entities who could deal with issues about systemic risk to be in a room with creditors and debtors to facilitate a workout.

If that's not possible, or if that kind of thing's not needed because you have a small non-risky kind of firm involved, you go to a petition. And once you're in the Bankruptcy Court, as needed, the Bankruptcy Court can access that same expertise that was in the room from the federal side to help it account for any systemic risk issues that may be present as it processes a case, largely under existing Chapter 11 and Chapter 7 rules, with the prominent exception that venue is only allowed in the districts that have the 12 Federal Reserve Banks to concentrate the system's expertise for cases where there truly may be systemic risk.

And by the modification of the automatic state provisions so that on a very, very fast-hitting basis, the court, with the views of the relevant entities in front of it, including the agencies, can make a call on whether derivatives and other accepted contracts can actually be stayed in the case because of the potential for systemic risk via their execution.

So to conclude, there actually is a bankruptcy proposal out there that tries to nicely balance a lot of these competing interests. There's a lot of support for it in the expert community.

David Gray Carlson: Let me ask you about this bill. The Geithner Bill covers insurance companies, which are not eligible to be bankrupt. Does your bill allow for taking over insurance companies?

Daniel M. Flores: No. It doesn't allow for taking over insurance companies. It allows for the bankruptcy of insurance companies.

To get back to the very basics of the debate, one of the things that is the foundation, if not the only thing at the foundation of the Geithner and other similar proposals, is the idea that there are companies that are Too Big to Fail, either because of size or interconnectedness. And that those companies need to be treated specially.

That often means the possibility of a takeover by the federal government as the company is wound down or reorganized. It certainly means special rules that apply to them and advantages that can come from those rules.

The way I put it to people is that foundation essentially introduces moral hazard into the equation, induces risk-taking to be undertaken by the riskier firms. And therefore, is sort of at war with the instinct to respond to the financial crisis that was brought on by excessive risk.

It's sort of like the old sandlot game where so many of us on the baseball field, trying to figure out who would hit first, would run ourselves up the baseball bat to see who could hit first.

The way these proposals work is we introduce moral hazard into the system, as I described, and then so much of the rest of the statute are attempts to grab that moral hazard bat and put a control on the moral hazard that the market will then escape from, put another control eventually, that the market will escape from. And on and on we go.

The systemic risk is never removed from the system. And we just pave our way to the next crisis.

The bill that Republicans have out there just gets out of that game entirely. There aren't special rules for one set of companies that favor them over the other. And there is not takeover authority. There's no bailout authority. Bailouts are prohibited.

Bob Keach: Dan, thanks for that. And since we've had that, I'll turn into discussed. Adam, so we can get everything out on the table, why don't you talk about resolution authority? What's going on there? And how the Administration's approach is different, fundamentally, than the one Dan just described.

Adam Levitin: The Administration's approach, and by talking about it, I am not endorsing it.

Bob Keach: A disclaimer. Nobody here is adopting an of these things as their own at the moment.

Adam Levitin: Let me first say that we have the Administration's proposal and we have various bills in the House and Senate. And I, frankly, get rather confused as to what's in which one. Keeping track of who's making which move is not the easiest here, and who's defining financial institution how.

But the basic gist of the non-bankruptcy proposals is to have some sort of standing systemic resolution authority generally vested in the FDIC so that if a covered institution, and there are huge questions about is this just financial institutions? Is GM a financial institution? How broad this goes.

But if a covered financial institution gets in trouble, the regulators can step in and have some form of a resolution process. Some proposals allow for the equivalent of what the FDIC calls Open Bank Assistance, whereby fresh government money is being injected. Others just allow resolution authority, basically receivership, so there's no new money being injected. And the basic idea is to try and resolve the company as quickly as possible.

I think there's a real danger in any non-bankruptcy proposal in that it makes resolution authority a highly political issue. Let's imagine that this current crisis didn't happen in 2008, but that it happened in the fall of 2000, on the eve of the Bush/Gore presidential election. This would have been a horrifically contentious issue. Far more than we had this fall, because every move the Administration made would have been viewed as trying to tilt the election.

Similarly, if we had it in 2004. Maybe it would have even been worse, because the sitting President would have been running for reelection.

And one of the real virtues of bankruptcy is that it depoliticizes individual resolutions. Bankruptcy is political. Bankruptcy is all about distribution. And distributional issues are political. But we resolve those distributional issues in bankruptcy up front. We kind of put on a Rawlsian veil of ignorance. We don't know who's going to be the debtor. And we decide the priority scheme in the abstract.

Daniel M. Flores: So what you're saying that, while the Bankruptcy Code provisions contain political influences, they're fixed.

Adam Levitin: Exactly. They're not going to be changed based on the case. But you don't have the authority to say, I really like Trade Vendor X. I'm going to bump him up in the priority scheme.

Now, you can demote someone, right? But only for proper cause.

Bob Keach: But the Rule of Necessity. I thought you could do that.

Adam Levitin: Well, okay, we've got critical vendor motions. There's some fuzzy edges. But the basic idea in bankruptcy is that the distributional order is fixed. We know what it is and Congress is not going to step into individual bankruptcy cases and legislate.

Resolution Authority means it's not fixed. That if out of some systemic concern, we may say the juniors get paid in full and the seniors don't. Maybe you could imagine in 2004, say. We have a close presidential election. Ohio is a swing state. And the auto companies are in trouble. A lot of employees in Ohio. It would be very tempting for an administration to step in there and say, we're going to guarantee the pensions 100%, and the bondholders take it on the chin.

And I think that, as a system, that's really not where we want to be. That we don't want to have that kind of political game-playing with the resolution process.

Bob Keach: Adam, before we go too much farther, and especially, before we get a response, I want to just frame a little bit about what the bill does. And let me just hit a couple highlights, and you tell me whether I'm getting it right or wrong.

Basically, at least in the Administration proposal, you have essentially the Secretary of the Federal Reserve and the FDIC getting together and deciding whether or not a firm poses sufficient systemic risk to be a candidate for resolution authority. And how exactly they have to agree on that, and what the voting rules are is not clear, obviously.

But essentially, they make a determination. And it's like an involuntary. They decide, essentially, the firm is subject to resolution authority. And thereafter, once the decision is made, it proceeds largely like an FDIC receivership, correct?

Adam Levitin: Yes. And it's not clear what ability a firm has to contest this.

Bob Keach: Well, there's the...

Adam Levitin: I mean there (inaudible)...

Bob Keach: There's the ability to sue in District Court, apparently, over the initial determination...

Adam Levitin: But they...

Bob Keach: Sometime after you've already been seized.

Adam Levitin: Seized and liquidated, yes. It's effectively without meaningful judicial review.

Bob Keach: And thereafter, for those of you who are familiar with bank receiverships, it proceeds largely like an FDIC receivership, with that sort of same panoply of powers in the sense that you could be involuntarily merged with another firm, the assets could be sold to another firm, you could just be liquidated, et cetera, et cetera.

Unidentified Male Speaker: Can't be enjoined by a court.

Bob Keach: Right. There's very little judicial recourse. It's very much like an FDIC receivership.

The other major element of the bill, as I understand it, and this was to address what was perceived to be a weakness of the last round of takeovers and rescues, is the direct lending authority by the Federal Reserve, the ability of the Federal Reserve to buy equity in the firm. There's essentially the creation of a potential money pipeline for either loans or investments, correct?

Adam Levitin: Well, at least the Dodd Bill, and I might be confusing the Dodd Bill and the Administration's proposal. The Dodd Proposal does not allow for direct lending to individual firms. It authorizes the Fed to provide systemic assistance, which (inaudible)...

Bob Keach: Yes, I think that's actually a difference in the bills.

Adam Levitin: But not direct lending to individual firms. So under the Dodd Bill we wouldn't see the Fed pumping in money to AIG. Instead, I think it would be that the Fed would be purchasing, let's say, mortgage-backed securities to sustain the market.

Bob Keach: And we're going to oversimplify here, the major difference between Senator Dodd's more recent proposal and the Administration's proposal is, obviously, the Administration has far more trust and love for the Federal Reserve. Senator Dodd seems to have far more trust and love for the FDIC, it seems like.

Daniel M. Flores: But no one trusts the Bankruptcy Bar and the courts. Yes, it's the problem. First of all, if I could jump in...

Bob Keach: Yes, sure.

Daniel M. Flores: I think that Adam's point about political influences is very, very well taken. We all know what happens in politically driven economies. And we know they don't work.

And the idea of creating a system that would help save our economy from systemic risk by handing it over to political influences, I think, is a recipe for disaster.

The real questions that are in play about bankruptcy are, if we have a failure of a large, interconnected firm, can bankruptcy respond to its insolvency fast enough? And can bankruptcy adequately handle the company's derivative obligations and other liabilities that are, perhaps, capable of propagating risks throughout the financial system?

And frankly, the only bill that starts by asking is there something missing in bankruptcy now, can we add something to bankruptcy to fix that, is H.R. 3310, which tries to allow the bankruptcy system to move faster and better account for derivatives and risk than Chapter 11 currently does.

It's interesting. The only reason, I think, that we're all even thinking about abandoning the Bankruptcy Code for a non-bankruptcy resolution authority, besides the political issues I mentioned before, is the belief that sort of settled in place fairly promptly after the Lehman bankruptcy, and has stayed there too long, is that somehow Lehman going into bankruptcy is what triggered the financial panic last fall.

I think the work by economists shows pretty well that it actually wasn't Lehman going into bankruptcy in and of itself that created the financial panic. What created the panic was the inconsistent approach of the Fed and the Treasury to failing firms starting, actually, if you can go all the way back, I think, to Continental, Illinois.

Bear Stearns is the critical near-term example. Bear Stearns was bailed out. The market looked at Bear Stearns in the middle of the credit crisis in which all of this took place, and formed a settled expectation that anybody like Bear or bigger would be bailed out. Therefore, the market relied on that. It didn't adequately plan for bankruptcy to deal with insolvencies. And it didn't curtail its risky practices.

When the Lehman decision was made about six months later, it went the other way, completely unsettling that expectation and (inaudible)...

Adam Levitin: Well, not only there this view that the decision making was ad hoc, it was not transparent.

Daniel M. Flores: That's right. It was not transparent. It happened in back rooms. There are some who would say that the Lehman example involved a lot of chicken-playing between Lehman and the Fed and others.

And, like I said, it wasn't so much Lehman going into bankruptcy, but the fact that Lehman didn't get bailed out that really started the edifice to crumble.

Shortly thereafter, of course, AIG, in a whipsnapping kind of moment, was bailed out. And very shortly after that, Secretary Paulson and Chairman Bernanke came to Congress saying that the sky was falling, that they needed three-quarters of $1 trillion to prop the sky up. And they offered a 2 1/2 page Legislative plan to Congress and the nation and the world as their rescue plan.

What that showed was an inconsistent government that was panicked and had no adequate response for the crisis. That's what panicked the market. That's what took it under.

And frankly, I submit what that means is we don't need to abandon bankruptcy to deal with measures to forestall the next crisis or better handle it. We need to abandon government intervention that can be inconsistent and panicky.

David Gray Carlson: I have to dispute the notion that if the Bankruptcy Courts are involved there is no politics. We just went through the Chrysler and the GM...

Unidentified Male Speaker: Well that...

David Gray Carlson: Bailouts. Those were highly political.

Daniel M. Flores: That's true. But I think the key thing about that instance is what preceded the bankruptcies. What preceded the bankruptcies were TARP-funded politically driven bailouts of GM and Chrysler that Congress actually shot down in the last Congress, but were then funded via what I would suggest are at least some questionable interpretations of the TARP authority by the Bush Administration, and carried forward by the Obama Administration in ways, pre-bankruptcy, that basically ran thoroughly roughshod over the kinds of expectations over how creditors would be treated, that one would expect in bankruptcy.

And it was only after that cascade of measures outside of bankruptcy came to what many of us could predict was going to be doomed end, and things pivoted to bankruptcy, that that carcass landed in the Bankruptcy Court. And it was a thoroughly perverted process by that point.

If we have a system that doesn't allow the bailouts to being with, and starts everybody down the bankruptcy road to begin with, I don't think we'll see any more experiences like the GM and Chrysler bankruptcies.

Bob Keach: Let me throw this to George for a second. Because Professor Kuney, you were early out of the box with a proposed alternative chapter for Too Big to Fail in your *Journal* article. Yours is slightly different than the one that Daniel's described. Why don't you tell us a little bit about what you advocated in your article, and how it might be different.

George Kuney: Well, the proposal is different than Chapter 14. We called it Chapter 10 to begin with. And that was a good place...

Bob Keach: From a marketing standpoint, the 14 thing may be better, because old Chapter 10's not all that popular.

George Kuney: Not all that popular.

Bob Keach: Just a thought.

George Kuney: I'm willing to re-brand.

Bob Keach: Yes.

George Kuney: The idea there was to, again, take advantage of the bankruptcy system's transparency and certainty, and the fact that we've got a judiciary over 300-strong who's used to dealing with distributional problems.

We've also got a system which, in recent years, has moved towards the 363 sale. The idea that the first thing you want to do is separate the assets from the financial structure so the business can continue and we don't have a cascading set of failures of related firms, vendor firms and employees.

Essentially, the proposal came down to nationalizing the Delaware and Southern District of New York process of Critical Vendor Motions, and opening it up to all ordinary course payments so that we're basically backdating the petition date so that anybody in the normal payment cycle is still going to receive their payments as they come due.

That then sets you up, and I won't steal the thunder from the next panel, but to works towards a quick and rational 363 sale process instead of a plan process. I think if I had my way, and there's no reason I should, the analog provisions for the disclosure statement and plan would be morphed into the standard 363 two-step, with some distinct rules about what kinds of provisions would be allowed in the sale orders, what sort of terms would be happening, how we get to an oranges and oranges comparison of bids, and maximize value in that fashion.

Bob Keach: So obviously, we're dealing with Too Big to Fail companies, so in theory, we're dealing with large companies. But the proposal obviously assumes that the liquidity to pay ordinary course transactions is not the issue, but that restructuring other issues on the balance sheet, derivatives, senior secured debt et cetera, is the issue, and that that can be addressed in an abbreviated GM-style process.

George Kuney: Absolutely. And we may get more regularized than GM. In fact, we were thinking of GM and Chrysler at the time. When the article came out, you had letters being written from the Michigan Governor to ask the companies to file in Michigan. Of course, they weren't going to file in Michigan. You had to have the certainty of going to New York, going to Delaware, where you've got a sophisticated body of practice, a sophisticated judiciary that's used to handling these issues.

We've sort of got a mini-federalism kind of argument here. Instead of the states being little laboratories for working out problems, we've got the districts of the Bankruptcy Courts. And I think it's pretty much without argument that the folks who have innovated and succeeded in bankruptcy are the Bankruptcy Bar and Bench, the practice in Delaware and the Southern District of New York.

Interestingly, this also affects, in a backhanded sort of way, the venue-shopping complaints of people like the Professor, who I think we all agreed not to name, by taking those practices that people are responding to and nationalizing them so they're available in Los Angeles, in Detroit, and not just in Delaware and New York, and a few other districts.

Bob Keach: Speaking of Delaware, and let me just throw a question at Judge Carey for a second. Although I'm not sure there's a Federal Reserve Bank in Wilmington, so you might not see any cases out of Danville, either.

Adam Levitin: It's an obviously an anti-Delaware venue provision.

Bob Keach: You, fortunately, have presided over some very large and complex financial cases, and the Delaware Bench has, in general. Frankly, personally, I think we start too late in this game, and that we could look at the group of sub-prime mortgage companies that file in Delaware and were resolved in the Delaware Bankruptcy Courts as actually the first step in what we now think of as the global meltdown.

So you had New Century. I think Judge Sontchi had American Home Mortgage. These were complex cases. They were derivative-centric, to make up a phrase. Chapter 11 seemed to work in those cases, didn't it?

Kevin J. Carey: Well, New Century was interesting to me for a couple of reasons. But one of them was that it was filed in April of '07, which was after the crisis, in a form, was already in full swing. And yet nobody was really talking about it. And the heat really didn't get high enough until after that. And then, of course, everything got even worse.

But I guess, fortunately, from a judge's standpoint, the derivatives and netting issues, although they were teed up early in the case by the parties, I was never asked to decide. And maybe the parties were afraid to ask me to decide it.

Judge Sontchi, however, did end up writing a couple opinions in *American Mortgage* deciding what was subject to the netting provisions and what wasn't.

But it moved along rapidly. I had a hearing a week for an extended period of time. We did as, I guess later happened in the other, bigger cases that we're now talking about, there were immediate 363 sales. Maybe not of the magnitude of the larger cases. But what happened was, and no one disagreed about this, that the value of the company's assets were dissipating on a daily basis.

Bob Keach: That was a melting ice cube with a blowdryer on it.

Kevin J. Carey: Yes.

Bob Keach: Yes.

Kevin J. Carey: And frankly, the counterparties, I'm not sure were all that eager, and of course, as a judge, you don't always know what's happening outside of the courtroom, blessedly, to assert the rights that they claimed in their filings that they had. Because it just seemed to be that everyone got together and said, listen, we've got to capture whatever value there is to be captured before it's completely gone.

So we raced through so much of the case in the early months. And, from my standpoint, and this really raises the bigger issues that people are now debating in the 363 versus 1129 issue, and that is what should you be using 363 for? And the sub-part of that question and debate is, what due process is being offered in those cases where the sales move so quickly?

And I think a fair argument can be made there is some process, but what's due process? When a judge is faced with a circumstance in which nobody disagrees that if we don't sell this asset now, the value will be lost, it seems to me that's almost always the thing to do.

And that's what happened in New Century.

Adam Levitin: But whatever the limitations are on due process in the 363 sales, it's robust process compared with a FDIC resolution. That it's transparent, there is an opportunity to be heard, that there's an appeals process. We saw Chrysler went all the way up to the Supreme Court.

And it may not be the perfect process, but it's something. And I think that we shouldn't discount that something too lightly.

Unidentified Male Speaker: Well, and there's another (inaudible)...

Bob Keach: Let me throw out another question for the whole panel to talk about, and you can throw in some other things on this. But we sort of have all the proposals on the table, now. And I think we should probably, as Harvey Miller did yesterday, and I think Professor Levin said it during the derivative panel, which is Chapter 11 with the safe harbors modified or stripped out would work perfectly fine here. We don't really need to reinvent something.

So if we talk about Chapter 14 or 10 the, quote, new chapter, Chapter 11 maybe with tweaking derivatives and resolution authority, either Dodd or Administration as the sort of universe here, let's go back to the beginning. Because one of the things that's interesting to me, and I'll just open this up, and then maybe David, you start us, and we'll go from there, is the definitional issues abound.

Let's start with this concept that's been tossed around for two days now about systemic risk. The Administration Bill is simple. Systemic risk is whatever Geithner and the current Fed Reserve Chairman and whoever else is involved tell us it is.

But what are we talking about? Because one of the real interesting dichotomies here is we have systemic risk with AIG. A heavily derivative-centric firm, to use my new, made-up term. CIT was the fifth largest bankruptcy in the history of the United States and barely got a mention on the Hill.

What is this systemic risk concept we're talking about? And is it just whether Goldman Sachs is invested in the company or not?

David Gray Carlson: What is systemic risk? It's obviously a judgment about consequences. So systemic risk is the prediction of extremely dire consequences. I don't think we can go further toward a definition than that.

Bob Keach: But isn't the problem with that the virtually unreviewable concept? Daniel?

Daniel M. Flores: I think that's fair. I think that there's a heated real-world academic debate, for lack of a better term, over whether there is such a thing as systemic risk.

But I think most people thinking seriously about it would acknowledge that systemic risk is a term that all-too-readily can be translated into political risk for Washington decision makers. That is a mischief in the systemic risk concept that has to be exterminated before this concept can be useful.

Stepping back from that, I think systemic risk, what the term is about, is the potential for runs. Either bank runs or non-bank runs on the financial system. There are those such as Peter Wallison at AEI, and I remember the Pew Commission, who would say that, sure, systemic risk exists. It exists in the world of banking. It is about bank runs. And the FDIA response to that, outside of banks, there's no such thing as systemic risk.

I'm not an economics expert. I'm not sure. But I do think it's fair to say that the systemic risk that could occur outside of banking is simply about potential runs. And therefore, the question is how can we control against runs on non-bank financial institutions?

We can regulatorily, prophylactically lay in place regulations that help temper excessive risk so that the risk doesn't build up to begin with. Once we're in a situation in which systemic risk, if it's out there outside the banking world, starts to manifest itself, we can have a system that quashes it right off the bat.

And the place to start thinking about that, I think, is in the current system in place to deal with insolvencies in bankruptcy. And only if we can't figure out how to deal with it there should we look anywhere else.

Bob Keach: I think, in the concept, and Adam, I want to hear from you on this and everybody else, but the concept of systemic risk is being used at least in two ways by the Administration, and I'm sure by others.

But there is this concept of runs. And the traditional bank run was, of course, was everybody runs to the bank and takes their money out. The kinds of runs we're now talking about seem to be follow the derivative counterparties, take their collateral and go home. They terminate their derivatives. They close those out, which is a different and potentially even larger and more serious run.

But if we take GM and Chrysler for a second, which was an example of government intervention and is, to some degree, a model for some of what's going on, that was a different sort of consequence or a theory of consequence. That was the supply chain will collapse, unemployment will result from the supply chain collapse, as well as the auto industry collapse itself, that will lead to

millions of lost jobs. And therefore, the economic consequences to the municipalities, et cetera, that result from that kind of gross unemployment.
If I take CIT as an example, many people would say that a GM-like consequence, maybe not of similar magnitude, could have existed had CIT not resolved it so quickly, because they were the lender of first and almost only resort to a huge segment, for example, of retail and other industries.

Yet again, we have a totally different approach to those companies, is the difference that retail workers tend not to be organized? What is the difference there?

David Gray Carlson: Good question. But if I could sort of just tap my memory about the financial bailout, I recall a lot of discussion about toxic assets. Assets with a face value of 100. Properly, they should have had a value of 80. But if you went out on the market today, this is in the middle of the bailout, that is, you could only get 40. So there seem to be...

Bob Keach: In Europe, yes.

David Gray Carlson: There seem to be some sort of begging of Wall Street, would you please give us time for the market to recover so that the stuff that is worth aiding on a discounted value basis will go back up to its proper market value.

And I also recall that Secretary Paulson, his original idea was, he was going to buy these assets. That always confused me. Was he going to buy these assets for 41 or was he going to buy them for 79? That was never clear to me.

Unidentified Male Speaker: It's also unclear to him.

Bob Keach: Also ultimately why he didn't buy any, I think, yes.

David Gray Carlson: So he put it into bank-preferred stock, as well, which I thought was a pretty good move. I hate to defend Secretary Paulson.

Daniel M. Flores: In Secretary Paulson's defense, he was working in the midst of what was a genuine credit crisis with genuinely scary things happening all around him. It was a tough spot to be in. I disagree with a lot of the actions that he took. But I can understand the human fallibility.

Isn't it curious that the sky was going to fall because of toxic assets? And the sky wouldn't fall if we had three-quarters of $1 billion to buy toxic assets. And the sky didn't fall, but we still haven't addressed toxic assets. And we still haven't spent, nor I would say personally, should we, the three-quarters of $1 trillion.

To me, what that says really, at a very deep bottom line is we didn't need all that. Bankruptcy was adequate. Bankruptcy can deal with these situations if we just let it.

Bob Keach: And building off of that, because this is why I'm sort of pushing on this eligibility point, if we're going to have special chapters, as opposed to just tweaking the existing code, if we're going to have special chapters or resolution authority or Dodd-like resolution authority for Too Big to Fail firms, which we define as firms that pose systemic risk, don't we have to know who the hell we're talking about?

Who gets the special chapter? Who gets resolution for it?

Adam Levitin: We tend to think of systemic risk as being financial firms. And that very well may be right. But then how do we explain a GM or Chrysler? The answer might just be that GM and Chrysler shouldn't have gotten any special treatment.

But I think we need to be careful about the difference between Too Big to Fail and systemic risk. That a company like Boeing, we might consider it Too Big to Fail. That if Boeing were to be liquidated piecemeal, then we would be losing one of the major aircraft manufacturers. It affects military contracting. Huge employer. That we may not like those consequences.

But I don't know that that's in any way systemically important. Yet I suspect that if Boeing were to get in trouble, we would probably be looking at a similar outcome to GM or Chrysler.

And there are different needs when you're dealing with a financial company than with an industrial company. With an industrial company, often what we're concerned about is preserving going concern value. Keeping all of the operations together and maintaining employment.

With a financial company, a lot of the value is often reputational, and trust and confidence. And that goes away really fast when a financial company gets in trouble. So the sub-prime mortgage lenders that filed in Delaware in 2007, my guess is that they haven't really been reorganized. Assets were sold off as quickly as you could. It was like ice cream melting on a hot day. It was just, let's find the best parts we can for these assets and be done with it. And there was no going concern value, per se, being protected. It was just, can we find any way to stop the asset depreciation?

Bob Keach: Although there was certainly value being preserved. Because the difference between selling the servicing platform, for example, on Tuesday versus Friday was probably potentially tens of millions, if not more. So you are talking about a value preservation.

Adam Levitin: It was value preservation, but it was not an enterprise value. It was not the combination of all the elements in New Century together. It was different pieces. It was like a store with ice cream. You want to sell the ice cream before it melts, but that's not going concern value that you've protected. You've just protected the value of that asset.

And this may speak to needing different procedures for these different types of companies. So financial institutions, the key concern there is, let's do this fast. And bankruptcy does have some disadvantages relative to the FDIC process. But it's not because of bankruptcy procedure. And I think this is something that's often misunderstood.

Bankruptcy can move pretty darn fast. The problem is an informational one. The FDIC, when they go in and take over a bank, they've already been crawling all over that bank for weeks. Large banks have resident examiner teams. The FDIC has a tremendous amount of information about the institution. It knows what the subsidiaries are. It knows the structure. It knows where the assets are.

Not so with non-banks. So Harvey Miller yesterday said that Lehman called up at, I think, two in the afternoon and said, we need to file by midnight. And he said, I have no idea how this company is structured. I don't know what Lehman is, even. What are the elements of Lehman? Where's the money? Where are the subsidiaries located?

That is where you get the slowdown is that bankruptcy, you have a learning period at the beginning of the case that an FDIC resolution doesn't have.

Daniel M. Flores: But you're pointing out a dynamic that has occurred most recently as a result of the turmoil in the economy. Most bankruptcies, in my experience, are planned. Nobody had a chance to plan anything in this recent crisis.

So whether you spilled into a bailout, you spilled into an 11, or whatever form of process the company got into, it just happened.

Daniel M. Flores: I would interject there, with one caveat, which is I think the people did have a chance to plan for bankruptcy in this crisis. The fundamental problem was that they refused to take it. They banked on the possibility of bailouts, particularly in the Lehman instance and some of the other big firms.

Unidentified Male Speaker: (Inaudible) Claims Court.

Unidentified Male Speaker: I think Harvey would agree with you on that.

Daniel M. Flores: Yes. In fact, Harvey testified that before our committee a couple of weeks ago.

One of the things in response to that is something that Charles Calomiris from Columbia Business School has advocated, and others have, too, which is prophylactically to require institutions that may be involved in runs to have living wills or other better pre-set plans in place so if an insolvency occurs it could be processed much more cleanly, much more rapidly.

Be it in bankruptcy or outside of bankruptcy, I think there's a lot of merit to that idea, and it should be well considered. It's a tough thing to actually do, but it's a very good idea.

Bob Keach: And let's explore that idea. Because that's actually come up in different contexts with, again, and we'll get back to this in a second. But with the systemic risk firms, this idea of living wills, which is that people pre-plan, essentially, their restructuring. In other words, there would be a plan in place for when they got into trouble as to how they would get themselves out of trouble, under whatever the existing regime was into which they were going to enter for that purpose.

It's an interesting idea. And I think it seems to be taking hold in Europe. And lots of people think it has merit.

It's not clear to me precisely how it would work in the sense that, obviously what gets you out of trouble today is not what would get you out of trouble two years from now. So at a minimum, I suppose this is true of everybody's living wills, we ought to go revisit the Trusts and Estates Rules every year or two if we're going to make this work, correct? This is going to have to be a continually updated plan, it seems to me.

David Gray Carlson: I would distinguish, analytically here, there ought to be a distinction in our discussion between whether there should be a bailout or not. And that's a very political question, no mater what side you're on. You can take, as you will, the Herbert Hoover position. But that's politics, that there should be no bailouts.

So put that aside. You can have your political position on whether there should be bailouts. But then there's the question of, given the decision to have a bailout, should it be cycled through the Bankruptcy Courts or not?

It seems to me that discussion assumes that there shall be a bailout.

Bob Keach: Isn't it actually common? And I'll throw this out because, Dan, I think you'll probably disagree with it, but isn't it actually a common feature of the non-existing Chapter 11 proposals in many senses that there's a presumption here that government money will be used? We're talking about building the funnel through which it will go?

David Gray Carlson: That's exactly right.

Daniel M. Flores: That's right. And my disagreement is at a very foundational level with David's comment. To bail out or not is not just a political decision. It certainly has some political elements to it. But it's also an economics decision.

If one is going to have an economic system in which bailouts are available, and bailouts are only going to be available to very large companies, very large companies, as a matter of economics and economic incentives, are going to depend on those bailouts. Are going to take extra risk. Are going to more easily access credit than smaller folks, the folks some have called the Too Small to Save.

What that will produce is (inaudible)...

Adam Levitin: (Inaudible) the Reform Commission, Too Small to Save is a number that just keeps getting bigger and bigger depending on who you talk to.

Daniel M. Flores: That's right. As a matter of economics, what I think locking into a bailout-driven system does is it unleashes an inexorable engine of concentration in the industry involved whereby smaller companies become bigger and bigger to take advantage of the advantageous rules for bigger companies.

That actually increases risk. It diminishes competition. It disadvantages the quality of goods and service and price for consumers. And so really, at a very basic economic level, the decision of whether or not to have a bailout regime is very much not political, but an economic policy.

Bob Keach: And Dan, let's explore that, because I think that's actually fascinating. And let me reiterate the point. Because this bring into play what I call the antitrust branch of the Too Big to Fail folks. And you were jumping on this, because I think this is an aspect of what you wrote about.

The theory here is that if resolution authority is seen as a structured bailout mechanism, or maybe even an unstructured Administration-controlled bailout mechanism, we'll actually have people encouraged to become big just to fit into that mechanism.

One other approach, obviously, that being taken and it's, I guess, not a bankruptcy approach, is what I'll call the antitrust regime, which is, let's just shrink these companies so that we don't have to think about it. Let's approach them from the standpoint that we're just not going to let firms get large enough to have to take advantage of this, where the ones that are large enough, we're going to break apart so that we don't have to worry about it.

Is an aspect of what you're talking about that we would not let firms get so big that we needed a special regime to deal with them? Anybody?

Unidentified Male Speaker: I think that's actually Daniel's point.

Daniel M. Flores: I guess I'll chime in. I believe in free markets. I hesitate to introduce mechanisms by which government, particularly the government in

Washington, decides who gets to live, who gets to die, who gets to be big, who gets to be small.

I think the key thing is to make sure that rational marking incentives are in place so that the actors decide who it makes sense to be big, and who it makes sense to be small. In some industries, it makes sense to have a few big players. That's the most efficient way to deliver the goods and services. In others, it makes to have many, many small players.

What you need are incentives that allow the rational decision to made. And it doesn't introduce distortions into that process that set off these risk-inducive mechanisms or other engines of mischief in the economy, that we then do need government to come back and respond to.

So I think, frankly, what we need, if I can just get to the chase, is we need a bankruptcy reform that will help to deal with the kinds of companies we're talking about. And we need some proactive regulation that will help companies get back to the right incentives to police themselves better.

Kevin J. Carey: Dan, let me ask you a question about that. And it's something that is of some concern to me. If there were to be a resolution process outside of bankruptcy, I set that aside and say, for the moment, as a bankruptcy judge, I'm unconcerned what Congress would decide to do.

But if you're doing to funnel these things through bankruptcy, what do you do in the circumstance in which government, through its lending power or otherwise, is the driving force in the bankruptcy? Really, the controller. And what remedy, if any, do you permit the other constituents in the bankruptcy for redress of when the government acts badly, that if it were a private party, it would be subject to different kinds of things. But in government, it's not ordinary.

Adam Levitin: Can I add to that question?

Bob Keach: Let him answer this one first, then you hold yours, and we'll give him another one.

Daniel M. Flores: I think it's a fair question. And the Republican response to H.R. 3310 is to cut that possibility off to begin with. No government bailouts. There are provisions in non-bankruptcy titles of the bill that cut off the Fed's ability to bail out. There are provisions in bankruptcy that preclude the government from providing federal DIP financing.

And the end result is the government never gets to be the genie that's out of that bottle that you described.

Bob Keach: Adam, you had something else?

Adam Levitin: I think what Judge Carey, the situation he was considering was the way the government's done some sort of rescue loan pre-petition, as with GM. But what really concerns me about using bankruptcy to try to resolve a Too Big to Fail institution is that you need financing to do it. Even if you're going to do a liquidation, you need financing if you want to preserve value.

I'm not talking about going concern value. I'm talking about the melting ice cream. That you need to go and buy a freezer to keep that value. So you need some money. And if there was private money to finance the resolution, the normal bankruptcy system would work.
The problem is, when you get a company that really is too big, that private money may not be available, or it may not be available fast enough. And do we just let the ice cream melt and have a free-fall liquidation? Or do we allow government

to step in as either a debtor in possession financer, or guaranteeing an asset sale?

Daniel M. Flores: I guess my response is to beg to be able to say, no, you're asking the wrong question.

Adam Levitin: Okay.

Daniel M. Flores: What I was getting to earlier with my discussion of the market incentives is what we need to have in place is a system that forces the market, and I would say by relying on very clear bankruptcy rules, and only bankruptcy rules, for insolvencies that let all shareholders, all debtors, all creditors know that when Humpty Dumpty falls off the wall, they're going to have to deal with it. It's going to be on their dime, not the taxpayers'.

If those are the rules that are in place and...

Bob Keach: Well, let's just explore that. All right? Let's just explore that for a second. Because essentially, that's just a legislative version of creative destruction, right?

What you're saying is that in the case of GM and Chrysler, where no one else, in theory, would have loaned sufficient money to maintain them as going concerns, that the government should not, would not step in to provide that financing.

Daniel M. Flores: Well, that's right. And I'm not taking any sides here in the auto sector. But I would (inaudible)...

Bob Keach: No, I'm just using that as an example.

Daniel M. Flores: I know. But I would point to the example of Ford, that actually did all the right things as we led up to the credit crisis, and did okay. And Ford and the non-domestic transplant manufacturers, had GM and Chrysler gone under, I think would have picked up the market share that was accounted for. Suppliers would have survived. And things would have done better than what we have on our hands now.

But what I was getting to was the idea that if the rules are such that the market knows it is going to have to clean up the mess if the mess happens, then particularly when we're talking about the systemic risk situation where what you have is a dynamic of debtors, counter-party creditors and people contracting with each other all over the place to hedge against risk, they are going to transact in a way that will control the growth of any firm so it doesn't reach the size where it, theoretically, is going to be so big it will bring everybody else down.

Bob Keach: Adam, just based on your paper, I trust you disagree with that notion?

Adam Levitin: Yes, I think that's the right move, but I just don't think it's going to work. I think, philosophically, that's exactly the...

Bob Keach: The right idea, but it's a fantasy?

Adam Levitin: Yes, that ultimately, we're chicken. That's the problem. That what Dan is proposing sets up all the right incentives. But we are, sooner or later, going to find ourselves in a case where we are just too scared about the potential consequences. And it's always that we don't really know what's going to happen.

We're too risk-averse. We don't want to risk a social catastrophe for the sake of upholding some principles.

I don't like to see the economy politicized, but a de-politicized economy can, at certain times, become sort of a suicide principle.

Bob Keach: Okay, but then...

Adam Levitin: And we don't want that.

Bob Keach: Then hold on one second. Hold that thought. Because I'm still plagued by this definitional problem. And Professor Kuney, I guess I'd like to hear from you on this.

I'm looking at the title of the Resolution Authority, which is called Resolution Authority for Systemically Significant Financial Companies Act of 2009. There are, I think, 50 or so definitions in this bill, not one of which defines systemically significant financial company. But this is easy, because they just get to decide who's in it.

But if we're not going to use this kind of approach, again, let's take your idea, for example. Who's in? How do we decide who gets into whatever special regime we might create?
Bankruptcy, it's easy. Everybody's in, right? You don't have to be insolvent. You just have to be not a bank, not a trust, not some of the ineligible characters. We sort of defined who's out, but everybody else is in.

How do we define who's in special regimes?

George Kuney: I think actually the Bankruptcy Code model is the only way to approach it. If we're legislating a definition for Too Big to Fail or systemically important companies today, it's not going to work for the companies tomorrow.

As I think was pointed out yesterday a number of times, the Bankruptcy Code of 1978 has been remarkably flexible and continued to work even though the businesses that it's confronting today, or they're confronting it, were not imagined at the time that it was passed.

By the time we end up legislating a definition for the crisis of today, that crisis will have passed, and we'll have moved on to produce another crisis, another problem.

So from my perspective, excluding certain entities, as the Bankruptcy Code currently does, from certain chapters, is a superior approach. I think what you then do, and perhaps Daniel would agree with this, you produce different chapters, as many as are needed, to produce different tools, different regimes, for debtors in possession, primarily to avail themselves of, based upon the particularities of their business.

The problems with derivatives and the special exemptions for them have been referred to, and I won't rehash all that, but fixing that would do an awful lot to making Chapter 11 itself more useful.
I think having an expedited sale process that was regularized makes a lot of good sense. People will continue to seek out the tools, if they're available, that will help solve their problems.

The government as lender is the biggest problem that we have when we get into problems of Chrysler, GM or any of the financials. And do we want to set up the government as a 364 lender of last resort, or maybe first resort? The interest rates are very appealing, I'll say that, for interim DIP financing.

Bob Keach: Let's rehash the derivatives thing just a little bit. Because both Professor Lubbin yesterday, and to a much more clear extent, Harvey Miller in his luncheon remarks, both said that Chapter 11 is adequate to this task or, frankly, any other task relating to systemically significant financial institutions if we simply deal with the overbreadth of the derivative safe harbors and the existing Chapter 11.

In the Resolution Authority, they deal with that by allowing for a very short stay. I think one to three days.

Daniel, I'm not sure how Chapter 14 deals with this issue, but if we fix the derivatives problem, in other words, if we can restrict the overbreadth of the safe harbors and allow for some reasonably lengthed stay of the closeout, termination, et cetera, of derivative transactions, wouldn't that, all by itself, solve most of the problem we now see with the AIGs of the world, for example?

Daniel M. Flores: I think that's right. The key things are eliminate moral hazard, better address derivatives, and facilitate speed.

The way that Chapter 14 and H.R. 3310 deals with it is it allows a company that's balled up with derivatives and potential systemic risks flying out of the executioner derivatives to get into a room very quickly with a board composed of the Secretary of the Treasury and others, with its functional regulator, with the FDIC if it's involved inside a bank holding company, and others to try and provide for a workout relying on forbearance or other ways to avoid execution of the derivatives.

However, if it's very clear that that's not going to work, basically what we have in the bill is the Market Stability and Capital Adequacy Board can essentially waive the debtor right on through to the Bankruptcy Court in Chapter 14. If the Board consents with the debtor, the debtor can file a Consent Motion that obviously the Board's consenting to, for a stay of the qualified financial contracts that otherwise wouldn't be stayed.

That, as long as there's consent by the Board, creates an automatic stay. There are requirements to deal with whether it's going to be a permanent stay very quickly. There's required to be briefing on the issues of whether to maintain or lift the stay within five days of...

Adam Levitin: It requires the court to hold a hearing within five days.

Daniel M. Flores: Pardon? No, no, I think briefing has to come in from all parties concerned within five days. And that can include from the regulators. In fact, I think some of the regulators have to weigh in. And then, within five days thereafter, the court has to have a hearing on that. Within five days after that, the court has to issue and order.

Adam Levitin: Just so we have the proposal on the table clearly, who's on the board that has to consent to seek the stay?

Daniel M. Flores: The board is composed of the Secretary of the Treasury and similar officials. Let me get to the right provision in the bill.

Adam Levitin: But it's similar to the same guys who are deciding to put companies into resolutions (inaudible)...

Daniel M. Flores: Well, it is. But see, the key thing is, what seems to be needed to deal with systemic risk, if it comes up, is that the right folks within the government who know about systemic risk and know how to address it, i.e. particularly the Fed, but also Treasury and others, can exercise influence on the process. But to avoid politicization of the process, not to be able to dictate the result.

So we have this board, it's composed of the Secretary of the Treasury, the Chairman of the Fed, the Chairman of the SEC, the Chairperson of the FDIC, the Chairman of the CFTC, and the Chairperson of the Financial Institutions Regulator. They're doing things to assure capital adequacy and market stability.

But in these cases, they basically come in and facilitate what are sort of 1907-style JP Morgan-like negotiations to try and save the situation without a bankruptcy. And if they consent, the case can go straight on into bankruptcy, and there can be this brief automatic stay of the QFCs until such time as a briefing can be concluded and the court can issue a decision. And all, hopefully, within 15 days of the petition.

The hope is that that will rapidly, effectively, transparently, and with all the right views and all the right expertise in front of the court weighing in, allow the court of make the right decision.

Bob Keach: Let me just back up with that. And, as Judge Carey pointed out, and I'll ask him to weigh in on this as well, and it's certainly in cases that we've had where there are derivatives, even though the safe harbors existed and people exercised their rights to theoretically remove the derivatives from the prevue of the court, there is never exactly a lot of fervor, particularly in down markets, for the counterparties to actually exercise their rights to sell off their collateral.

And the more we actually deal with derivatives and insolvencies, Lehman being an example right now, it's probably a laboratory right now for this issue, the more it seems like there's nothing wrong with just having the stay apply, and having the board you talked about or the FDIC or the Federal Reserve to come in and ask for relief from the stay, I don't know.

Let me ask Judge Carey. If the Federal Reserve ran into your court on day 2 of the AIG bankruptcy and said, please lift the stay on derivatives trading in these instances, because otherwise, the system's going to explode, I assume you would listen to that.

Kevin J. Carey: I would do whatever the statute required me to do within the timeframe that it dictated.

But at the beginning of a case of that magnitude, there is just so much to do. I say to myself, why not, as you'd indicated, Bob, why not just let the stay be in place? And if somebody wants it lifted, let it go through the normal process. And that's an expedited process in and of itself. We've come to the point now, in the 11s that I see, where minutes are like years.

Bob Keach: Yes.

Kevin J. Carey: I'll go through a month of the case. I feel like I've been through dog years. It's just so much is compressed into the beginning. Now, there are lots of good reasons why much of it should be. But I think there are equally good reasons why a lot of it, despite the fervor of the parties, doesn't necessarily have to be (inaudible)...

Bob Keach: And the reason I threw that out, Daniel, is that it strikes me that that aspect of the Chapter 14 Bill, which distinguishes it from normal Chapter 11, suffers from the same weaknesses that Resolution Authority does in that you have a decision-making body within the government deciding whether or not a crucial element of relief in the case will or will not exist.

Daniel M. Flores: No, I disagree. And (inaudible) why I do is a part of the problem with how to resolve this is what do you do with repo financing and others who (inaudible) style financing that the system depends on very heavily and is transacted upon to be sort of in and out, in and out, in and out, constantly moving transaction practice.

We've provided in the bill for this by setting up a flexible regime in which, like I said, the Board gets involved in the case pre-filing and can consent or not to a motion that would kick off an automatic stay at the time of petition. So there wouldn't be a gap between, if the Board consented, to when the case shows up and Judge Carey would issue a stay. That would help prevent executions.

But if the Board is not convinced, prior to the time of the petition, that the case is going to generate a systemic risk implosion, the Board doesn't consent to the motion. In that case, the debtor comes in and asks for the stay to be applied, but it's not automatic.

Bob Keach: Let me just play devil's advocate for a minute, which is virtually every element of the U.S. government involved in financial regulation was in favor of the current breadth of the safe harbors in 2005. In other words, they just ate the industry line with respect to the need for the breadth of derivatives.

And again, this may not be my personal position, but just to play devil's advocate for a second, why should we think that a committee consisting of those same people are going to be any less Wall Street-friendly when it comes to whether to impose a stay or not?

Kevin J. Carey: Well, we aren't because again, our system is a case-by-case system to allow the Bankruptcy Court to be helped by the expertise of these entities regarding a stay question. We've put in this system whereby, with the consent of the expert Regulators, there can be a very brief automatic stay. And the court provides a check on that by lifting or not, after a full briefing by everyone. Or if the Board stays out, the court can hear whether or not it should do something, again with briefing by everyone.

So it's a checked and balanced system that the Fed and others don't dictate. It's also a case-by-case system instead of a, the automatic stay covers all QFCs or the automatic stay doesn't cover all QFCs. And I have yet to see anything that comes close to being as adaptable and effective in responding to the actual circumstances we have in cases like this, as the provisions in H.R. 3310 are.

Bob Keach: We're going to run out of time. One of the things that came out of yesterday, and one of these that I think is worth considering by the experts on the Derivatives Panel was you actually could narrow the definition of what are exempted financial instruments. And you could cover, for example, overnight repos. You wouldn't necessarily have to roll the entire universe of credit swaps and forward contracts, for example, into that next. But there are certain instruments you could exempt.

Let's take the time we have. Because I suspect this will spur as much debate as anything. For the $64,000 question, and I'm going to start at Professor Kuney's end and we'll work back towards Daniel.

As I said, we've got a number of proposals on the table about how to deal with Too Big to Fail institutions. And we've got definitional issues. Financial institutions, Boeing, GM, where do we fit?

You're a one-person legislature, Professor Kuney. What would you like to see happen here? How would you structure this?

George Kuney: I think my approach would be very conservative. And it would be modifying existing tools, modifying existing 11, passing a 10 or a 14, which really picks up on the experience that we've had, really, in the last 10 years in terms of expediting sales.

I don't think you create or enshrine a dictatorship, even if it's a dictatorship of six highly qualified people inside the government who are politically motivated. I think you give it to folks like Judge Carey.

Kevin J. Carey: That's what scares a lot of people.
George Kuney: I understand. And one thing that hasn't been brought out here, but that I am concerned about, is the fact that if we don't have a special chapter that addresses these kinds of things, you end up with procedures and precedents in some courts and in some large cases, because emergency is the best time to do dramatic things. Which are then trickling down into smaller cases.

I believe Judge Carey mentioned to me the other day that he's already had the GM case cited to him as precedent for rapid 363 issues. This has happened consistently since the passage of the Code. We get a big case, a big emergency, there's a reason to grant a code under stay. And the next thing you know, there's an apartment in La Mesa, California and the borrower doesn't want his personal guarantee to be drawn. And we're citing...

Bob Keach: It goes into everybody's first-day motion package. Yes, yes.

George Kuney: Which is now available on the Internet, et cetera. So I think you keep it simple. You play on the Bankruptcy Code's strength, which is, right now both a plan and a sale process. You institutionalize those. And you make it nationwide.

Bob Keach: Adam?

Adam Levitin: I largely agree with Professor Kuney. I'm not certain that we need a special chapter, but it's certainly something I'd be open to.

What I would do would be basically keep the existing system, and our default rule would be if your business fails, it's bankruptcy. And maybe we have a special chapter that's available for larger institutions. Maybe we don't. The bankruptcy is the backdrop rule.
But if we get scared enough about the consequences of any institution's failure, we have a mechanism all ready for acting. It's called Congress. It's not that Congress is good about this. It's just that they're the least of all evils. That I'd rather have Congress making the call that we're not going to use bankruptcy, we're going to have a bailout, than having any collection of regulators do this.

And again, this is not that I think Congress does a great job with this, it's just that they're the least evil possibility here.

Kevin J. Carey: It's really your secret plan to assure inaction?

Adam Levitin: (Inaudible) would largely have that effect. And I think that's one of the virtues. That Congress is slow to act. It's only going to act when it gets really scared, when you have the Treasury Secretary and the Chairman of the

Fed come in and say, the sky's going to fall tomorrow if you don't act. And they're not going to do that too lightly.

And even if they do, we saw that Congress came in with a 2 1/2 page proposal to create the TARP, and it took a while before they got it. It expanded into like a 400 page version and then a 1,000 page version that didn't do anything more than the 2 1/2 page version actually did, but it took a while.

Bob Keach: I think we just felt so much better about it.

Adam Levitin: So I think our current system has its problems but it has the virtue that we know how it works. That you assume 11, and if you want special treatment, you've got to scare Congress enough, and there are political consequences for it. And we'll see some of that in this next election.

Kevin J. Carey: With respect to the resolution process, I have only one issue. And that is giving the government virtually unfettered power and authority to do that which it wishes. It's like giving the executive the sole authority to determine who's an enemy combatant. There are problems inherent in that.

With respect to putting this problem to the Bankruptcy Court to solve, I'd just say a few things. It's always helpful, I think, to have provisions which maintain the status quo, at least for a limited period of time. It cuts down on the frenzy and the chaos.

If Congress wants to tell me to do something, tell me with clarity what it is you'd like me to do. If you'd like me to exercise my discretion, then leave that to me, and make it clear that's what I can do.

Bob Keach: George?

George Kuney: Me?

Bob Keach: I'm sorry. David.

David Gray Carlson: I want to divide this into two questions. Should there be a bailout? I'm not unsympathetic with Daniel's anti-bailout view. But let's suppose that the politicians have decided there shall be a bailout. Should the Geithner Bill be passed to facilitate the bailout, or is the current system adequate? I vote for the current system. I don't see any great need for the Geithner Bill.

I'm sort of a fan of the Chrysler and BM bankruptcies. The government decided to fund the 363(b) sales. The government came in with flags waving. The bankruptcy judges took a good look at it and approved these plans. It worked very quickly.

Now, you can disagree with the politics of bailing those companies out. And I have no opinion about that. But I think the process of the 363(b) sale worked rather admirably.

Now, I've got to say, it's a good thing this was in the Second Circuit, which has all these Lionel Line of cases that say that you can have a sale of the whole business, not a Chapter 11 plan. Had that not been the case, I think we could not have moved quickly in the auto cases.

Bob Keach: Okay. Dan?

Daniel M. Flores: My short answer would be bankruptcy, bankruptcy, bankruptcy, CHR 3310.

The longer answer would be, let's think about hearings and a mark of a 3310 so we can make it ever better.

But it's funny. Every time that I've been exposed to a group of people opining on what to do in this area, which group has not been composed of government decision makers looking to be given more power to decide what happens, the consensus position has been we can and should do this in bankruptcy.

And I think that taps into something very, very fundamental about our system and our people's culture. We all know that in the 1780s, political machinations and discrimination involving interstate commerce, along with some other important things, threatened to consume the nation and the experiment.
In the Constitution, the framers thought it was sufficiently important to protect the country that they actually established authority for Congress to pass uniform bankruptcy laws so that, throughout the nation, everybody was working under the same system.

And that was going to be a system that would be worked out in the courts. It wasn't going to be the dominion of political actors. And the same wisdom, I think, applies today. We need a system that has a level playing field, that has transparency, that has clear rules and gives everybody with a stake in a case a chance to be heard and convince the court of what the right result is. And as long as we, in bankruptcy, add for the non-bank institutions a set of rules that adapts to their situations and assures a level playing field between big companies and small companies, we get to the right answer.

Bob Keach: Thanks. We have time for one or two questions. Do we have any questions or, I was going to say comments, but I really don't want comments. Any questions from the audience? If you do, please come down to the mike.

Seeing none, I want to thank a fantastic panel for tackling a really difficult issue. We're going to take a short 15 minute break. You can recaffeinate, and we'll be back here to talk about the sale model of reorganization, GM, Chrysler and beyond. See you in 15 minutes.

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REPEAL THE SAFE HARBORS

STEPHEN J. LUBBEN*

INTRODUCTION

It is often said that banks are not subject to the ordinary bankruptcy regime because bankruptcy is a negative cash flow event for banks.[1] While traditional companies that file bankruptcy gain the benefits associated with halting their debt payments, banks would experience a rapid departure of customers, reducing their cheapest source of funding. That is, there would be a run on the bank.

No doubt this is true for depository banks. But if a run on the bank is a bad thing, which undoubtedly it is, why would we want to expand the number of firms that are subjected to a run? That is what the immense expansion of the derivative safe harbor provisions did in 2005.[2]

Consider the case of AIG. By and large, AIG was a profitable insurance and leasing company. But its financial products division in London had decided to sell as many credit default swaps as it possibly could, without worrying too much about any sort of risk management of those swaps.[3] In essence, the financial products division became like a giant insurance company writing policies without any reserves to pay claims.

Once it became clear that the financial products division would have to have to pay out on those CDS contracts—many were written as "credit enhancements" on mortgage backed securities—AIG's counterparties requested assurance that AIG would be able to meet its obligations.[4] Specifically, as AIG's credit rating fell, due in part to the increased risk of a large payout on the swaps, its counterparties had a

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[1] *See* Stephanie Ben-Ishai, *Bank Bankruptcy in Canada: A Comparative Perspective*, 25 BANKING & FIN. L. REV. 59, 64 (2009) (discussing further harmful consequences of financial institutions justify regulation of financial institutions in bankruptcy).

[2] As noted in the legislative history, these changes were "derived from recommendations issued by the President's Working Group on Financial Markets and revisions espoused by the financial industry." H.R. REP. NO. 109-31, at 20 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 106. As explained in Part I, the "safe harbors" are various provisions of the Bankruptcy Code that operate to exempt derivatives from the normal operation of the Bankruptcy Code. Throughout this paper, I assume the reader is generally familiar with derivatives. For background on derivatives, see FRANKLIN ALLEN, RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 727–28 (8th ed. 2006); Frank Partnoy, *The Shifting Contours of Global Derivatives Regulation*, 22 U. PA. J. INT'L ECON. L. 421, 421 (2001); and the sources cited, *infra* note 3.

[3] *See* Paul Kiel, *AIG's Spiral Downward: A Timeline*, PROPUBLICA, Nov. 14, 2008 http://www.propublica.org/article/article-aigs-downward-spiral-1114 (positing AIG's failure was due to its credit-default swap portfolio); *see also* Stephen J. Lubben, *Credit Derivatives and the Resolution Of Financial Distress, in* THE CREDIT DERIVATIVES HANDBOOK 47–56 (Greg N. Gregoriou & Paul U. Ali eds., 2008); Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 AM. BANKR. L.J. 405, 405 (2007) (discussing credit default swaps were first used by banks against risks faced in their loan portfolios, then grew into much larger market).

[4] *See* Kiel, *supra* note 3, at 1.

contractual right to demand that AIG post cash or other assets as collateral to back up the swaps.[5] This converted the previously unsecured claims on the swaps into secured claims.

It also became self-reinforcing—as AIG posted more collateral, it began to develop liquidity problems, which lead to the threat of further downgrades and collateral calls. There was no end in sight, save for the complete self-liquidation of AIG.[6] In short, a run on AIG had commenced.[7]

For a normal firm in this kind of downward spiral, the obvious answer would have been a chapter 11 petition. The imposition of the automatic stay would have stopped the efforts to grab AIG's assets, and it might have been possible to retrieve the posted collateral as a "preference."[8]

AIG had no such option, especially after 2005.[9] Because the contracts at issue were swap agreements, and subject to the "safe harbor" exceptions in the Bankruptcy Code, the counterparties could have continued to take collateral and previously posted collateral was irretrievable.[10]

Moreover, as Lehman Brothers has shown, even if the debtor has a more balanced derivative portfolio—with a mix of derivatives that are valuable to the debtor and valuable to the debtor's counterparties—the safe harbor provisions allow another kind of run on the bank. In particular, those parties who have collateralized swaps can terminate the swap, as in AIG, those parties who owe money to the debtor can find a countervailing swap and "net" the two out, and those parties who simply owe money to the debtor can attempt to withhold performance on the swap.[11] All of which destroys going concern value in the debtor—either by taking assets out of the estate or stopping cashflows that would otherwise benefit the debtor.

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[5] *See id.*

[6] By August 2008, AIG posted $16.5 billion in collateral on swaps. *See id.*

[7] Bear Stearns presents a similar story. *See* Michael C. Macchiarola, *Beware Of Risk Everywhere: An Important Lesson From The Current Credit Crisis*, 5 HASTINGS BUS. L.J. 267, 301 (2009) (explaining "rumors and speculation" caused run on Bear Stearns leading lenders to refuse to do business with the bank and ultimately, such rumors became "a self-fulfilling prophecy").

[8] *See* 11 U.S.C. §§ 362 (codifying automatic stay principle which states collection efforts must stop at time of filing bankruptcy petition), 547 (2006) (allowing trustee to avoid preferences).

[9] *Cf.* Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U. L. REV. 1609, 1611 (2009) (describing "[s]hadow bankruptcy" frustrates chapter 11 bankruptcy because private investors exert influence over companies reorganizing under chapter 11).

[10] *See* Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 YALE J. ON REG. 91, 91 (2005) ("The Code contains numerous provisions affording special treatment to financial derivatives contracts . . . No other counterparty or creditor of the debtor has such freedom; to the contrary, the automatic stay prohibits them from undertaking any act that threatens the debtor's assets.").

[11] *See* 11 U.S.C. § 560 (2006) (stating swap participant can "net out any termination values or payment amounts arising under or in connection with the termination"); *see also* 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 (2005) (noting Congress added protections for swaps in 1990).

Before the current crisis, it was often argued that the safe harbors were required to protect the financial system from the threat posed by the Bankruptcy Code.[12] Since those putative benefits do not seem to have materialized, and the financial system has not been harmed by its involvement in Lehman's domestic bankruptcy case, it is time to reexamine the need for the safe harbors. Indeed, because the existence of the safe harbors makes chapter 11 very nearly unworkable for financial companies like AIG and Lehman, I urge their complete repeal.[13]

This is even truer with regard to non-financial debtors, who make up the vast bulk of chapter 11 debtors.[14] In this context, the safe harbors have already been shown to be little more than windfall gifts to the financial industry and avenues for abuse.[15] Utility companies are arguing that their supply contracts are protected "forwards," and routine corporate transactions are being recast to make them "bankruptcy proof."

In Part I of the paper, I provide a concise overview of the safe harbor provisions in the Bankruptcy Code. Part II introduces the reasons given in support of these provisions. In Part III, I critique this reasoning and make the broader argument that derivatives should be treated like any other contract in bankruptcy, and thus the safe harbors should be repealed. And in Part IV, I suggest how chapter 11 could be modified, following the repeal of the safe harbors, to accommodate the bankruptcy of a financial firm.

Before commencing, it should be noted that in arguing for repeal of the safe harbors, I do not advocate pulling out sections of the Bankruptcy Code and leaving the Code otherwise the same. Derivative contracts are somewhat unique. The volatility, interconnectedness and sheer magnitude of the sums of money involved make financial firms unique. As part of the repeal that I suggest, the Code would have to adapt to these realities. For example, adequate protection becomes a crucial issue in this context, where the collateral in question may be subject to great volatility. As I discuss further in Part IV, it may be that derivative contracts should

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[12] *See infra* Part I (discussing safe harbor provisions).

[13] To be sure, chapter 11 in its traditional sense, was an unlikely option. But the firms might have benefited from a GM/Chrysler style reorganization, which would have allowed a quick separation of the good from the troublesome parts of the firms. *See infra* Part IV (urging repeal of safe harbors and proposing alternative way for "distressed financial institution"). It appears that such a plan was contemplated for AIG, but rejected by AIG's management, before the Lehman bankruptcy case. *See* James B. Stewart, *Eight Days*, NEW YORKER, Sept. 21, 2009, at 59, 69 ("Flowers proposed that his firm and Allianz buy A.I.G. . . . They would acquire the assets of the subsidiaries, but would need to be insulated from the liabilities of the parent.").

[14] *Cf.* 11 U.S.C. § 101(13) (2006) (defining "debtor" as "person or municipality concerning which a case under this title has been commenced").

[15] Hutson v. E.I. du Pont de Nemours & Co., (*In re* Nat'l Gas Distribs., LLC), 556 F.3d 247, 259 (4th Cir. 2009) (reversing and remanding holding of United States Bankruptcy Court that natural gas supply contracts did not constitute swap agreements under Bankruptcy Code and thus unprotected by Code's "safe harbor" protections on rationale that Congress intended broader definition of "commodity forward agreement"). *But see* Peter Marchetti, *Is the Agreement a Simple Supply or Swap?: A Post-BAPCPA Case of First Impression in the Fourth Circuit*, AM. BANKR. INST. J., Apr. 2009, at 30, 69 (stating bankruptcy court's holding in *In re* Nat'l Gas Distribs., LLC was "the dangerous slippery slope").

be permitted to retain pre-existing "mark to market" collateral arrangements despite the automatic stay. Other changes are also clearly in order.

Ultimately, my argument is motivated by a belief that the automatic stay would reduce systemic risks in more cases than it would exacerbate it. Presently, the safe harbors encourage a rush to sell derivatives, and buy replacement derivatives, upon a firm's financial distress. It seems manifestly implausible that this situation reduces systemic risk. If instead the automatic stay applied, the ripples of panic and market disruption that are currently generated would be at least moderated by the pause that a bankruptcy filing would bring, perhaps creating enough space for a distressed firm to transfer its business to a new, more stable owner. In short, systemic risk would be reduced.

I. THE SAFE HARBORS

The term "safe harbors" is a kind of shorthand for a variety of provisions in the Bankruptcy Code that reflect the "well-established Congressional intent to protect the derivatives markets from the disruptive effect of bankruptcy proceedings."[16] These provisions excuse several broad classes of derivative contracts from fundamental provisions of the Bankruptcy Code.[17]

For example, the Bankruptcy Code prohibits the termination of most contracts simply because the debtor has filed a bankruptcy petition.[18] Not so with derivative contracts.[19] Instead, the non-debtor party has an option to declare the bankruptcy filing an event that will terminate the derivative.[20] Termination in and of itself

[16] Brief & Memorandum of Law of Amicus Curiae in Support of Various Derivatives Counterparties' Objections to the Debtors' Motion for Establishment of the Deadline for Filing Proofs of Claim, Approval of the Form & Manner of Notice Thereof & Approval of the Proof of Claim Form at 3, *In re* Lehman Bros. Holdings, Inc., No. 08-13555 (JMP).

[17] In particular, "securities contracts," "forward contracts," "commodity contracts," "repurchase agreements", "swap agreements" and "master netting agreements." *See* 11 U.S.C. §§ 101(25) (defining "forward contract"), 101(47) (defining "repurchase agreement"), 101(53B) (defining "swap agreement"), 101(38A) (defining "master netting agreement"), 741(7) (2006) (defining "securities contract"), 761(4) (2006) (defining "commodity contract"). Some of the definitions are sufficiently broad that they may overlap with other definitions – compare, for example, the definitions of "forward contract" and "swap." *See, e.g.*, § 101(53B) (definition of "swap agreement," which includes several types of forward agreements).

[18] *See* 11 U.S.C. § 365(e)(1) (2006) ("[A]n executory contract or unexpired lease of the debtor may not be terminated . . . solely because of . . . (B) the commencement of a case under this title . . . "); *see also* 11 U.S.C. § 541(c)(1) (2006) ("[A]n interest of the debtor in property becomes property of the estate . . . .").

[19] To gain the protections of the safe harbor, one has to be among the protected classes. *See In re* Mirant Corp., 310 B.R. 548, 563 (Bankr. N.D. Tex. 2004) (rejecting plaintiff's argument that defendant was not protected counterparty). But the classes are defined with extreme breadth after 2005. For example, to be protected under "swap agreements" with the debtor, the counterparty must be a "swap participant" or a "financial participant." "Swap participant" is defined in the Bankruptcy Code as an "entity" (which includes individuals as well as corporations) that at any time before the filing of the petition has an outstanding swap agreement with the debtor. That would seem to cover anyone who would want to assert the applicability of the safe harbors. *See* § 101(53C).

[20] *See* 11 U.S.C. §§ 555 ("The exercise of a contractual right of a stockbroker, financial institution, financial participant, or securities clearing agency to cause the liquidation, termination, or acceleration of a securities contract . . . shall not be stayed, avoided, or other wise limited . . . ."), 559 ("The exercise of a

might be of little use, since the debtor might still be unable to "settle up" on the contract. But the safe harbors also provide for exceptions from the automatic stay[21]—the statutory injunction that normally stops creditors from undertaking any further efforts to collect on their debt, which then compels creditor participation in the collective process that is bankruptcy.[22]

If a derivative transaction has been collateralized—that is, the debtor's ability to pay is backed up by other assets—the exemption from the automatic stay means that the non-debtor party to a derivative contract can take the collateral.[23] This makes derivative counterparties entirely unlike other secured creditors, who have to get court permission to foreclose on their collateral.[24]

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contractual right of a repo participant or financial participant to cause the liquidation, termination, or acceleration of a repurchase agreement . . . shall not be stayed, avoided, or otherwise limited . . . ."), 560 ("The exercise of any contractual right of any swap participant or financial participant to cause the liquidation, termination, or acceleration of one or more swap agreements . . . shall not be stayed, avoided, or otherwise limited . . . ."), 561 (2006) ("[T]he exercise of any contractual right . . . to cause the termination, liquidation, or acceleration of or to offset or net termination values, payment amounts, or other transfer obligations . . . shall not be stayed, avoided, or otherwise limited . . . ."); *see also In re* Am. Home Mortgage, Holdings, Inc., 388 B.R. 69, 78 (Bankr. D. Del. 2008) ("Section 559 of the Bankruptcy Code . . . allows a non-debtor counterparty to a 'repurchase agreement' to exercise its contractual right . . . to liquidate, terminate or accelerate the repurchase agreement.").

[21] 11 U.S.C. §§ 362(b)(17) ("The filing of a petition under [this] section . . . does not operate as a stay . . . of the exercise by a swap participant or financial participant of any contractual right . . . under any security agreement or arrangement or other credit enhancement forming a part of or related to any swap agreement, or of any contractual right (as defined in section 560) . . . ."), 362(b)(27) (2006) ("The filing of a petition under [this] section . . . does not operate as a stay . . . of the exercise by a master netting agreement participant of any contractual right . . . under any security agreement or arrangement or other credit enhancement forming a part of or related to any master netting agreement, or of any contractual right . . . ."); *see also* §§ 362(b)(6) ("The filing of a petition under [this] section . . . does not operate as a stay . . . of the exercise by a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency of any contractual right . . . under any security agreement or arrangement or other credit enhancement forming a part of or related to any commodity contract, forward contract or securities contract, or of any contractual right . . . ."), 362(b)(7) ("The filing of a petition under [this] section . . . does not operate as a stay . . . of the exercise by a repo participant or financial participant of any contractual right . . . under any security agreement or arrangement or other credit enhancement forming a part of or related to any repurchase agreement, or of any contractual right . . .), 362(o) ("The exercise of rights not subject to the stay arising under subsection (a) pursuant to paragraph (6), (7), (17), or (27) of subsection (b) shall not be stayed by any order of a court or administrative agency in any proceeding under this title.").

[22] § 362(a) ("[A] petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970, operates as a stay, applicable to *all* entities . . . .") (emphasis added).

[23] Assuming the collateral has not been "rehypothecated." Rehypothetication means that the posted collateral is used as collateral in a new transaction by the party demanding collateral in the first transaction. For example, a counterparty could have collateral posted with Lehman, Lehman could have then used it to borrow for its own purposes, and then the collateral would not be held by Lehman at the time of its bankruptcy – rendering the right to collect the collateral despite the automatic stay worthless. *See* Complaint of Southern community Financial Corporation at 10, *In re* Lehman Brothers Holdings, Inc., 416 B.R. 392 (Bankr. S.D.N.Y. 2009) (giving example of rehypothetication possibility).

[24] *See* § 362(d) ("On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay . . . .").

The exemption from the automatic stay also facilitates the "setting off" of derivative contracts. For regular creditors, if they owe the debtor money and the debtor owes them money, these two mutual obligations create a kind of secured claim that, with court permission, can be netted against each other.[25] Derivative counterparties do not have to get court permission to setoff in this way, and it appears that they may not even have to have a right to setoff before the bankruptcy case.[26] That is, it appears that the 2005 amendments were designed to allow derivative parties to concoct a setoff after the bankruptcy—although the drafting of the statutory provision in question leaves this subject to some debate.[27] Derivative counterparties can setoff any of the specified "safe harbor" contracts against each other, no matter when the contracts were entered into or what their subject matter.[28]

Finally, derivatives are exempt from the avoidance provisions of the Bankruptcy Code.[29] In a typical bankruptcy case these provisions ensure creditor equality, but especially since 2005, creditor equality has been partially repealed. Normally if a creditor receives a payment on the eve of bankruptcy that allows that

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[25] § 362(a)(7) ("The filing of a petition under [this] section . . . does not operate as a stay . . . of the exercise by a repo participant or financial participant of any contractual right . . . to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such agreements, including any master agreement for such agreements...."); 11 U.S.C. § 553(a) (2006) ("[T]his title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor . . . ."); *see also* Citizens Bank of Md. v. Strumpf, 516 U.S. 16, 17–19 (1995) (positing petitioner had not violated automatic stay because administrative hold was "set off").

[26] § 553(a) ("[T]his title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case . . . against a claim of such creditor against the debtor that arose before the commencement of the case . . . .").

[27] The way the exemption was drafted, it does not appear to apply to section 553(b)(2)(A), which covers transfers after the petition date. *See* Stephen J. Lubben, *Systemic Risk and Chapter 11*, 82 TEMP. L. REV. 433, 443 n. 62 (2009).

[28] 11 U.S.C. § 560 (2006) ("The exercise of any contractual right of any swap participant or financial participant to cause the liquidation, termination, or acceleration of one or more swap agreements because of a condition of the kind specified in section 365(e)(1) of this title or to offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of one or more swap agreements shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title."). *See* 11 U.S.C. § 101(38B) (2006) ("The term 'master netting agreement participant' means an entity that, at any time before the date of the filing of the petition, is a party to an outstanding master netting agreement with the debtor."). In essence, the statute converts derivative counterparties' setoff rights into recoupment rights, without the requirement that the underlying obligations arise out of the same transaction or occurrence. *Cf.* Malinowski v. N.Y. State Dep't of Labor (*In re* Malinowski), 156 F.3d 131, 133 (2d Cir. 1998) (comparing and contrasting set off and recoupment); *In re* Am. Home Mortgage Holdings, Inc., 401 B.R. 653, 655–56 (D. Del. 2009) (discussing common law recoupment's application in bankruptcy law).

[29] 11 U.S.C. § 546(f)–(g),(j) (2006) ("[T]he trustee may not avoid a transfer made by or to (or for the benefit of)[:] a repo participant or financial participant, in connection with a repurchase agreement and that is made before the commencement of the case, except under section 548(a)(1)(A) of this title[;] . . . a swap participant or financial participant, under or in connection with any swap agreement and that is made before the commencement of the case, except under section 548(a)(1)(A) of this title[;] . . . a master netting agreement participant under or in connection with any master netting agreement or any individual contract covered thereby that is made before the commencement of the case, except under section 548(a)(1)(A) and except to the extent that the trustee could otherwise avoid such a transfer made under an individual contract covered by such master netting agreement.").

creditor to receive more than they would in the bankruptcy case, this "preference" must go back into the estate and the once favored creditor must be treated like everyone else.[30] Not so for derivatives; such a preference is not recoverable.[31] Similarly, under state law and the Bankruptcy Code, if the debtor sells its assets for insufficient value, that transaction may be undone as a constructive fraudulent transfer.[32]

This principle holds even if the non-debtor party acted in good faith—getting too good of a deal is a problem if the seller files for bankruptcy shortly thereafter.[33] And if the debtor transfers its assets with the actual intent to harm creditors, that is an "actual" fraudulent transfer that is not only avoidable but also sometimes a criminal offense.[34]

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[30] 11 U.S.C. § 547(b) (2006) ("Except as provided in subsections (c) and (i) of this section, the trustee may avoid any transfer of an interest of the debtor in property . . . .").

[31] 11 U.S.C. §§ 546(g) ("[T]he trustee may not avoid a transfer, made by or to (or for the benefit of) a swap participant or financial participant, under or in connection with any swap agreement and that is made before the commencement of the case, except under section 548(a)(1)(A) of this title."); 546(j) (2006) ("[T]he trustee may not avoid a transfer made by or to (or for the benefit of) a master netting agreement participant under or in connection with any master netting agreement or any individual contract covered thereby that is made before the commencement of the case, except under section 548(a)(1)(A) and except to the extent that the trustee could otherwise avoid such a transfer made under an individual contract covered by such master netting agreement."); *see* § 560 ("[T]he liquidation, termination, or acceleration of one or more swap agreements . . . shall not be stayed, avoided, or otherwise limited by operation of any provision of this title . . . ."); *see also* 11 U.S.C. §§ 555 ("The exercise of a contractual right of a stockbroker, financial institution, financial participant, or securities clearing agency to cause the liquidation, termination, or acceleration of a securities contract . . . shall not be stayed, avoided, or otherwise limited by operation of any provision of this title . . . ."), 556 ("The contractual right of a commodity broker, financial participant, or forward contract merchant to cause the liquidation, termination, or acceleration of a commodity contract . . . shall not be stayed, avoided, or otherwise limited by operation of any provision of this title . . . ."), 559 ("The exercise of a contractual right of a repo participant or financial participant to cause the liquidation, termination, or acceleration of a repurchase agreement because of a condition of the kind specified in section 365(e)(1) of this title shall not be stayed, avoided, or otherwise limited by operation of any provision of this title . . . ."), 561(a) (2006) ("[T]he exercise of any contractual right, because of a condition of the kind specified in section 365(e)(1), to cause the termination, liquidation, or acceleration of or to offset or net termination values, payment amounts, or other transfer obligations arising under or in connection with one or more (or the termination, liquidation, or acceleration of one or more)--(1) securities contracts, as defined in section 741(7); (2) commodity contracts, as defined in section 761(4); (3) forward contracts; (4) repurchase agreements; (5) swap agreements; or (6) master netting agreements, shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by any order of a court or administrative agency in any proceeding under this title.").

[32] 11 U.S.C. § 548(a)(1)(B)(i) (2006) (noting trustee is able to "avoid any transfer" if debtor "received less than a reasonably equivalent value in exchange for such transfer or obligation"); *see also* Uniform Fraudulent Transfer Act 1984 § 4(a)(2) ("A transfer made or obligation incurred by a debtor is fraudulent . . . if the debtor made the transfer . . . without receiving a reasonably equivalent value in exchange for the transfer or obligation").

[33] 11 U.S.C. § 548(a)(1)(B) (charging debtor with liability whether actions were "voluntary[y] or involuntary[y]").

[34] 11 U.S.C. § 548(a)(1)(A) (noting trustee can avoid any transfer of debtor made "with actual intent to hinder, delay, or defraud any entity"); Cal. Penal Code §§ 19, 531 (noting any person who is party to fraudulent conveyance "made[] or contrived with intent to deceive and defraud others, or to defeat, hinder or delay creditors" is guilty of misdemeanor "punishable by imprisonment in the county jail not exceeding six months, or by fine not exceeding one thousand dollars ($1,000), or by both").

Derivatives cannot be the subject of a constructive fraudulent transfer action and the 2005 amendments also impeded the ability to bring an actual fraudulent transfer action, although this latter change may have been inadvertent.[35]

Taken collectively, these "safe harbors" give the non-debtor party to a derivative contract an option to terminate upon the debtor's bankruptcy filing.[36] There is no obligation to terminate.

Moreover, termination does not equal payment. For example, a party that terminates a swap that is "in the money" from that party's perspective (i.e., the debtor owes the non-debtor party) will simply generate an unsecured claim absent an ability to seize collateral or offset the claim against some other liability to the debtor.[37] In short, the safe harbors are most likely to benefit large financial institutions, as these institutions are more likely to have either demanded pre-bankruptcy collateral, and have retained control over that collateral, or have a variety of derivative positions with a single debtor.

II. ARGUMENTS FOR SAFE HARBORS

The chief derivatives industry trade group, the International Swaps and Derivatives Association (ISDA), generally argues for the safe harbors as a necessary means to protect the ability to "net" derivatives upon a bankruptcy filing and thus avoid systemic risk.[38] As will be seen in the next section, the safe harbors actually go far beyond what is required to achieve this goal, and do not evidently advance this ambition, but it bears setting forth ISDA's argument more fully before examining its weaknesses. To ensure that I faithfully represent the main arguments, I quote liberally from ISDA documents found on its web page.[39]

ISDA frequently quotes from Congressional testimony and statements made at the time of the enactment of the safe harbors to support their application in specific

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[35] 11 U.S.C. §§ 546(g), (j), 548(d)(2), 560, 561. Although section 546 leaves open the ability to bring an actual fraudulent transfer action under section 548, section 548(d)(2) provides that derivative-related transfers are always for "value," and section 548(c) provides that a party "has a lien on or may retain any interest transferred or may enforce any obligation incurred, . . . to the extent that such transferee or obligee gave value," thus limiting the debtor or trustee's ability to fully unwind the transaction, and narrowing the cases in which even an actual fraudulent transfer claim will be useful.

[36] In a recent ruling in Lehman Brothers, Judge Peck determined that it is indeed an option, with an expiration date. A counterparty that waited 11 months to terminated had waived its rights. *In re* Lehman Brothers Holdings, Inc., 08-13555 (Bankr. S.D.N.Y. Sept. 17, 2009).

[37] 5 COLLIER ON BANKRUPTCY, ¶ 561.04, at 561-6, 10 (Alan N. Resnick et al. eds., 15th ed. Rev. 2008) (noting counterparty may be required to seek court's help to "direct the debtor to act to effectuate the remedy" because debtor is not required to cooperate with counterparty's enforcement remedies).

[38] As explained by ISDA, "Close-out netting applies to the occurrence of any or all of the following: the termination, liquidation and/or acceleration of any payment/delivery obligations. When invoked, close-out netting facilitates the calculation of a close-out (market/liquidation/replacement) value; the conversion of calculated values into a single currency; and the determination of the net balance of the values." ISDA RESEARCH NOTES, Nov. 2, at 7 n.2 (2009) http://www.isda.org/researchnotes/pdf/ISDA-Research-Notes2.pdf.

[39] ISDA Home Page, http://www.isda.org (last visited Mar. 6, 2009).

cases.[40] For example, in a recent amicus brief, ISDA quoted the 1999 statements of David H. Jones, Senior Deputy General Counsel to the Federal Deposit Insurance Corporation, where he explained to the Senate Banking Committee that,

> The series of "netting" amendments to the Bankruptcy Code . . . over the past two decades were designed to further the policy goal of minimizing the systemic risks potentially arising from certain interrelated financial activities and markets. Systemic risk has been defined as the risk that a disruption -- at a firm, in a market segment, to a settlement system, etc. -- can cause widespread difficulties at other firms, in other market segments or in the financial system as a whole. Netting helps reduce this risk by reducing the number and size of payments necessary to complete transactions.[41]

Specially, ISDA argues that close-out netting, that is, the termination of a parcel of related derivative trades upon a debtor's bankruptcy filing, "reduces the risk of a large insolvency have a 'domino' effect on the solvency of other market participants who have dealt with the insolvent."[42] ISDA argues that netting reduces credit risk of individual firms, and systemic risk to the entire economy.[43] The two forms of risk reduction are interrelated, in that by "reducing credit risk at each node in the network of relationships between market participants, close-out netting also has an important beneficial effect on systemic risk."[44]

ISDA has also argued that derivatives need special treatment to avoid "cherry picking." As asserted in connection with recent changes to the Canadian insolvency laws

> This "cherry-picking" of transactions would undermine the netting arrangements between the parties. Where a master agreement (or master agreement with respect to more than one master agreement)

[40] There may be some circularity here, if ISDA provided the testimony or helped craft the congressional statements.

[41] Brief & Memorandum Of Law Of The International Swaps & Derivatives Ass'n, As Amicus Curiae, In Support Of Defendant's Motion (A) To Dismiss Trustee's Complaint For Failure To State A Claim Under Federal Rule Of Bankruptcy Procedure 7012, Or, In The Alternative, (B) For Summary Judgment Under Federal Rule Of Bankruptcy Procedure 7056 at 8–9, *In re* Nat'l Gas Distrib. LLC, No. 06-00166-8-ATS (Bankr. E.D.N.C. Apr. 3, 2007).

[42] MEMORANDUM ON THE IMPLEMENTATION OF NETTING LEGISLATION: A GUIDE FOR LEGISLATORS AND OTHER POLICY-MAKERS 4 (2006), http://www.isda.org/docproj/pdf/Memo-Model-Netting-Act.pdf.

[43] *Id.* ("In other words, it reduces [credit] risk . . . .").

[44] Letter from Robert G. Pickel, Executive Dir. & CEO of ISDA, to Davida Lachman-Messer, Deputy Attorney Gen. of Isr. of Econ. & Fiscal Matters & Ministry of Justice of Isr., and Yoav Lehman, Supervisor of Banks of Bank of Isr. 2 (Dec. 13, 2004) *available at* http://www.isda.org/speeches/pdf/IsraelLetterDec13-04.pdf.

> is in place, the master agreement and all individual transactions under it form a single agreement.[45]

In another document, this time dealing with Russia, ISDA further explains that

> The primary concern with this "cherry picking" is that the inability to terminate and net the transactions increases the risk of a chain of interrelated defaults, that is, systemic risk.[46]

In short, the imposition of the automatic stay, and the subsequent inability to offset a series of derivative contracts is said to create systematic risk. Systematic risk is further exacerbated by "cherry picking," in that the ability to assume and reject contracts under section 365 will lead to the termination of only those derivative contracts under which the non-debtor is obliged to pay its counterparty, the debtor.

III. A CRITIQUE OF THE ARGUMENTS (AND THE ARGUMENT FOR REPEAL)

As has been widely recognized,

> Staying collection actions helps preserve firm value. A firm's most important assets include its web of contractual relationships . . . [accordingly, U.S. bankruptcy] law allow[s] a debtor to preserve most contractual relationships during the reorganization process.[47]

Thus, if the goals of chapter 11 are to be achieved, deviations from this basic rule should be justified by well-built arguments. ISDA's argument does not meet this standard.

First, consider the sweeping generality of the argument for the safe harbors, which at times appears to be little more than a claim that other firms will experience distress when a debtor files for bankruptcy protection. Yes, but that is true for all types of firms and creditors, and in all types of insolvency systems. For example, when a manufacturing firm enters chapter 11, its suppliers and dealers are likely to experience financial distress in turn.[48] But when the same manufacturing firm

[45] SUBMISSION OF THE INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION: REVIEW OF BILL C-12 TO THE SENATE STANDING COMMITTEE ON BANKING TRADE AND COMMERCE 5–6 (2008), http://www.isda.org/c_and_a/pdf/ISDALtrBillc12.pdf.

[46] ISDA RESEARCH NOTES, Nov. 2, *supra* note 38, at 7.

[47] Theodore Eisenberg & Stefan Sundgren, *Is Chapter 11 Too Favorable to Debtors?: Evidence from Abroad*, 82 CORNELL L. REV. 1532, 1537 (1997).

[48] Philippe Jorion & Gaiyan Zhang, *Credit Contagion from Counterparty Risk*, 64 J. FIN. 2053, 2055 (2009) ("The ongoing business of the trade creditor can be impaired by the bankruptcy of its borrower because this is often a major customer.").

experiences financial distress outside of bankruptcy, its suppliers and dealers are also likely to suffer.

The reality of collateral financial distress does not itself justify an exception from the automatic stay, or the rules regarding contracts or avoidance actions, because such an exception would utterly wreck chapter 11. Chapter 11 is designed around the notion of shared sacrifice and collective recovery—whereas granting exceptions to the process, even in cases of hardship, undermines those twin goals.

Similarly, while part of the "cherry picking" argument amounts to little more than a repeat of the broader systemic risk argument, the argument also asserts that such risk will be enhanced if the debtor is allowed to keep its "good" derivatives while rejecting its "bad" contracts, as section 365 normally allows. Of course, all the safe harbors do is turn around the normal rule and allow the non-debtor engage in "cherry picking" of its own.[49] The connection with reduced systemic risk is doubtful.

But what of the argument that the individual ripples of financial distress will ultimately aggregate in a manner that causes systemic risk or crisis? It is undoubtedly true that financial firms have an added amount of horizontal contracts with their peer firms. Lehman Brothers and Goldman Sachs dealt with each other in a way that would be foreign to GM and Ford. These bilateral connections do increase the risk that a single firm's failure could trigger an industry-wide collapse.

But even accepting this argument for the moment, it does not justify the current breadth of the safe harbors, which are not limited to financial firms and are drafted so broadly that almost any supply contract is protected.[50] The airline that files under chapter 11 immediately finds its portfolio of fuel hedges terminated, even though its bankruptcy should not have any systemic effects.

And even among financial firms, an exception from the normal rules of bankruptcy does nothing to protect firms from their counterparties' collapse. The safe harbors did nothing to protect the derivative markets from AIG's collapse—the U.S. Treasury's largess prevented the systemic collapse, and that generosity could have happened within the context of a bankruptcy case.[51] Much of ISDA's argument for the safe harbors seems to confuse avoidance of bankruptcy with avoidance of default.

What is lacking in the argument is any specific explication of how the Bankruptcy Code, as distinct from the general issue of counterparty risk, increases systemic risk.[52] In particular, how would it increase systemic risk to require

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[49] Shmuel Vasser, *Derivatives in Bankruptcy*, 60 BUS. LAW. 1507, 1542 (2005) (noting "only the non-debtor counterparty obtains the upside of a derivative in a bankruptcy, not the debtor").

[50] *See* Stephen J. Lubben, *Derivatives and Bankruptcy: The Flawed Case for Special Treatment*, 12 U. PA. J. BUS. L. 61, 61 (2009) ("Cherry picking is deemed 'bad,' for reasons that are generally rather vague.").

[51] David Cho, *N.Y. Fed Pushed AIG on Contracts*, WASH. POST, Oct. 28, 2009, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2009/10/27/AR2009102703963_pf.html (stating AIG was required to "reimburse the full amount of what it owed to big banks on derivatives contracts").

[52] Robert R. Bliss & George G. Kaufman, *Derivatives and Systemic Risk: Netting, Collateral, and Closeout* (FRB of Chicago, Working Paper No. 2005-03, 2005), *available at* http://ssrn.com/abstract=730648. As the authors note,

derivative counterparties to seek court approval to terminate a swap or setoff several obligations, as other contractual parties must?[53]

Indeed, some of the safe harbors plainly worsen systemic risk. For example, with no threat of having the transaction reversed as a preference, derivative counterparties have every incentive to setoff contracts and seize collateral upon the first hint of financial distress. In short, this particular safe harbor provision encourages a run on the bank.[54]

Moreover, the safe harbors do little to protect the non-debtor from the consequences of the debtor's default. A party who is "in the money" on a derivative contract with a debtor is allowed to terminate the contract—and assert an unsecured claim. The only potential benefit is the ability thwart the debtor's assignment of the derivative. A party that is "out of the money" on a derivative with the debtor also has an option to terminate the contract,[55] although termination should not be confused with a power to "undo" the contract. The non-debtor party will still have to pay the debtor in this state of affairs.

Indeed, the safe harbors only benefit parties in two respects. First, a party that has entered into multiple derivative contracts with a single debtor can net these contracts against each other. Second, a party that has demanded collateral to

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> Market participants tend to be more concerned with their own welfare in normal day-to-day business environments than with possibilities of adverse externalities in the form of systemic failures of markets. Netting, close-out, and collateral serve the needs of market participants even when there is no systemic threat: They facilitate market risk and counterparty credit risk management; and they permit expansion of dealer activities, enhancing the depth and liquidity of the derivatives markets.

Id.

[53] If the issue were simply potential delay, certainly strict time limits for hearing such motions would make more sense than a complete exception from the normal rules. It is equally true that many of the claims about delay in chapter 11 are uncorroborated. Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 MICH. L. REV. 603, 607–08, 626 (2009) (reporting from study of 1,422 chapter 11 cases that "[t]he median time spent in Chapter 11 is about eleven months"). And the evidence suggests that the early criticisms of chapter 11 have not been born out by the long-term evidence. Michael L. Lemmon, Yung-Yu Ma & Elizabeth Tashjian, *Survival of the Fittest? Financial and Economic Distress and Restructuring Outcomes in Chapter 11* (Sept. 2009), *available at* http://ssrn.com/abstract=1325562.

[54] If stopping preference actions is an important part of controlling systemic risk, one wonders why ISDA has done nothing to address section 5(b) of the Uniform Fraudulent Transfer Act, which also allows recovery of preferences made to insiders under state law. *See* UFTA § 5(b) (transfer is fraudulent "if the transfer was made to an insider for an antecedent debt, the debtor was insolvent at that time, and the insider had reasonable cause to believe that the debtor was insolvent"). One banker on the board is sufficient to make the bank an "insider" for purposes of this statute, UFTA section1(7) (definition of "insider"), and the statute of limitations is much longer under the UFTA than section 547 of the Bankruptcy Code. *See* UFTA § 9(c) (extinguishing cause of action "unless action is brought . . . under Section 5(b), within one year after the transfer was made or the obligation was incurred"); *see also* 11 U.S.C. § 546(a) (2006) ("An action or proceeding under section . . . 547 of this title may not be commenced after the earlier of . . . the later of 2 years after the entry of the order for relief; or 1 year after the appointment or election of the first trustee . . . or . . . the time the case is closed or dismissed").

[55] *Accord* 11 U.S.C. §§ 555, 559, 560, 561 (2006).

support a derivative transaction, and who has control over that collateral, is truly exempt from the bankruptcy process, at least to the extent of the collateral.[56] They can take the collateral in satisfaction of their claim.

Both benefits are most likely to accrue to large financial institutions: who else is apt to have a large number of derivative trades with a single debtor, and the ability to compel that debtor to post collateral?[57] Even then, these benefits are only useful if the non-debtor party is, on a net basis, "in the money" with respect to the debtor, otherwise the safe harbors will simply hasten the liquidation of the debtor's derivative portfolio.

Ultimately then, the argument for the safe harbors is quite simple: the safe harbors reduce systemic risk by giving large financial institutions special treatment.

This argument only holds, if at all, with regard to derivative transactions among financial institutions, and thus supports only a much narrower version of the existing safe harbors.[58] It also only holds if we believe that the special interrelations among financial firms, combined with some special volatility of derivatives, necessitates altering the Bankruptcy Code to prevent a systemic crisis.[59] There is little actual evidence to support even this narrow claim.[60]

For example, why are ISDA and its supporters at the Federal Reserve and the FDIC so certain that liquidation of a debtor's derivative portfolio reduces systemic risk or is otherwise socially optimal? It seems more likely that sale of a large financial institution's derivative portfolio as a whole would both maximize the value

[56] *See* Jonathon Keath Hance, *Derivatives at Bankruptcy: Lifesaving Knowledge for the Small Firm*, 65 WASH. LEE L. REV. 711, 737 (2008) (noting because non-debtor counterparties are not subject to automatic stay, creditor can terminate derivatives contract and if debtor put up enough collateral to cover obligation, creditor "essentially faces no risk of loss"). Financial firms exchange "mark to market" collateral on a daily basis, but larger investments banks, at least before Lehman's bankruptcy filing, often required the posting of additional collateral when dealing with a smaller entity like a hedge fund. *See* David J. Gilberg, *Regulation of New Financial Instruments Under the Federal Securities and Commodities Laws*, 39 VAND. L. REV. 1599, 1654 (1986) (noting dealers may require "[s]maller or lesser known counterparties" to post collateral "to secure their exposure under a forward contract," as opposed to larger repeat players who are dealt with "on an unsecured basis"). For non-financial firms using derivatives for hedging, any collateral posted will be held by the selling financial institution.

[57] *See* 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, 994 (1997) (demonstrating unique position of financial institutions to obtain less expensive financing). To be sure, the collateral point may change either as a result of experiences in the Lehman case or newly enacted regulations.

[58] Edwards & Morrison, *supra* note 10, at 98 ("[T]he Code encompasses far too many transactions. Fear of systemic risk is warranted only in cases involving the insolvency of a major financial market participant, with whom other firms have entered derivatives contracts of massive value and volume. Yet the Code offers special treatment to derivatives no matter how large or small the counterparty.").

[59] *See* Vasser, *supra* note 49, at 1511 (noting that in enacting safe harbors, "Congress also focused on the unique nature of the financial markets and their volatility").

[60] *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, 643 n.15 (2005) (positing systemic risk argument in favor of safe harbors "appears to have little empirical support").

of the estate and reduce systemic risk by avoiding the rush to "close out" myriad positions upon a bankruptcy filing.[61]

And is the Bankruptcy Code the proper place to address the interlocking nature of financial firms? Indeed, the safe harbors would seem to encourage excessive risk taking in this regard, by promoting the belief that firms need not worry about default. And while systemic risk may well result from poor risk management among financial firms, and regulatory failures that allow firms to become "too big to fail," by the time chapter 11 comes into play, the conditions leading to the failure of the firm, and the risk to its competitors, have already been created. Viewed in this light, the safe harbors make allowances for earlier risk management and regulatory failures.

IV. OUTLINES OF AN ALTERNATIVE SYSTEM

For the foregoing reasons, I urge the repeal of the safe harbors.[62] But once the safe harbors are repealed, how should the distressed financial institution resolve its situation? In this section I offer a brief sketch of my thoughts on how this question should be addressed.

One answer is to erect a new structure, as the Administration has suggested through its proposed Orderly Resolution Regime (ORR).[63] There is an element of reinventing the wheel here, as chapter 11 itself is an "orderly resolution regime" for myriad corporations every year. A distinct system would also start from scratch, whereas a modified chapter 11 system could draw on the existing skill and knowledge of chapter 11 practitioners and courts. This could be especially important given that a distinct ORR would be infrequently utilized.

The defenders of the ORR suggest several reasons why a bankruptcy system would not work, including

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[61] *See* Lubben, *supra* note 27, at 441 ("[T]he imposition of the automatic stay can prevent the liquidation of the debtor's assets at firesale prices, which may have systemic effects on other, non-debtor firms."); *see* Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1049 (2007) ("The first thing to note is that the standard explanation for the special treatment is not particularly compelling. It is far from clear that the exception reduces systemic risk; it may even increase this risk because it eliminates a possible curb on counter-parties' rush to close out their contracts in the event of a wave of failures.").

[62] The one exception I might make is for traditional, very short-term repo agreements. These are short term loans, often overnight, with small profit margins that may be unable to support the consequences of a sudden bankruptcy and the imposition of the automatic stay. To the extent these short, overnight loans are important sources of liquidity in the financial markets, they warrant special treatment. I would, however, correct the current definition of repurchase agreements, which covers transactions where the collateral can be returned within a year. 11 U.S.C. § 101(47) (2006) ("The term 'repurchase agreement' ... means—an agreement . . . which provides for transfer . . . at a date certain not later than 1 year after such transfer or on demand, against the transfer of funds...."). Such a transaction evidences a degree of risk taking and exposure to the debtor that is inconsistent with a traditional repo arrangement.

[63] David Cho et al., *Bill in Works to Let U.S. Dissolve Failing Firms*, THE WASH. POST, Oct. 27, 2009, at A14, *available at* http://www.washingtonpost.com/wpdyn/content/article/2009/10/26/AR2009102603260.html?hpid=topnews.

> First, corporate bankruptcy is focused almost exclusively on the interests of creditors of the firm, with little concern for "third party" effects such as systemic risk. Second, the restrictions on the claims of creditors inherent in bankruptcy will likely result in counterparties (and employees) refusing to do business with a financial institution either in or approaching bankruptcy. Third, court proceedings are likely to move slowly, as opposed to administrative proceedings like an ORR. Finally, whereas the ORR would permit the government to intervene in various ways before the firm "fails," traditional corporate bankruptcy would not.[64]

The key difficulty with this analysis is that it assumes chapter 11 is as it always must be, while the very idea of modifying chapter 11 to accommodate financial firms presupposes change. For example, the financial institution's regulator should have the ability to initiate a bankruptcy proceeding. And that bankruptcy proceeding should have the ability to address all aspects of the institution—whether it be a bank holding company, hedge fund, or insurance company.

Given the difficulty that financial firms would have pursuing a traditional reorganization, and the potential effects that a bankruptcy case of uncertain duration might have on the financial markets, it would make sense to provide such firms with a limited period in which to reorganize. For example, a financial debtor might have 90 days to achieve a reorganization or sale, after which the case would be dismissed or converted to a chapter 7 liquidation, with no automatic stay for financial contracts. If the particular circumstances dictated that even 90 days was too disruptive to the market, creditors or regulators would have the ability to move to convert or dismiss at an earlier point. And creditors would retain their individual rights to move to lift the automatic stay.

Because financial contracts and the collateral that supports them are likely more volatile than traditional assets, the Bankruptcy Code's adequate protection provisions, which protect secured creditors during a bankruptcy process, become even more important.[65] I suggest that preexisting "mark to market" collateral arrangements should presumptively be allowed to continue post-petition, and that the debtor should have the burden of seeking court approval or counterparty consent to alter these arrangements if they are no longer appropriate.[66] Given the new reality that secured post-petition lenders often have a claim on all of the debtors assets, combined with a super-priority administrative claim,[67] it will be necessary to

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[64] Rodgin Cohen & Morris Goldstein, *The Case for an Orderly Resolution Regime for Systemically-Important Financial Institutions*, THE PEW CHARITABLE TRUSTS FINANCIAL REFORM PROJECT 1 (Oct. 21, 2009), http://www.pewfr.org/admin/project_reports/files/Cohen-Goldstein-FINAL-TF-Correction.pdf.

[65] 11 U.S.C. §§ 361, 362(d), 363(c)(2) (2006) (providing adequate protection to secured creditors).

[66] *Cf.* § 363(c)(2) (allowing trustee to use, sell, or lease cash collateral if each entity with an interest consents).

[67] 11 U.S.C. § 364(c)(1) (2006) (providing court authorization of "the obtaining of credit or the incurring of debt" will have "priority over any or all administrative expenses").

provide greater protection to financial creditors than current section 507(b) provides[68]—perhaps in the form of a carveout of the DIP lender's collateral.[69]

The argument against using bankruptcy "court proceedings" because they are too slow repeats in a new mode the old canard about chapter 11 being a source of great delay, despite abundant evidence to the contrary,[70] and ignores the experience in Lehman, GM, and Chrysler, among other cases that are indicative of the "new and improved" chapter 11.[71] And the notion that pre-default creditors would behave differently if the looming procedure were called by a different name is just odd. This again seems to confuse the source of the problem: a firm's inability to meet its obligations is distinct from whatever procedure is used to address the problems.

In short, it seems that with a limited amount of tuning, chapter 11 could be easily adapted to the plight of financial firms after the safe harbors were repealed. And this initial analysis suggests that a newly created proceeding is unnecessary. This also has the benefit of utilizing a well-understood structure, with pre-existing traditions and standards.

CONCLUSION

Normally if you are a secured creditor in a bankruptcy case, you have to get court approval to take the collateral, even if it is in your possession.[72] That same rule holds if you have the right to setoff countervailing obligations.

If you want to avoid that, you have to set up either an escrow or securitization structure that will keep the collateral out of the bankruptcy estate.[73] The safe harbors in the Bankruptcy Code give the derivatives industry a kind of "free pass." They get treated as though they established an escrow or securitization, without actually doing it.

The core policy question is whether this is justified, or whether derivative counterparties should be treated like everybody else. The argument in favor of special treatment is a vague contention that special treatment reduces systemic risk.

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[68] At present, section 507(b) provides for a priority administrative claim for a creditor who was given "adequate protection," that turned out to be inadequate, but this claim is subordinate to claims under section 364(c)(1) and secured claims. *See* 11 U.S.C. § 507(b) (2006) (stating claims and expenses with priority).

[69] Richard B. Levin, *Almost All You Ever Wanted to Know About Carve Out*, 76 AM. BANKR. L.J. 445, 451 (2002) (stating importance of carve out as payment source).

[70] *See supra* note 53. Complaints about long, drawn-out chapter 11 cases are a prime example of what Paul Krugman has termed zombie fallacies—ideas that you kill repeatedly, but refuse to die. Adjustment and the Dollar, http://krugman.blogs.nytimes.com/2009/10/24/adjustment-and-the-dollar/ (Oct. 24, 2009, 10:10 EST).

[71] Stephen J. Lubben, *No Big Deal: The GM and Chrysler Cases in Context*, 83 AM. BANKR. L.J., 531 n.51 (2009) (referencing Stephen J. Lubben, *The "New and Improved" Chapter 11*, 93 KY. L.J. 839, 41–42 (2005)).

[72] 11 U.S.C. § 541 (2006) (stating estate includes all property of debtor "wherever located and by whomever held").

[73] *See* Edward J. Janger, *The Death of Secured Lending*, 25 CARDOZO L. REV. 1759, 1770 (2004) (stating property of estate excludes securitization assets).

The argument in favor of normal treatment is that it will maximize the value of the debtor's estate and reduce systemic risk by removing the perceived need to buy and sell myriad derivative contracts shortly after the debtor's collapse.

In this short paper I have argued that ISDA's argument for the safe harbors is shallow and uncorroborated. This is a position that other leading scholars have also embraced.[74] Given recent events, it seems appropriate to reexamine the arguments.

I thus submit the safe harbors should be repealed. Stopping the run on the bank seems distinctly preferable to facilitating the run.

[74] Edwards & Morrison, *supra* note 10, at 103–04 (arguing exclusion of derivatives from bankruptcy process increases risks of contagion in financial system); Partnoy & Skeel, Jr., *supra* note 61, at 1049 (terming ISDA's argument unpersuasive).

TESTING THE BANKRUPTCY CODE SAFE HARBORS IN THE CURRENT FINANCIAL CRISIS

ELEANOR HEARD GILBANE*

INTRODUCTION

A. Derivative Transactions and Financial Contracts Are a Cornerstone of Today's Economy

Derivative transactions and financial contracts are well recognized as a critical component of our modern complex and multi-faceted economy. The evolving economy now implicates numerous types of derivative transactions and financial contracts including modern customized permutations. Critical to the functioning of the derivatives markets is the ability of parties to value their transactions on a net basis with the counterparty and to close-out and replace the transaction in the event one party defaults.[1] But for many years, it was believed that when one party to these transactions became insolvent or filed a petition for relief under Title 11 of the United States Code (the "Bankruptcy Code"), the ability of a party to terminate and close-out transactions could be uncertain.

This fear was premised on the fact that contractual provisions that trigger the right to terminate or modify an executory contract upon a party's insolvency or commencement of bankruptcy proceedings, known as *ipso facto* clauses, are ordinarily unenforceable against a debtor under section 365(e) of the Bankruptcy Code, and the exercise of such rights to recover property or act against property of the debtor is prohibited by the automatic stay under section 362 of the Bankruptcy Code.[2] Because of these restrictions, there was great concern that the derivative and

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[1] ANTHONY C. GOOCH & LINDA B. KLEIN, DOCUMENTATION FOR DERIVATIVES: ANNOTATED SAMPLE AGREEMENTS AND CONFIRMATION FOR SWAPS AND OTHER OVER THE COUNTER TRANSACTIONS 268–71 (4th ed. 2002) [hereinafter GOOCH & KLEIN]; Richard D. Bernsteing, Jessica L. Matelis & John R. Oller, *Failed Financial Institution Litigation: Remember When*, 5 N.Y.U.J.L. & BUS. 243, 272 (2009) (noting close-out netting provisions as "vital to financial institutions active in the derivatives market"); *see also* William L. Harvey, *Securing Derivatives Obligations with California Real Estate—Selected Enforcement Issues*, 3 HASTINGS BUS. L.J. 251, 261 (2007) (asserting close-out netting to be "central to the derivatives markets").

[2] 11 U.S.C. § 362 (2006); *In re* Solutia Inc., 379 B.R. 473, 485 (Bankr. S.D.N.Y. 2007) (holding section 362 prohibits "any act to obtain property of the estate"); *In re* Mirant Corp., 303 B.R. 319, 323 (Bankr. N.D. Tex. 2003) (noting section 362 "prohibit[s] acts to obtain or exercise control over property of the estate of a debtor"). Additionally, any transfers of an interest in the debtor's property in the ninety days prior to a

financial contract markets could be destabilized upon the filing of a bankruptcy petition by a counterparty. For this reason, beginning in 1982 with amendments for forward contracts, commodity contracts, and security contracts,[3] continuing in 1984 with protections for repurchase agreements,[4] and again in 1990, with protections for swap agreements and amendments to the existing protections for forward contracts,[5] Congress purposefully enacted safe harbors in the Bankruptcy Code (the "Safe Harbor Provisions") to protect the ability of certain counterparties to certain financial and derivative contracts to exercise rights to terminate, liquidate, and close-out derivative transactions and financial contracts and to foreclose against collateral posted thereunder.[6]

B. Congress' Initial Enactment of Safe Harbor Protections for Derivative Transactions and Financial Contracts

From their start, the Safe Harbor Provisions were specific in their scope. Located primarily in sections 362(b)(6), 362(b)(7), 362(b)(17),[7] 546, 556, 559, and 560 of the Bankruptcy Code,[8] they protected the ability of certain counterparties, who are parties to swap agreements,[9] forward contracts,[10] commodity contracts,[11]

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debtor's filing for bankruptcy protection may be recoverable under section 547(b) of the Bankruptcy Code. 11 U.S.C. § 547(b) (2006); *see also* H.C. Schmieding Produce Co. v. Alfa Quality Produce Inc., 597 F.Supp.2d 313, 317 (E.D.N.Y. 2009) (noting payments made up to ninety days before a debtor's bankruptcy filing to be recoverable by trustee); *In re* Caremerica, Inc., 409 B.R. 759, 765 (Bankr. E.D.N.C. 2009) (holding transfers "made within the 90-day period before the date of filing" avoidable).

[3] *See* H.R. REP. NO. 97-420, at 2 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583, 584–85.

[4] *See Bankruptcy Law and Repurchase Agreements: Hearing on H.R. 2852 and H.R. 3418 Before the Subcomm. on Monopolies and Commercial Law of the H. Comm. on the Judiciary*, 98th Cong. (1984).

[5] *See generally* H.R. REP. NO. 101-484 (1990), *reprinted in* 1990 U.S.C.C.A.N. 223.

[6] *See Interest Swap: Hearing on S. 396 Before the Subcomm. on Courts and Administrative Practice of the Comm. on the Judiciary*, 101st Cong. 16 (1989) [hereinafter *Interest Swap Hearing*] (statement of Marc Brickell) ("Participants in the swap market are concerned that, if a counterparty files for bankruptcy, the automatic stay and other provisions of the Bankruptcy Code could be interpreted to bar the implementation of these critical contractual provisions."); H.R. REP. NO. 97-420, at 2 (1982) ("The prompt closing out or liquidation . . . minimizes the potentially massive losses and chain reactions that could occur if the market were to move sharply in the wrong direction."); *see also* Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1648 (2008) (asserting "1990 'swap amendments' allow the solvent counterparty to a derivative contract to terminate the contract, foreclose on collateral and apply it to the debtor's obligation under the contract").

[7] The safe harbor provision protecting enforcement and swap participant's rights despite the automatic stay was initially enacted as section 362(b)(14) but later renamed as section 362(b)(17). 11 U.S.C. § 362(b)(17) (2006); *see* Bank One Corp. v. Comm'r of Internal Revenue, 120 T.C. 174, 269 (2003) (noting section 362(b)(14) changed to section 362(b)(17) in 1990).

[8] 11 U.S.C. §§ 362(b)(6), 362(b)(7), 362(b)(17), 546, 556, 559, 560 (2006) (creating bankruptcy insulating provisions for market participant financial contracts to avoid additional market defaults and bankruptcies by other market participants).

[9] Defined at 11 U.S.C. § 101(53B) (2006).

[10] Defined at 11 U.S.C. § 101(25) ("A contract (other than a commodity contract, as defined in section 761) for the purchase, sale, or transfer of a commodity, as defined in section 761(8) of this title, or any similar good, article, service, right or interest . . . .").

securities contracts,[12] and repurchase agreements,[13] to exercise contractual rights under *ipso facto* clauses to close-out ("Close-Out") (terminate, liquidate or accelerate) their contracts with a debtor without obtaining relief from the automatic stay and despite the general prohibition on *ipso facto* clauses.[14] Additionally, the Safe Harbor Provisions permitted certain counterparties to exercise their contractual rights to offset or net out ("Setoff") any mutual debt and claim under or in connection with any such safe harbored agreement.[15] The Safe Harbor Provisions also protected certain pre-petition transfers ("Transfers") from being avoided by the trustee or debtor-in-possession unless the transfer was made with the actual intent to defraud, delay or hinder a creditor.[16] It was these three basic rights that were viewed as critical to maintaining market stability and liquidity.[17]

Protecting the exercise of these rights through the Safe Harbor Provisions was intended to preserve liquidity and to minimize volatility in the marketplace in the event that a counterparty to such transactions might become a debtor under the Bankruptcy Code.[18] The focus was on the resolution of financial transactions: "because financial markets can change significantly in a matter of days, or even hours, a non-bankrupt party to ongoing securities transactions and other financial transactions could face heavy losses unless the transactions are resolved promptly and with finality."[19] The Safe Harbor Provisions were designed "to ensure that the swap and forward contract financial markets are not destabilized by uncertainties regarding the treatment of their financial instruments under the Bankruptcy Code."[20]

Importantly, Congress weighed the risks in enacting the initial Safe Harbor Provisions and while it recognized the importance of allowing counterparties to close-out their derivative transactions with a debtor and exercise setoffs to arrive at

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[11] Defined at 11 U.S.C. § 761(4) (2006) (enumerating list of commodities contracts covered within subsection).

[12] Defined at 11 U.S.C. § 741(7) (2006).

[13] Defined at 11 U.S.C. § 101(47) (2006).

[14] *See* 11 U.S.C. §§ 555, 556, 559, 560 (2000) (current versions at 11 U.S.C. §§ 555, 556, 559, 560 (2006)).

[15] *See* 11 U.S.C. §§ 362(b)(6), 362(b)(7), 362(b)(17), 555, 560 (2000) (current versions at 11 U.S.C. §§ 362(b)(6), 362(b)(7), 362(b)(17), 555, 560 (2006)).

[16] *See* 11 U.S.C. §§ 546(e), 546(f), 546(g), 546(j) (2000) (current versions at 11 U.S.C. §§ 546(e), 546(f), 546(g), 546(j) (2006)).

[17] *See, e.g.*, GOOCH & KLEIN, *supra* note 1, at 272; *see also* Scot Tucker, *Interest Rate Swaps and the 1990 Amendments to the United States Bankruptcy Code: A Measure of Certainty Within Swap Contracts*, 1991 UTAH L. REV. 581, 612–14 (1991) (describing amendment goals).

[18] *See* H.R. REP. NO. 101-484, at 1–3 (1990), *reprinted in* 1990 U.S.C.C.A.N. 223, 223–25; H.R. REP. NO. 97-420, at 1 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583, 583 (determining that because of the "volatile nature [of] the markets, certain protections are necessary to prevent the insolvency of one commodity or security firm from spreading to other firms and possibl[y] threatening the collapse of the affected market").

[19] *See* H.R. REP. NO. 101-484, at 2.

[20] *Id.* at 1. The concerns that Congress faced in 1990 "closely parallel[ed] those which led to the 1982 and 1984 amendments regarding securities contracts, commodity contracts, forward contracts, and repurchase agreements," which similarly "exempt[ed] the liquidation and setoff of mutual debts and claims arising under" those types of agreements. *Id.* at 2–3.

a net sum owing to either the debtor or the counterparty, it simultaneously determined that the unique nature of such financial and derivative transactions did not significantly harm the debtor or necessarily deprive it of a valuable asset needed for reorganization.[21] For example, because swap agreements are by definition hedging instruments and most debts are accelerated upon a bankruptcy filing, Congress understood that there would be little need in most circumstances for the debtor to maintain that hedge through the bankruptcy proceedings.[22] In contrast, the termination of a lease or other executory contract could deprive the debtor of a valuable asset necessary for reorganization. For these specific reasons, the motivation and necessity for the Safe Harbor Provisions outweighed the need for the traditional protections of a debtor's rights with respect to executory contracts, the automatic stay, and preferential transfers.

C. *The Market Proposed Amendments for Consistency and Clarity*

Because the initial Safe Harbor Provisions were enacted from 1982 to 1990 product-by-product, in a piecemeal fashion, the Bankruptcy Code contained unintentional inconsistencies with respect to the treatment of different contracts. Additionally, from 1990 to 2005, during a period of time in which the United States economy grew exponentially, Congress did not substantially amend or update the Safe Harbor Provisions to encompass new types of derivative transactions. The markets became increasingly concerned that the inconsistent and outdated Safe Harbor Provisions would not protect newer innovative contracts and counterparties' ability to close out transactions and to net obligations in the event of a failure of a large financial market participant.[23] Ultimately, these concerns prompted Congress to enact reforms to the Safe Harbor Provisions in 2005 through the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA").[24] In

[21] *See* Tucker, *supra* note 17, at 582–83 (positing provisions' policy goals were achieved without injuring creditors).

[22] *Interest Swap Hearing*, *supra* note 6, at 69 (statement of William Perlstein, Wilmer, Cutler and Pickering) (distinguishing swap agreements and describing them as hedging transactions from a lease; also finding no need for debtors to keep hedging transactions in place when most debt obligations accelerate upon filing bankruptcy); *see also id.* at 53, 56–60 (statement of John Jerome, Milbank, Tweed, Hadley, and McCloy) (noting most chapter 11 debtors do not pay interest to unsecured creditors and therefore have no need for interest rate protection from swap agreements); *id.* at 61, 64 (statement of Frank G. Sinatra, Rebound Management Inc.) (stating interest rate swaps' significance deems necessary revision to Code).

[23] *See Bankruptcy Reform Act of 1999 Hearing (Part III): Hearing on H.R. 883 Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 106th Cong. 4 (1999) [hereinafter *1999 Hearing*] (statement of Rep. James Leach) (arguing for Code amendments to avoid risk of systemic failure of large financial institutions); H.R. REP. NO. 109-31, pt. 1, at 20 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 105 (indicating amendments to Code made to avoid "systemic risk").

[24] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, PUB. L. No. 109–8, 119 Stat. 23 (2005); *see* H.R. REP. NO. 109-31, pt. 1, at 7 (listing H.R. 833 as one of many predecessors); *id.* at 20 (noting "the provisions were derived from recommendations from the President's Working Group and revisions espoused by the financial industry"); *id.* at 20 n.78 (observing H.R. 4393 is a predecessor bill). See Appendix I for a blackline of the amendments enacted by BAPCPA.

enacting reforms through BAPCPA, Congress broadened the definitions of certain safe harbored agreements, added a class of counterparties to protect large market participants, and created greater uniformity with respect to the exceptions to the automatic stay in section 362 and exceptions to the *ipso facto* prohibitions in sections 555, 556, 559 and 560. Additionally, Congress created protections for cross-product netting to allow a counterparty to net all of its obligations across multiple safe harbored contracts with a debtor.[25] BAPCPA amended the Bankruptcy Code and other relevant banking laws,[26] to "reduce systemic risk in the marketplace,"[27] and to "minimize the risk of disruption" in the event of one party's insolvency, by "allow[ing] the expeditious termination or netting of certain types of financial transactions,"[28] and by eliminating inconsistencies among the definitions and types of safe harbored agreements that were protected in the event of insolvency or the commencement of bankruptcy proceedings.[29]

In 2006, with the passage of the Financial Netting Improvements Act ("FNIA"), Congress made additional "technical changes" to the Safe Harbor Provisions "by strengthening and clarifying the enforceability of early termination and close-out netting provisions and related collateral arrangement in U.S. insolvency proceedings."[30] As with BAPCPA, Congress sought to reduce systemic risk in the financial markets by clarifying the treatment of certain transactions in the event of bankruptcy or insolvency.[31] The overall purpose in enacting FNIA was to clarify the definitions and increase consistency among the various insolvency laws so as to provide certainty and decrease the risk of systemic failure of our financial markets associated with activities in derivatives market.[32]

D. The Safe Harbors in the Current Financial Crisis

In the three years that have passed since Congress' most recent revisions (and several years since the netting amendments were proposed to Congress in 1998), the United States derivatives economy has grown exponentially. The value of the

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[25] H.R. REP. NO. 109-31, pt. 1, at 125 (defining cross-product netting as when several financial transactions between two parties are netted to maximize risk-reducing benefits, and ensuring it will be enforceable under FDIA and FCUA).

[26] In addition to amending the Bankruptcy Code, BAPCPA amended the "Federal Deposit Insurance Act, the Financial Institutions Reform, Recovery and Enforcement Act of 1989, the Federal Deposit Insurance Corporation Improvement Act of 1991, the Federal Reserve Act, and the Securities Investor Protection Act of 1971." *Id.* at 20 n.77.

[27] *Id.* at 3.

[28] *Id.* at 20.

[29] *See id.* at 119.

[30] H.R. REP. NO. 109-648, pt. 1, at 2 (2006); *see* Financial Netting Improvements Act of 2006, Pub. L. No. 109-390, 120 Stat. 2692 (2006) (stating purpose as improving "the netting process for financial contracts"); 152 CONG. REC. 129, H8651 (daily ed. Nov. 15, 2006) (statement of Rep. Baker) (highlighting advantages and importance of bill). See Appendix II for a blackline of the amendments enacted by FNIA.

[31] *See* H.R. REP. NO. 109-648, pt. 1, at 3.

[32] *See id.* at 1–2.

derivatives market in October 2008 was $531 trillion in comparison to $106 trillion in 2002, and to practically nothing two decades ago.[33] Furthermore, this nation's economy has now suffered what many feared—major failures of large derivative market participants and a great financial crisis. In the reorganization or liquidation of major market participants, the amended Safe Harbor Provisions are for the first time being evaluated and interpreted by the market, courts, debtors and counterparties. In certain cases it is clear that the recent amendments to the Safe Harbor Provisions had their intended effect; they updated the law and provided necessary clarification. In other cases, there remains ambiguity about which rights, which counterparties, and what contracts are protected, and whether the protections accomplish their goals. What appears to be clear overall is that BAPCPA and FNIA broadened the classes of protected *transactions* and *counterparties*, but did not alter the scope of previously exercisable *rights* under the Safe Harbor Provisions.

This article addresses the significant amendments to the Safe Harbor Provisions in BAPCPA and FNIA concerning derivative transactions and financial contracts, their purpose, scope, and effect. Specifically, section II describes the history behind the BAPCPA and FNIA amendments. Section III explains the specific changes to the Bankruptcy Code in further detail. Section IV examines the recent jurisprudence interpreting the relevant Safe Harbor Provisions, the uncertainties that have led to litigation, and the lessons that may be learned. Finally, section V explains certain remaining ambiguities, including questions about the scope of the Safe Harbor Provisions.

I. THE SAFE HARBOR PROVISIONS AND THE AMENDMENTS WERE INTENDED TO CLARIFY TREATMENT AND PROTECTIONS FOR DERIVATIVE TRANSACTIONS AND FINANCIAL CONTRACTS

A. The Markets Lobbied Congress for Clarifying Amendments

The concerns about potentially inconsistent treatment, because the Safe Harbor Provisions were enacted piecemeal over time and did not cover newer innovative products, prompted members of the market as early as 1993 to begin considering their reform. Members from the International Swaps and Derivatives Association ("ISDA") and the President's Working Group on Financial Markets,[34] a group formed to review and propose legislation to address the concerns of the derivatives

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[33] Peter S. Goodman, *Taking Hard New Look at a Greenspan Legacy*, N.Y. TIMES, Oct. 8, 2008, at A1.

[34] The President's Working Group's members included representatives from the Commodity Futures Trading Commission, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, the Securities and Exchange Commission, and the Department of Treasury, including the Office of the Comptroller of Currency. H.R. REP. NO. 105-688, pt. 1, at 1 (1998); *see also* H.R. REP. NO. 109-648, pt. 1, at 2 (stating netting provisions reflect work by President's Working Group on Financial Markets); H.R. REP. NO. 109-31, pt. 1, at 20 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 105 (acknowledging provisions stem from President's Working Group on Financial Markets).

market, lobbied Congress for amendments that would clarify, update, and improve consistency between the Safe Harbor Provisions in the Bankruptcy Code and other federal banking statutes to provide assurance as to the netting of derivative transactions and financial contracts in bankruptcy.[35] These efforts culminated in 1998 in the submission of a formal legislative proposal, which was delivered in a report to Congress on March 16, 1998, by Secretary Rubin, as Chairman of the Working Group.[36] The specific goals of that legislative proposal were to (1) "eliminate uncertainty in the interpretation of certain" Safe Harbor Provisions; (2) harmonize the Safe Harbor Provisions of the Bankruptcy Code with other federal insolvency laws where appropriate; and (3) "update [the Safe Harbor Provisions] to reflect changes in the market."[37]

Incorporating language almost verbatim from the President's Working Group's legislative proposal, in 1998 Congress introduced the Financial Contract Netting Improvements Act of 1998 (H.R. 4393),[38] and later, the Bankruptcy Reform Act of 1999 (H.R. 833),[39] both of which emphasized the need for clarity regarding orderly resolution of derivative transactions and financial contracts. Clarity in the statute was critical in the reduction of "systemic risk"—or "the risk that the failure of a firm or disruption of a market or settlement system will cause widespread difficulties at other firms, in other market segments or in the financial system as a whole."[40] While H.R. 4393 was pending, Long Term Capital Management ("LTCM"), a major hedge fund, experienced a severe liquidity crisis, lost billions in capital during the late summer of 1998, and nearly failed but for the assistance of a consortium of its own counterparties, who feared worse repercussions if LTCM were left to default.[41] The near failure of LTCM further ignited fears of a domino

[35] *See 1999 Hearing*, *supra* note 23, at 18 (statement of Rep. Leach) (noting proposed legislation "build[s] on recommendations" from October 1993 Banking Committee minority report on derivatives and contained proposals derived from President's Working Group on Financial Markets review of current statutory provisions); *id.* at 350 (statement of Oliver Ireland, Associate General Counsel, Board of Governors, Federal Reserve System) ("Many of these provisions incorporate, or are based on, amendments to these statutes that were endorsed by the President's Working Group on Financial Markets."); H.R. REP. NO. 109-31, pt. 1, at 20, 105.

[36] Press Release, *U.S. Dep't of the Treasury, Treasury Deputy Assistant Sec'y for Fed. Fin. Roger L. Anderson Delivers Testimony to the Senate Judiciary Subcomm. on Admin. Oversight and the Courts* (May 19, 1998), *available at* http://www.treas.gov/press/releases/rr2458.html [hereinafter *Testimony of Anderson*] (reporting Rubin transmitted proposal to Congress); *see also 1999 Hearing*, *supra* note 23, at 18 (statement of Rep. Leach).

[37] *Testimony of Anderson*, *supra* note 36.

[38] *See* Financial Contract Netting Improvement Act of 1998, H.R. 4393, 105th Cong. (1998); H.R. REP. NO. 105-688, pt. 1, at 1 (1998).

[39] *See* Bankruptcy Reform Act of 1999, H.R. 833, 106th Cong. (1999); H.R. REP. NO. 106-123, pt. 1, at 86, 93–94 (1999) (confirming H.R. 833 contained proposed amendments for consumer bankruptcies in addition to recommendations made by President's Working Group on Financial Markets).

[40] H.R. 4393, *supra* note 38; *1999 Hearing*, *supra* note 23, at 3, 5; H.R. REP. NO. 106-123, pt. 1, at 93–94 n.32; H.R. REP. NO. 105-688, pt. 1, at 2.

[41] *See 1999 Hearing*, *supra* note 23, at 14, 16 (statement of Rep. Leach) (discussing failure of Long Term Capital Management); Report of the President's Working Group on Financial Markets, *Hedge Funds,*

effect and systemic collapse if the Bankruptcy Code and the Safe Harbor Provisions were not amended.

On October 1, 1998, Alan Greenspan, then Chairman of the Federal Reserve, testified before Congress, urging it to learn from the lessons of LTCM and posing questions about how to avoid such a situation in the future.[42] In April 1999, the President's Working Group issued a report on LTCM's failure and the prevention of a collapse of the world's financial markets in the event of a recurrence.[43] That report hypothesized that in the event of LTCM's bankruptcy, the immediate close-out and netting of outstanding derivative transactions would have been critically important to the stability of the world's financial markets.[44]

Given the lessons learned from LTCM, the President's Working Group reaffirmed its support for the Financial Contract Netting Improvement Act (H.R. 4393) and recommended "expanding and clarifying the definitions of the financial contracts eligible for netting . . . and allowing eligible counterparties to net across different types of contracts, such as swaps, security contracts, repos, and forward contracts."[45] This became known more commonly as cross-product netting, meaning for example, the process by which a counterparty could net its forward contract obligations with a debtor against its swap agreement or repurchase agreement obligations with a debtor. Addressing these specific concerns, clarifying definitions, and allowing cross-product netting was believed to be vital to the growing economy. The goal of reform was to clarify that the safe harbor treatment would apply to the expanded derivative markets as they had evolved—and not alter the nature of the previous protections provided (such as allowing termination and netting despite the automatic stay and *ipso facto* clauses). Consequently, concerns that the amendments could impede a debtor's ability to reorganize were dismissed as not outweighing the need for clarification in the statute.

Leverage, and the Lessons of Long-Term Capital Management, April 1999, at 13 [hereinafter President's Working Group Report] (analyzing hedge fund steps of failure and assistance of consortium of counterparties).

[42] *See Hedge Fund Operations Before the Comm. on Banking and Financial Servs.*, 105th Cong. 40 (1998) (statement of Alan Greenspan, Chairman, Federal Reserve Board), *available at* http://www.federalreserve.gov/boarddocs/testimony/1998/19981001.htm (enumerating questions to address to policy makers to avoid future failure).

[43] *See* President's Working Group Report, *supra* note 41, at 12–13, 16–17 (discussing steps leading to hedge funds' failure and how to stabilize trading activity for future).

[44] *See id.* at 19 (positing closeout and netting may have alleviated loses and provided stability to market).

[45] *See id.* at 40. The Financial Contract Netting Improvement Act, H.R. 4393 (1998), which was ultimately included as part of BAPCPA, had "four principal purposes: [(1)] strengthen provisions of the Bankruptcy Code and FDIA that protect the enforceability of termination and close-out netting and related provisions of certain financial agreements and transactions[; (2)] harmonize the treatment of these financial agreements and transactions under the Bankruptcy Code and FDIA[; (3)] amend the FDIA and FDICUIA to clarify that certain rights of the FDIC acting as conservator or receiver for a failed insured depository institution (and in some situations, rights of SIPC and receivers of certain uninsured institutions) cannot be defeated by operation of the terms of the FDICIA[; and (4)] make other substantive and technical amendments to clarify the enforceability of financial agreements and transactions in bankruptcy or insolvency." H.R. REP. NO. 105-688, at 3–4.

B. The Safe Harbor Provisions Did Not Alter the Scope of Protected Rights

The principal amendments to the Safe Harbor Provisions in 2005 (BAPCPA) and 2006 (FNIA) with regard to the treatment of derivative and financial contracts were as follows:

- Clarify that a counterparty's right to Close-Out, Setoff and Transfer would be permitted for each protected product type (forward contracts, repurchase agreements, securities contracts, swap agreements, commodity contracts) regardless of the terminology (i.e. termination, liquidation) used;[46]
- Broaden the definitions of "swap agreement" and "repurchase agreement" to clarify the scope of those definitions;[47]
- For each protected product type, include in the definition of the product agreement, master agreements, credit enhancement and guarantees covering these agreements;[48]
- Add protections for cross-product netting and master netting agreements, agreements that allowed a party to combine already netable obligations under other safe harbored products with the debtor;[49] and
- Clarify protections for transfers and setoff rights acquired in the ninety days prior to bankruptcy in sections 546(g), 553(a)(2)(B) and 553(a)(3).[50]

As stated above, these reforms appear to have been largely clarifying in nature without making dramatic changes in the *type* or *scope* of rights protected by the original Safe Harbor Provisions. They are discussed in more detail below.

II. SPECIFIC AMENDMENTS

A. Certain Amendments were Intended to Eliminate Inconsistencies Concerning Rights to Close-out

Prior to 2005, the Safe Harbor Provisions were inconsistent in their terminology with respect to a counterparty's right to Close-Out. For example, section 556 protected a commodity broker or forward contract merchant's exercise of contractual rights to cause the *liquidation* of a commodity contract or a forward contract upon a debtor's filing of a bankruptcy petition.[51] While it was understood in

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[46] *See* H.R. REP. NO. 109-31, pt. 1, at 132 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 192.
[47] *See id.* at 128–29.
[48] *See id.* at 129.
[49] *See id.* at 131.
[50] *See id.* at 133–34.
[51] 11 U.S.C. § 556 (2000) (protecting contractual right of forward contract merchants and commodity brokers "to cause the liquidation of a commodity contract"); *see In re* R.M. Cordova Int'l, Inc., 77 B.R. 441, 448 (Bankr. D.N.J. 1987) (discussing liquidation rights conferred by former section 556); Thomas G. Kelch

the industry that the way to liquidate a forward contract with continuing obligations was to declare early termination, and then calculate the amount due under the contracts,[52] section 556 did not explicitly state "termination," leading to uncertainty about whether "termination" in addition to "liquidation" would be protected.[53] Former section 560, on the other hand, protected the right of any swap participant to cause the *termination* of a swap agreement upon a debtor's insolvency or filing of a bankruptcy petition, leading to uncertainty about whether a party could "liquidate" the transactions and supporting collateral.[54]

To address this concern and the arbitrary differences, Congress, through BAPCPA, amended sections 555 (protecting liquidation of securities contracts), 556 (liquidation of forward contracts), 559 (liquidation of repurchase agreements), and 560 (termination of swap agreements) to clarify that the exercise of contractual rights to "liquidate, terminate, or accelerate" for *each* specific product could be effected. This change provided the necessary assurance that the right to Close-Out would be protected regardless of industry-specific terminology.[55]

Additionally, Congress expanded the definition of "contractual right" in section 560, which was also incorporated by reference into sections 555, 556, and 559 and new section 561, to include rights arising "(i) from the rules of a derivatives clearing organization, multilateral clearing organization, securities clearing agency, securities exchange, securities association, contract market, derivatives transaction execution facility or board of trade; (ii) under common law . . . ; or (iii) by reason of normal business practice."[56] This amendment was intended to correspond to the definition in the "enactment of the CFMA" (the Commodity Futures Modernization Act of 2000), and thus increased consistency among the federal statutes.[57]

& Howard J. Weg, *Forward Contracts, Bankruptcy Safe Harbors and the Electricity Industry*, 51 WAYNE L. REV. 49, 84–85 (2005) (arguing former section 556 phrase "cause the liquidation" may have been drafting error or oversight).

[52] Rhett G. Campbell, *Energy Future and Forward Contracts, Safe Harbors and the Bankruptcy Code*, 78 AM. BANKR. L.J. 1, 22 (2004) (noting inherent difficulty in liquidating forward contract with continuing obligations because actual price on future performance date is unknown).

[53] *See id.* (discussing ambiguity regarding whether safe harbor for liquidation included termination).

[54] 11 U.S.C. § 560 (2000) (protecting swap participant's contractual right "to cause the termination of a swap agreement"); *see In re* Mirant Corp., 314 B.R. 347, 351 (Bankr. N.D. Tex. 2004) (discussing swap participant's right under former section 560 to terminate swap agreement); Kelch & Weg, *supra* note 51, at 87 n.219 ("No reason can be found in the legislative history or elsewhere for the anomalous use of 'terminate' in § 560.").

[55] GOOCH & KLEIN, *supra* note 1, at 304–05; *see also* 11 U.S.C. §§ 555, 556, 559, 560 (2006) (indicating contractual right to cause liquidation, termination, or acceleration of various types of financial agreements will not be stayed or limited by any other provision under this title); H.R. REP. NO. 109-31, pt. 1, at 132 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 192 (noting protection of rights from automatic stay is "consistent with the policy goal of minimizing systemic risk").

[56] H.R. REP. NO. 109-31, pt. 1, at 133.

[57] *See id.* (noting definition of "contractual right" in Bankruptcy Code reflects enactment of CFMA).

B. The Amendments Broadened the Definitions to Clarify Protection for Newer Product

1. Amendments to Definition of Swap Agreements

In order to address the dramatic increase in the use of swap transactions from 1990 to 2005 and the diversification of the types of swaps used, Congress updated and broadened the definition of "swap agreements" to include every conceivable type of swap transaction including customized transactions.[58] The definition of swap agreement in section 101(53B) of the Bankruptcy Code now includes equity derivatives, credit derivatives, and weather derivatives.[59] Additionally, Congress expanded the descriptions in the statute of interest rate, currency, and commodity derivatives, and added protections for futures, options or forward agreements in relation to any type of swap agreement.[60] Broadening the definitions was intended to provide certainty that newer forms of swap agreements would be included in the protections and not subject to the risk that the debtor would cherry-pick—assume one swap while rejecting another.[61] Yet, because the goal was "to protect markets, not particular types of creditors,"[62] "[t]he definition of 'swap agreement'" was not intended to include "[t]raditional commercial arrangements, such as supply agreements, or other non-financial market transactions, such as . . . residential or consumer loans . . . ."[63] The proponents of the legislation did "not want to create a situation where what is actually a loan receives special treatment just because the documentation calls the transaction a swap."[64]

2. Amendments to Definitions of Repurchase Agreement, Forward Contract, Commodity Contracts and Securities Contract

Other amendments to the definitions of safe-harbored agreements included broadening the definition of a "repurchase agreement" to include mortgage-related securities, mortgage loans and interests therein,[65] and the inclusion of "or any other

[58] *See id.* at 127–29 (providing for variety of economic transactions to be included in definition of "swap agreement").

[59] 11 U.S.C. § 101(53B)(A)(i) (2006).

[60] 11 U.S.C. § 101(53B)(A)(i)–(iii).

[61] *1999 Hearing*, *supra* note 23, at 186 (statement of Seth Grosshandler Partner, Cleary, Gottlieb, Steen & Hamilton) (positing broadening definition of "swap agreement" minimizes risk of "cherry-picking" between different types of swap agreements); *see* H.R. REP. NO. 109-31, pt. 1, at 128 (remarking amended definition will "achieve contractual netting across economically similar transactions").

[62] *Testimony of Anderson*, *supra* note 36 (noting proposed amendments to Bankruptcy Code were careful to exclude commercial loans from definition of swap transactions).

[63] H.R. REP. NO. 109-31, pt. 1, at 129 (stating commercial arrangements cannot be treated as "swaps" just because parties label them as "swap agreements").

[64] *Testimony of Anderson*, *supra* note 36.

[65] H.R. REP. NO. 109-31, pt. 1, at 127 (indicating broadened definitions conform to amended FDIA).

similar agreement" to the definitions of "forward contract," "commodity contract," "repurchase agreement," and "securities contract," for flexibility as the market matured.[66] Each of these definitions was amended to include as a single agreement any master agreement for any class of protected contracts.[67] As a result, a party could document any number or type of financial contract under the same master agreement and the master agreement would be treated as a swap agreement as it relates to a swap, a forward contract as it relates to a forward, and so on.[68]

3. Addition of Protection for Credit Enhancements

Congress also amended the definitions for each protected class of agreements to include any credit enhancement or guarantee relating to such type of agreement, thus ensuring that the arrangement or enhancement itself could be eligible for termination, liquidation, acceleration, and setoff under the Bankruptcy Code.[69] A creditor who is the beneficiary of a guarantee on a swap provided by the debtor could exercise its rights to liquidate, accelerate, terminate or setoff under the guarantee to the swap.[70] This has implications for setoffs because prior to the 2005 amendments, only setoffs under swap agreements themselves were permitted without seeking relief from the automatic stay. For example, a creditor who owed a debtor under a swap, would not have been able to set off that obligation against a claim it had against the debtor under a guarantee for a different swap, absent relief from the stay. Under the amended statue, the counterparty, assuming there is mutuality, may be able to offset a claim under a guarantee of a swap by a debtor against its obligation arising under a swap with the same debtor.[71]

4. New Category of Counterparties: Financial Participants

In enacting the Safe Harbor Provisions, Congress recognized that the "overriding goal of minimizing systemic risk" must be balanced against the debtor's need to reorganize, which is safeguarded by the automatic stay, the prohibition on *ipso facto* clauses and the right of the debtor to recover transfers from the estate

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[66] *See id.* at 128 (observing definition of "swap agreement" already contained phrase "any similar agreement").

[67] *See id.* at 163 (defining "forward contracts"); *id.* at 168 (defining "repurchase agreements"); *id.* at 171 (defining "swap agreements"); *id.* at 273–74 (defining "securities contract"); *id.* at 275 (defining "commodity contract").

[68] *See* H.R. REP. NO. 109-31, pt. 1, at 333 (2005) (affirming such agreements shall be treated as one swap agreement); GOOCH & KLEIN, *supra* note 1, at 328.

[69] *See* H.R. REP. NO. 109-31, pt. 1, at 129 (including offsets under FDIA and FCUA).

[70] *See id.* (noting that this includes agreements related to "swap agreements"); GOOCH & KLEIN, *supra* note 1, at 282; *see also* 11 U.S.C. § 101 (53B)(A)(ii) (2006) (showing definition includes similar agreements).

[71] *See* 11 U.S.C. § 362 (b)(17) (2006); 11 U.S.C. § 101(53B) (2006) (defining "swap agreement"); GOOCH & KLEIN, *supra* note 1, at 282.

immediately prior to the petition date.[72] "[B]ecause of the concerns . . . about not creating exceptions to the automatic stay unless the overriding goal of minimizing systemic risk justifies it," the legislation in amending the Safe Harbor Provisions, as proposed and enacted, "preserves the limitations on the types of entities that can benefit from the new provisions."[73]

These "counterparty limitations," specify that the rights in the Safe Harbor Provisions are only available if "a *party* meets specific criteria."[74] Prior to BAPCPA, *only* those entities that met the definition of "forward contract merchants" and "commodity brokers" could benefit from the Safe Harbor Provisions relating to "forward contracts" and "commodity contracts."[75] Some courts narrowly interpreted the definition of "forward contract merchant" as limited to an entity that engages in purchases and sales of a commodity as part of its regular operations in the forward contract trade and did not consider a "forward contract merchant" to be simply anyone or entity that had a forward contract with a debtor.[76] In contrast a "swap participant" is defined more broadly as any entity that has a swap agreement with the debtor prior to the petition date.[77] Through BAPCPA, Congress added a new class of protected persons, the "financial participant," to ensure that large market participants would benefit from the protections for financial and derivative contracts even if they did not fit the definition of "forward contract merchant" or other classes of protected persons.[78]

A "financial participant" is defined as a counterparty who has transactions with a total gross dollar value of at least $1 billion in notional principal or actual principal amount outstanding on any day during the previous fifteen-month period, or has gross mark-to-market positions of at least $100 million (aggregated across counterparties) in one or more agreements or transactions on any day during the previous fifteen-month period.[79] A financial participant receives the protections in sections 362(b)(6), 555, and 556 without regard to its ability to satisfy the protected party definitions.[80]

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[72] *See Testimony of Anderson*, *supra* note 36 (noting proposal limits types of entities that benefit from new provisions).

[73] *Id.*

[74] President's Working Group Report, *supra* note 41, at E-5.

[75] *See* 11 U.S.C. §§ 555, 556 (2000) (providing narrow definition of party entitled to benefits); *see also In re* R.M. Cordova Int'l, Inc., 77 B.R. 441, 448 (Bankr. D.N.J. 1987) (explaining section 556 and rights provided to forward contract merchants and commodity brokers).

[76] *In re* Mirant Corp., 310 B.R. 548, 570 (Bankr. N.D. Tex. 2004) (finding that purchaser on supply contract that did not regularly engage in the sale and purchase of a commodity was not a "forward contract merchant"); *cf. In re* Borden Chem., 336 B.R. 214, 224–25 (Bankr. D. Del. 2006) (finding party was a forward contract merchant because in its regular operations "acted as both a buyer and a seller of natural gas through the use of forward contracts").

[77] *See* 11 U.S.C. § 101(53C) (2006).

[78] H.R. REP. NO. 109-31, pt. 1, at 130 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 190.

[79] 11 U.S.C. § 101(22A) (2006).

[80] H.R. REP. NO. 109-31, pt. 1, at 130–31.

Congress also included "financial participants" as beneficiaries of the protections for repurchase agreements in section 559 and swap agreements in section 560, although the tests for qualifying as a repo participant or a swap participant required only a finding that the counterparty entered into a repurchase agreement or swap agreement with the debtor.[81] Congress noted that in some instances an entity could qualify as both a swap participant and a financial participant or a repo participant and a financial participant and the definitions were not mutually exclusive.[82] Financial participant also included in its definition "clearing organizations," a change that would allow clearing organizations to take advantage of the Safe Harbor Provisions, and further minimize systemic risk.[83]

C. New Provisions for Master Netting Agreements and Master Netting Participants

Perhaps the most significant change with respect to the BAPCPA amendments to the Safe Harbor Provisions,[84] and the subject of most debate,[85] was the addition of protections for cross-product netting through the addition of a new class of products, "master netting agreements" in section 101(38A), a new class of protected counterparties, "master netting agreement participants" in section 101(38B), and the addition of provisions protecting the rights to Close-Out, Setoff and Transfer by a master netting agreement participant in connection with "master netting agreements" in sections 362(b)(27), 546(j), 561 of the Bankruptcy Code.[86]

The term "master netting agreement" is defined in new section 101(38A) of the Bankruptcy Code as follows:

> (A) . . . an agreement providing for the exercise of rights, including rights of netting, setoff, liquidation, termination, acceleration, or close out, under or in connection with one or more contracts that are described in any one or more of paragraphs (1) through (5) of section 561(a), or any security agreement or arrangement or other credit enhancement related to one or more of the foregoing, including any guarantee or reimbursement obligation elated to 1 or more of the foregoing; and

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[81] *See* 11 U.S.C. §§ 101(46) and (53C) (2006) (defining "repo participant" and "swap participant," respectively); *see also In re* Interbulk, Ltd., 240 B.R. 195, 200, n.6 (Bankr. S.D.N.Y. 1999) (finding if agreement between parties is "swap agreement" then parties to it are "swap participants").

[82] H.R. REP. NO. 109-31, pt. 1, at 131.

[83] *See id.*

[84] *See 1999 Hearing*, *supra* note 23, at 17 (statement of Rep. James Leach) (describing netting provision as a "seminal change" based upon a "multiyear study"); *Testimony of Anderson*, *supra* note 36.

[85] *See 1999 Hearing*, *supra* note 23, at 21 (statement of Rep. James Leach) (noting some concern about cross product netting); *id.* at 360 (statement of Prof. Randal C. Picker, Vice Chair, National Bankruptcy Conference) (arguing against cross-product netting amendments).

[86] *See* H.R. REP. NO. 109-31, pt. 1, at 133. The Bankruptcy Code defines a master netting agreement participant is an entity that prior to the petition date "[wa]s a party to an outstanding master netting agreement with the debtor." 11 U.S.C. § 101(38B) (2006).

> (B) if the agreement contains provisions relating to agreements or transactions that are not contracts described in paragraphs (1) through (5) of section 561(a), [the agreement] shall be deemed to be a master netting agreement only with respect to those agreements or transactions that are described in any one or more to paragraphs (1) through (5) of section 561(a).[87]

The Congressional Report notes that a master netting agreement could be used to "(i) document a wide variety of securities contracts, commodity contracts, forward contracts, repurchase agreements and swap agreements, or (ii) as an umbrella agreement for separate master agreements between the same parties, each of which is used to document a discrete type of transaction."[88]

New section 561(b) protects the "contractual right" (as defined in section 560) of a master netting agreement participant to enforce the rights of termination, liquidation, acceleration, offset or netting that parallel the protections in product-specific sections 555, 556, 569 and 560. Specifically, section 561 provides that:

> (a) . . . the exercise of any contractual right, because of a condition of the kind specified in section 365(e)(1), to cause the termination, liquidation, or acceleration of or to offset or net termination values, payment amounts, or other transfer obligations arising under or in connection with one or more (or the termination, liquidation, or acceleration of one or more)—
>
> (1) securities contracts, as defined in section 741(7);
> (2) commodity contracts, as defined in section 761(4);
> (3) forward contracts;
> (4) repurchase agreements;
> (5) swap agreements; or
> (6) master netting agreements,
>
> shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title.[89]

The purpose behind the protection for cross-product netting was to permit two parties to net all of their obligations across their derivative products to reach a net sum. The protections for master netting agreements "[were] designed to protect the

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[87] 11 U.S.C. § 101(38A) (2006).
[88] H.R. REP. NO. 109-31, pt. 1, at 131.
[89] 11 U.S.C. § 561(a) (2006).

termination and close-out netting provisions of cross-product master agreements between parties."[90] In support of the addition of the provisions protecting cross-product netting, the Congressional Report notes:

> Cross product netting permits a wide variety of financial transactions between two parties to be netted, thereby maximizing the present and potential future risk-reducing benefits of the netting arrangement between the parties. Express recognition of the enforceability of such cross-product master agreements furthers the policy of increasing legal certainty and reducing systemic risks in the case of an insolvency of a large financial participant.[91]

Opponents of cross-product netting argued that existing protections in the Bankruptcy Code for within-product setoff and liquidations were sufficient.[92] This was because prior to BAPCPA, section 362(b)(6) permitted the cross-product netting of amounts owed under securities contracts, forward contracts and commodity contracts.[93] But it was not clear that cross-product netting was allowed across repurchase agreements and swap agreements, or repurchase agreements and forward contracts because the Safe Harbor Provision sections for those sections only allowed within-product netting.[94] Proponents for cross-product netting argued that there was "no plausible rationale for treating" cross-product netting of security agreements, commodity agreement and forward contracts differently than netting between "swap agreements and repurchase agreements."[95] Other supporters argued: "it is time for the market safe harbors to be rationalized and made consistent in their application to all financial products for all participants."[96] Additionally, because the

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[90] H.R. REP. NO. 109-31, pt. 1, at 131.

[91] *Id.* at 125.

[92] *See 1999 Hearing*, *supra* note 23, at 360 (statement of Prof. Randal C. Picker, Vice Chair, National Bankruptcy Conference) (arguing provisions providing for master netting should be deleted).

[93] *See* 11 U.S.C. § 362(b)(6) (1986) (protecting the setoff "by a commodity broker, forward contract merchant, stockbroker, financial institutions, or securities clearing agency of any" mutual debt and claim under or in comment (6) under subsection (a) of this section, of the setoff by a "commodity broker, forward contract merchant, stockbroker, financial institutions, financial participant, or securities clearing agency of any" mutual debt and claim under or in connection with commodity contracts, as defined in section 761 of this title, "forward contract[s], or securities contract[s]," as defined in section 741 of this title, that constitutes the setoff of a claim against the debtor for a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payments, as defined in section 101 or 741 of this title, arising out of commodity contracts, forward contracts, or securities contracts against cash, securities, or other property held by, or due from such "commodity broker, forward contract merchant, stockbroker, financial institutions, financial participant, or securities clearing agency" to margin, guarantee, secure or settle commodity contracts, forward contracts, or securities contracts).

[94] *See 1999 Hearing*, *supra* note 23, at 392 (statement of Seth Grosshandler, Partner, Cleary, Gottlieb, Steen & Hamilton) (addressing emerging anomalies created by protective provisions of Bankruptcy Code).

[95] *Id.*

[96] *See id.*

United Kingdom allowed cross-product netting, these provisions furthered the goal of ensuring that the United States remained a competitive financial market.[97]

Opponents, on the other hand, argued that the "setoff across products, so called cross-product netting, or . . . master netting," was unnecessary because,

> [t]here is no indication that the absence of such cross-product netting features has led to widespread difficulties or systematic disruptions in the financial markets for such products. The expansion of these provisions would take us farther down the path of allowing sophisticated parties to opt out of bankruptcy. In addition, master netting could deprive a debtor of much-needed cash collateral, which in some instances may lead to conversion and liquidation to the detriment of other creditors.[98]

In response, Congressman James A. Leach noted that, "[w]ith regard to the cross-product netting provisions, nothing in this title expands netting to any new contracts."[99] Netting had been recognized by the Bankruptcy Code for years and "[c]ross product netting simply extends those benefits to get one net amount for all contracts that are already netable by permitting a wide variety of financial transactions between two parties to be netted . . . ."[100]

The protections for master netting agreements and cross-product netting were designed, therefore, to clarify that cross-product netting *was* allowed and to eliminate inconsistencies that could lead to uncertainties about the exercise of that right. Indeed, section 561 is specific in that it permits a master netting agreement participant to exercise the *same* rights *already permitted* for within-product netting under sections 555, 556, 569, and 560. Section 561 allows a master netting agreement participant to terminate, liquidate or accelerate or offset or net out termination values, payment amounts, or other transfer obligations arising under or in connection with one or more (or the termination, liquidation, or acceleration of one or more) of the following specifically enumerated contracts: (1) securities contracts, (2) commodity contracts, (3) forward contracts, (4) repurchase agreements, (5) swap agreements, or (6) master netting agreements. The source of the "contractual rights" protected in section 561 parallel those rights in amended sections 555, 556, 559 and 560, which include "rights arising: (i) from the rules of a derivatives clearing organization, multilateral clearing organization, securities clearing agency, securities exchange, securities association, contract market, derivatives transaction execution facility or board of trade; (ii) under common law;

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[97] *Id.* at 20 (statement of Rep. James Leach).
[98] *Id.* at 363 (statement of Prof. Randal C. Picker, Vice Chair, National Bankruptcy Conference).
[99] *Id.* at 21 (statement of Rep. James Leach).
[100] *Id.*

or (iii) by reason of normal business practice."[101] Because "contractual right" includes rights that arise by virtue of agreement, common law, or normal business practice, if a party to certain safe-harbored contracts with the debtor had not executed a master agreement covering all relevant contracts, a master netting participant may be able to invoke the normal business practice of closing out transactions and calculating a single close-out amount with respect to all contracts that would be covered by a master netting agreement.[102]

Moreover, the protections for master netting agreements, however innovative, are not unfettered. Section 561(b) carefully circumscribes a counterparty's exercise of rights under section 561 *only* to the extent that such counterparty could exercise such a right under section 555, 556, 559, or 560.[103] Additionally, section 101(38A) specifies that a master netting agreement can *only* be an agreement protecting rights already exercisable under an already protected agreement listed in section 561(a)(1)-(5).[104] The protections for a master netting agreement exclude contracts or *any portion* of a contract unrelated to an already-protected contract.[105] Furthermore, section 362(b)(27), which provides parallel exemptions to the automatic stay for master netting agreements as are contained in the other Safe Harbor Provisions, requires that *each* contract covered by the master netting agreement be eligible in its own right for a safe harbor exemption under sections 362(b)(6), 362(b)(7) or 362(b)(17).[106] Sections 546(j) and 548(d)(2)(E) also limit the protections against the trustee's avoidance powers for master netting agreements "to the extent [a] trustee could otherwise avoid such a transfer made under an individual contract covered by such master netting agreement."[107] If the parties have contractually waived or altered their setoff rights, section 561 does not revive them—"the netting rights of a party to a master netting agreement would be subject to any contractual terms between the parties limiting or waiving netting or set off rights."[108]

Thus, as its proponents had contended, section 561 merely *extends* the benefits already available under other Safe Harbor Provisions to allow a counterparty to net amounts under all its protected contracts with a debtor.[109] "This limitation will prevent bundling of non-[qualified] agreements under a master agreement in order to provide special . . . treatment to those agreements[,]"[110] and is consistent with the

[101] H.R. REP. NO. 109-31, pt. 1, at 133 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 193.

[102] GOOCH & KLEIN, *supra* note 1, at 331–32; *see also* H.R. REP. NO. 105-688, pt. 1, at 17 (suggesting counterparty having to establish its "contractual rights" was within normal business practice of parties).

[103] *See* 11 U.S.C. § 561(b)(1) (2006).

[104] *See* 11 U.S.C. § 101(38A) (2006).

[105] *See* 11 U.S.C. §§ 101(38A), 101(38B), 561(a) (2006).

[106] *See* 11 U.S.C. § 362(b)(27) (2006).

[107] 11 U.S.C. § 546(j) (2006); *see also* 11 U.S.C. § 548(d)(2)(E) (2006) (limiting debtor's transfer powers).

[108] H.R. REP. NO. 109-31, pt. 1, at 133–34 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 193–94.

[109] *See 1999 Hearing*, *supra* note 23, at 21 (statement of Rep. James Leach).

[110] Michael H. Krimminger, *Adjusting the Rules: What Bankruptcy Reform Will Mean for Financial Markets Contracts*, Oct. 11, 2005, http://www.fdic.gov/bank/analytical/fyi/2005/101105fyi.html.

overall goal of serving the public policy of market stability by protecting particular markets rather than particular parties.[111]

D. Additional Amendments Clarified Treatment Regarding Transfers of Clams and Interests in the Debtor's Property

Additional amendments in 2005 included an exception to the provisions of both sections 553(a)(2)(B)(ii) and 553(a)(3)(C) "for a setoff of the kind described in 362(b)(6), 362(b)(7), 362(b)(17), 362(b)(27), 555, 556, 559, or 561."[112] Section 553(a)(2) prohibits a setoff if the creditor obtained its claim against the debtor *via* transfer either (i) post-petition, or (ii) (a) within the 90 days preceding the petition date and (b) "while the debtor was insolvent."[113] Similarly, section 553(a)(3) denies the setoff if the creditor incurred its debt to the debtor either "(A) after the 90 days before the [petition date]; (B) while the debtor was insolvent; and (C) for the purpose of obtaining a right of setoff . . . ."[114] These sections were intended to be exceptions to the traditional rule in section 553(a) that a creditor's setoff rights of mutual pre-petition claims are preserved.[115]

The Congressional record notes that the exceptions added in 2005 to sections 553(a)(2)(B) and 553(a)(3) were intended to "clarify that the acquisition by a creditor of setoff rights in connection with swap agreements, repurchase agreements, securities contracts, forward contracts, commodity contracts and master netting agreements cannot be avoided as a preference."[116] A creditor who (i) acquires setoff rights (by virtue of a transfer of a claim or incurrence of a debt), (ii) in connection with a safe harbored contract, (iii) in the 90 days preceding

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[111] *See Testimony of Anderson*, *supra* note 36; Jonathan Keath Hance, *Derivatives at Bankruptcy: Lifesaving Knowledge for the Small Firm*, 65 WASH. & LEE L. REV. 711, 716 (2008) ("With BAPCPA, Congress renewed its contention that derivatives instruments must be afforded special consideration in order to reduce the risk of disruption in financial markets upon the bankruptcy of a key market participant."). Previous exemptions for derivatives focused on the parties, for example: forward contract merchants. The BAPCPA amendments clarified that the entire market was to be protected, not just certain parties. 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, 645, 648 (2005).

[112] 11 U.S.C. § 553(a)(2)(B)(ii) (2006), (a)(3)(C) (2006).

[113] 11 U.S.C. § 553(a)(2) (establishing guidelines for prohibiting setoffs).

[114] 11 U.S.C. § 553(a)(3) (explaining situations where setoffs may be denied).

[115] *See* H.R. REP., NO. 95-595, at 183, 185 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6143–44, 6145 (discussing purpose of exceptions in Bankruptcy Act). Section 553(a) preserves a creditors right to exercise a setoff in bankruptcy provided that the setoff be of mutual pre-petition claims. 11 U.S.C. § 553(a) (2006) (noting preservation of setoff rights involving mutual pre-petition claims); *see, e.g.*, Citizens Bank of Md. v. Strupft, 516 U.S. 16, 18 (1995) (holding Bankruptcy Code preserves existing rights of setoff); Official Comm. of Unsecured Creditors v. Mfg. and Traders Trust Co. (*In re* Bennett Funding Group, Inc.), 146 F.3d 136, 140 (2d Cir. 1998) (holding section 553(a) imposes additional requirements); *In re* SemCrude LLP, 399 B.R. 388, 393 (Bankr. D. Del. 2009) (stating section 553 preserves non-bankruptcy rights of creditors to setoffs).

[116] H.R. REP. NO. 109-31, pt. 1, at 134 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 194.

bankruptcy, and (iv) while the debtor was insolvent, cannot have those rights taken away as a having been a preferential transfer.

Sections 546(e) and (g) added protections for "financial participants;" moreover, section 546 clarified that transfers "under or in connection with any swap agreement" could not be avoided except in the event of actual fraud.[117] Section 546(j) added the same protections for a transfer made under or in connection with a "master netting agreement" as currently is provided for margin payments, settlement payments and other transfers received by qualified parties under section 546 and 548(d), except to the extent the trustee could otherwise avoid such a transfer made under an individual contract covered by such master netting agreement.[118]

E. FNIA Made Technical Changes

Congress enacted FNIA in 2006, only one year after BAPCPA, with the simple purpose of making "technical changes to the netting and financial contract provisions incorporated by [BAPCPA] to update the language to reflect current market and regulatory practices, and help reduce systemic risk . . . ."[119] The sponsors of the bill, Representatives McHenry (FL) and Wasserman Schultz (NC), two freshman members of Congress (who may not have witnessed the changes through BAPCPA), urged Congress to enact FNIA as a "technical bill" that both sides of the aisle and the President's Working Group could agree upon,[120] the origin of which was "grounded in the collapse of . . . Long Term Capital Management."[121] The FNIA amendments appear to have been intended to serve the same purpose as the BAPCPA amendments: "The primary goal of our legislation is to minimize systemic risk in situations when the procedure for resolving a single insolvency could trigger other failures elsewhere in the market."[122] In arguing for its adoption, Representative Baker stated:

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[117] *See* 11 U.S.C. § 546(e), (g) (2006) (explaining exceptions for financial participants of swap agreements).

[118] *See* 11 U.S.C. § 546(j) (2006) (expanding range of protected contractual rights).

[119] H.R. REP. NO. 109-648, pt. 1, at 1 (2006), *reprinted in* 2006 U.S.C.C.A.N. 1585 1585.

[120] 152 CONG. REC. H7598, H7600 (daily ed. Sept. 27, 2006) (statement of Rep. McHenry).

[121] *Id.* at H7601 (statement of Rep. Wasserman Schultz).

[122] *Id.*

> The provisions of the bill now suggested by the gentleman from North Carolina is [sic] the ability to close out what are called netting relationships to prevent the failure of one entity from causing a domino effect of more serious disruption, known as systemic risk. Absent the adoption of these provisions with the growth in size of hedge funds and in number of hedge funds, there is considerable market uncertainty as to how a bankruptcy proceeding would affect market liquidity.[123]

The FNIA amendments did not make sweeping changes, but rather were described as "minor" and intended to conform the language of the financial and netting provisions of the Bankruptcy Code to other statutes to create consistency.[124] Specifically, in connection with the FNIA, Congress further expanded the definitions of "swap agreement," "forward contract" and "securities contract" in the Federal Deposit Insurance Act ("FDIA") and the Federal Credit Union Act "FCUA"), and made conforming amendments to sections 101(22)(A), 101(22A), 101(25)(A), 101(53B) and 741(7)(A) of the Bankruptcy Code.[125] These updates were intended to revise the law through the FNIA so that some of the "newer forms of contractual arrangements" were given the same protections with respect to "financial netting."[126] "Financial netting," Congress described, "involves settling mutual obligations at their net value as opposed to each obligation's gross dollar value."[127]

Additionally, FNIA rewrote the automatic stay provisions in sections 362(b)(6), 362(b)(7), 362(b)(17) and 362(b)(27) and the provisions addressing the avoidance powers of a trustee in sections 546(e)-(g) and (j).[128] These changes were intended to merely "conform the provisions of the Bankruptcy Code to the parallel provisions of the FDIA and FCUA."[129] Congress "confirmed" by these amendments, its intent to:

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[123] 152 CONG. REC. H8650, H8651 (daily ed. Nov. 15, 2006) (statement of Rep. Baker); *see also* 152 CONG. REC. H7598, H7601 (daily ed. Sept. 27, 2006) (statement of Rep. Wasserman Schultz) ("[N]etting . . . is a critically important tool . . . which have [sic], until now, been denied to our . . . financial institutions.").

[124] *See* 152 CONG. REC. H8650 (daily ed. Nov. 15, 2006) (statement of Rep. McHenry) (stating amendments are minor).

[125] *See* H.R. REP. NO. 109-648, pt. 1, at 5–7, 18–20 (2006).

[126] *Id.* at 3.

[127] *Id.*

[128] *See* Financial Netting Improvements Act of 2006, H.R. 5585, 109th Cong. § 5 (2005) (amending sections 362(b)(6), 362(b)(7), 362(b)(17), 362(b)(27), 546(e), 546(f), 546(g), and 546(j)); H.R. REP. NO. 109-648, pt. 1, at 7–8 (explaining amendments to automatic stay and trustee avoidance powers).

[129] H.R. REP. NO. 109-648, pt. 1, at 7 (discussing FNIA changes to section 362(b)).

> protect, free from the automatic stay, all rights previously protected by Sections 362(b)(6), (7), and (17), including self-help foreclosure-on-collateral rights, setoff rights and netting rights (including foreclosure on, and setoff against, cash and securities held to margin or secure claims for margin payments and settlement payments, title transfer arrangements and the right to offset obligations owed against collateral pledged to the debtor).[130]

III. RECENT CASES INTERPRETING AMENDED SAFE HARBORS

The Safe Harbor Provisions, as amended in BAPCPA and FNIA, did not apply to bankruptcy cases commenced prior to their enactment.[131] As a result, and presumably because the amendments were intended to *clarify* treatment of derivative transactions and financial contracts (and thereby *reduce—not increase—* litigation concerning the exercise of counterparties' specified rights), there has been sparse case law interpreting the amended provisions to date. There have been, however, at least four cases decided that have addressed the amended Safe Harbor Provisions:[132] *Hutson v. E.I. du Pont de Nemours & Co.* (*In re National Gas Distributors, LLC*);[133] *Calyon New York Branch v. American Home Mortgage Corp. (In re American Home Mortgage, Inc.)*;[134] *Casa de Cambio Majapara S.A. de C.V. v. Wachovia Bank* (*In re Casa de Cambio Majapara*);[135] *Calpine Energy Services L.P. v. Reliant Electric Solutions, L.L.C.* (*In re Calpine Corp.*).[136] While not controlling outside their own jurisdictions, given the paucity of case law, these decisions may be persuasive to other courts faced with interpreting the amended Safe Harbor Provisions and in determining which parties and what products merited protection under the statute and the scope of exercisable rights. In *In re National*

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[130] *Id.*

[131] *See* H.R. 5585 § 7, 120 Stat. at 2700 (stating FNIA amendments will not apply to cases commenced before FNIA's enactment date); Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, S. 256 109th Cong. § 1501(b)(1), 119 Stat. 23, 216 (2005) (stating BAPCPA amendments will not apply to cases commenced before BAPCPA's effective date); *In re* McKinney, 457 F.3d 623, 624 (7th Cir. 2006) (dismissing appeal premised on BAPCPA because proceedings commenced before BAPCPA's effective date).

[132] As of the date this article was written. After this article was written but before publication, the Bankruptcy Court for the Southern District of New York decided a matter in the Lehman Brothers bankruptcy that addressed the safe harbor provisions. *See* Lehman Bros. Special Fin., Inc. v. BNY Corporate Servs. Tr. Ltd. (*In re* Lehman Bros. Holdings Inc.), 422 B.R. 407, 421 (Bankr. S.D.N.Y. 2010) (noting that payment priority modification in document governing distribution of payment under swap did not receive protection under section 560 because it did not "expressly deal with liquidation, termination or acceleration").

[133] 556 F.3d 247, 253 (4th Cir. 2009) (analyzing BAPCPA's expanded definition of "swap agreement").

[134] 379 B.R. 503, 520 (Bankr. D. Del. 2008) (finding contract between debtor and plaintiff qualified as "repurchase agreement" under definition expanded by BAPCPA).

[135] 390 B.R. 595, 600 (Bankr. N.D. Ill. 2008) (holding amended section 546(g) applied because defendant's transactions were transfers to swap participant in connection with swap agreement).

[136] No. 05-60200, 2009 WL 1578282 (Bankr. S.D.N.Y. May 7, 2009) (discussing which contractual rights were available under forward contract to party under safe harbor protections).

Gas Distributors, *In re American Home Mortgage*, and *In re Case de Cambio*, the courts examined the broadened definitions for the types of protected transactions and protected counterparties. In a different vein, *In re Calpine Corp.* addressed the *scope* of contractual rights exercisable by a protected counterparty. Looking at these cases alone, it seems that the Safe Harbor Provisions broadened who and what was protected but did not alter the type of rights such protected parties could exercise against a debtor.

A. The "Broader" Definition of Swap Agreement Is Not Necessarily "Clearer"

Included in the broadening of the definition of "swap agreement," was the addition of "commodity forward agreements" within that definition. The term "commodity forward agreement" is not defined, but the term "forward contract," which is a distinctly *non-swap* agreement, *is* defined in section 101(25) of the Bankruptcy Code. A "forward contract" is:

> (A) a contract (other than a commodity contract [as defined in section 761]) for the purchase, sale, or transfer of a commodity, as defined in section 761(8) of this title, or any similar good, article, service, right or interest which is presently or in the future becomes the subject of dealing in the forward contract trade, or product or byproduct thereof, with a maturity date more than two days after the date the contract is entered into . . . .[137]

Courts have interpreted the definition of a forward contract to be inclusive of both financially and physically-settled agreements.[138]

Whether a contract is a "forward contract" or "swap agreement" may have an impact on the ability of a creditor to withstand avoidance of a pre-petition transfer under sections 544, 545, 547, 548(a)(1)(B) and 548(B) of the Bankruptcy Code. This is because the exception to recovery of pre-petition transfers in connection with forward contracts in section 546(e) of the Bankruptcy Code is limited in comparison to the similar protections for swap agreements in section 546(g). In order to receive the benefits of section 546(e) a party would have to qualify as a

[137] 11 U.S.C. § 101(25) (2006).

[138] Williams v. Morgan Stanley Capital Group Inc. (*In re* Olympic Natural Gas Co.), 294 F.3d 737, 742 (5th Cir. 2002) (refusing to adopt distinction between "financial" forward contracts and "ordinary purchase and sale" forward contracts); *In re* Borden Chems., 336 B.R. 214, 218–19 (Bankr. D. Del. 2006) (noting forward contracts encompass entirety of transaction in commodity and forward contracts and specifically any natural gas contract constitutes such commodity); *see, e.g.*, H.R. REP. NO. 101-484, at 4 (1990), *reprinted in* 1990 U.S.C.C.A.N. 223, 226 (defining forward contract as contract for purpose of sale, transfer or purchase of commodity); S. REP. NO. 101-285, at 2 (1990) (indicating purpose of forward contract is to hedge against possible fluctuations in the price of a commodity).

"commodity broker, forward contract merchant, . . . or financial participant,"[139] as those terms are defined in sections 761(4), 101(26), and 101(22A) respectively. Additionally, section 546(e) protects from avoidance only transfers that are "margin prepayment[s]" or "settlement payment[s]," as those terms are defined in sections 101(38) and 101(51A) respectively.[140] Section 546(g), on the other hand, is much less restricted, protecting *any* "transfer[s], made by or to . . . a swap participant . . . under or in connection with any swap agreement."[141] A "swap participant" is simply an entity that prior to the petition date "has an outstanding swap agreement with the debtor."[142]

In *Hutson v. E.I. du Pont de Nemours & Co.* (*In re National Gas Distributors, LLC*), the trustee sought to avoid several pre-petition contracts for the delivery of natural gas to the debtor as constructively fraudulent transfers.[143] In defense, the customers argued that their contracts were "commodity forward agreements" within the newly amended definition of "swap agreements" in the Bankruptcy Code, and not avoidable under section 546(g).[144] Utilizing case law prior to the BAPCPA amendments, the bankruptcy court found that the contracts at issue were not within the traditional definition of a "swap agreement," which required all swap agreements to be financial in nature.[145] The contracts at issue contemplated actual

[139] 11 U.S.C. § 546(e) (2006) (stating trustee may not avoid transfers made by or to parties such as commodity broker, forward contract merchant, or financial participant,); *see, e.g.*, PHP Liquidating, LLC v. Robbins, 291 B.R. 592, 596 (D. Del. 2003) (noting trustee cannot avoid transfers such as settlement payments); *In re* Enron Creditors Recovery Corp., 407 B.R. 17, 29 (Bankr. S.D.N.Y. 2009) (mentioning which parties trustee cannot avoid transfers from or to under section 546).

[140] 11 U.S.C. § 546(e) (indicating additional transfers receive protection under section 546(e) such as "margin prepayment[s]" or "settlement payment[s]"); *see, e.g.*, *Williams*, 294 F.3d at 739–40 (highlighting Morgan Stanley's argument that payments constituted "settlement payments" made in "forward merchant contract" as defined by section 546(e)); Am. Tissue Inc. v. Donaldson, Lufkin & Jennrette Secs. Corp., 351 F. Supp. 2d 79, 107 (S.D.N.Y. 2004) ("DLJ challenges the fraudulent conveyance claims on the ground that the monies paid by ATI were 'settlement payments' within the meaning of 11 U.S.C. § 546(e) . . . .").

[141] 11 U.S.C. § 546(g) (noting trustee may not avoid transfer, made by or to swap participant "under or in connection with any swap agreement"); *see, e.g.*, *In re* Nat'l Gas Distributor, 415 B.R. 209, 212 (Bankr. E.D.N.C. 2009) (noting Army contended that agreements related to natural gas from debtor to be "swap agreements" under section 101(53B)); Tucker, *supra* note 17, at 611 ("The amendment to section 546 specifically exempts swap-participant transfers made in connection with a swap contract from avoidance under sections 544, 545, 547, 548(a)(2), and 548(b).").

[142] 11 U.S.C. § 101(53c) (2006) (defining swap participant as entity that has "outstanding swap agreement" with debtor prior to start of bankruptcy); *see, e.g.*, *In re* Mirant Corp., 314 B.R. 347, 351 (Bankr. N.D. Tex. 2004) (highlighting debtors' acknowledgement that section 101(53B) defines "swap participants").

[143] 556 F.3d 247, 249 (4th Cir. 2009) (noting trustee seeks to avoid contracts).

[144] *Id.* at 250 (highlighting customers' argument that agreements were swap agreements protected under Bankruptcy Code).

[145] *See In re* Nat'l Gas Distributors, LLC, 369 B.R. 884, 899 (Bankr. E.D.N.C. 2007), *rev'd*, 556 F.3d 247 (4th Cir. 2009); *see also* 11 U.S.C. § 101(53B)(A) (enumerating types of agreements falling within definition of "swap agreement"); Ayes v. U.S. Dep't of Veterans Affairs, 473 F.3d 104, 108 (4th Cir. 2006) (arguing "similar" is used by Congress to limit, rather than expand definition of term). For the traditional definition of swap agreement in the market see *In re* Enron Corp., 328 B.R. 58, 69–70 (Bankr. S.D.N.Y. 2005) (citing *In re* Interbulk, Ltd., 240 B.R. 195, 201 (Bankr S.D.N.Y. 1999)) and JACK CLARK FRANCIS ET AL., THE HANDBOOK OF EQUITY DERIVATIVES 527 (1995).

delivery of the product as opposed to being traded on a financial market, and thus, were not "swap agreements" under the pre BAPCPA jurisprudence.[146]

On direct appeal, the Fourth Circuit reversed and remanded for further findings as to whether the contracts at hand were "commodity forward agreements" within the *new* definition of "swap agreement" under the Bankruptcy Code.[147] Breaking with prior jurisprudence, the Fourth Circuit concluded that commodity forward agreements, unlike other swap agreements, could be physical in nature.[148]

In reaching its decision, the Fourth Circuit turned to rules of statutory construction including legislative history and dictionary definitions for its interpretation.[149] The court analogized the definition of "commodity forward agreement" in section 101(53B), to "forward contract" in section 101(25), which courts have interpreted as having both physical and financial components and not found only in financial markets.[150] The Fourth Circuit determined that "forward contract" must have a *narrower* meaning than "forward agreement" because Congress noted that the inclusion of "forward" in the definition of "swap agreement" could refer to a "forward transaction . . . even *if not a forward contract*."[151] Additionally, *Black's Law Dictionary* distinguishes between the definition of "agreement" and "contract" and, therefore, "[e]very contract is an agreement [] but not every agreement is a contract."[152] The Fourth Circuit further held that the contracts in the *National Gas* case contained hedging components, and therefore, they were not traditional supply contracts, which "cannot be treated as swap agreements under the Bankruptcy Code."[153] Accordingly, the court found that

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[146] *See In re Nat'l Gas Distributors*, 369 B.R. at 899; H.R. REP. NO. 109-648, at 7 (2006) (reiterating Congress' intent to exclude sales-of-goods contracts from definition of "swap agreement"); H.R. REP. NO. 109-31, pt. 1, at 129 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 189 (stating traditional commercial transactions, including supply agreements, should not fall within definition of "swap agreement").

[147] *See* Hutson v. E.I. du Pont Nemours & Co. (*In re* Nat'l Gas Distributors), 556 F.3d 247, 260–61 (4th Cir. 2009).

[148] *See id.* at 258 (reasoning forward agreements may be physically settled because courts have recognized forward contracts may be physically settled); Williams v. Morgan Stanley Capital Group (*In re* Olympic Natural Gas Co.), 294 F.3d 737, 742 (5th Cir. 2002) (rejecting distinction between financial forward contracts and purchase-and-sale forward contracts); *In re* Borden Chems., 336 B.R. 214, 221 (Bankr. D. Del. 2006) (stating forward contracts were intended to possess both financial and physical characteristics).

[149] *See In re Nat'l Gas Distributors*, 556 F.3d at 254; *cf.* BFP v. Resolution Trust Corp., 511 U.S. 531, 537–38 (1993) (using *Black's Law Dictionary* to determine meaning of statutorily undefined term); Schwegmann Bros. v. Calvert Distillers Corp., 341 U.S. 384, 395–96 (1951) (Jackson, J., concurring) (providing guidelines for resort to legislative history).

[150] *See In re Nat'l Gas Distributors*, 556 F.3d at 257; *In re Borden Chems.*, 336 B.R. at 218 (identifying physical delivery as central feature of forward contracts); *Williams*, 294 F.3d at 741 (stating forward contracts are not necessarily subject to rules of market or board of trade).

[151] *In re Nat'l Gas Distributors*, 556 F.3d 247, 255 (4th Cir. 2009) (citing H.R. REP. NO. 109-31, pt. 1, at 129) (emphasis added).

[152] *Id.* at 255 (citing BLACK'S LAW DICTIONARY 74 (8th ed. 2004)).

[153] *Id.* 258 (suggesting contracts potentially be treated as swap agreements because contained hedging elements; were not merely traditional supply contracts) (citing H.R. REP. NO. 109-31, pt. 1, at 122 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 183–84).

nothing in the Bankruptcy Code or the legislative history suggests that forward agreements *cannot* be physically settled and, in fact, because "forward contracts" can be physically settled, the same should be true of "forward agreements."[154] The Fourth Circuit, therefore, remanded, holding that the bankruptcy court gave the statute a more narrow reading than was required.[155]

In remanding, the Fourth Circuit noted the difficulty that the bankruptcy court would have in determining whether the contracts are "commodity forward contracts" without the benefit of developed case law or clear market-place definitions.[156] The statutory definition was broadened to such an extent that "the potpourri of agreements included in the term 'swap agreement' barely distinguish any major commercial contract from a swap agreement."[157] The court provided some guidance in the following non-exclusive elements for a "forward commodity agreement": (i) the subject must be a commodity; (ii) maturity must be more than two days after the date of entry into the agreement; (iii) the quantity, time and price must be fixed at the time of contracting; and (iv) the contract does not have to be assignable, or traded on an exchange, but must have a relationship to the financial markets.[158] The first three of these criteria are very similar to those courts have used in defining "forward contracts."[159] Thus, the last criterion, a "relationship to the financial markets," may be the *only* means for distinguishing a "forward commodity agreement" from a "forward contract."

National Gas may have partially, if not completely, erased the distinction between what is a "swap agreement" and what is a "forward contract." Parties to a "forward commodity agreement" that might not otherwise satisfy the requirements for protection from avoidance of transfers for forward contracts under section 546(e) could now benefit from the broad protections for swap agreements in section 546(g). Additionally, *National Gas* shows that despite Congress' effort to broaden the definition of swap agreements to provide certainty that the newer forms of swap

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[154] *Id.* at 258 (citing *Williams*, 294 F.3d at 742) (noting no reason to distinguish between financial forward contracts or physically settled forward contracts); *see, e.g.*, *In re Borden Chems.*, 336 B.R. at 223 (holding agreement which called for actual delivery of natural gas constitutes forward contract); *In re* Mirant Corp., 310 B.R. 548, 566 (Bankr. N.D. Tex 2004) (finding natural gas supply agreements to be forward contracts).

[155] *In re Nat'l Gas Distributors*, 556 F.3d at 258–59 (remanding and finding Bankruptcy Court's interpretation of "commodity forward agreements" within section 101(53B)(A) of Bankruptcy Code overly narrow).

[156] *See id. at* 259 ("In determining whether the contracts in this case are 'commodity forward agreements,' the bankruptcy court will not, unfortunately, have the benefit of developed case law, nor even the benefit of clear market-place definitions.").

[157] *See id.* (acknowledging wide range of transactions incorporated into statutory definition of "swap agreement" essentially include most major commercial contracts).

[158] *See id.* at 259–61 (describing elements considered statutorily necessary for characterization of transaction as "commodity forward agreement").

[159] *See In re Borden Chems.*, 336 B.R. at 218–19 (listing first three of four criteria for definition of forward contracts, and as fourth that forward contracts contemplate physical delivery)*; see also* Grain Land Coop v. Kar Kim Farms, Inc., 199 F.3d 983, 990 (8th Cir. 1999) (highlighting "contemplation of physical delivery" as defining characteristic of unregulated cash-forward contract); *In re Mirant Corp.*, 310 B.R. at 565 (examining subject-matter and maturity dates to determine whether agreements constitute "forward contracts").

agreements would be included in the Safe Harbor Provisions,[160] the newer forms of swap agreement were not defined, and thus, are left open to interpretation and litigation—exactly what Congress intended to avoid.[161]

B. New Definitions of "Repurchase Agreement," "Financial Participant" and "Securities Contract" Eliminate Inconsistent Treatment

Traditionally, a repurchase agreement is defined as a two-part transaction—first, an agreement to sell one of several specified products, and second, a simultaneous agreement to repurchase the sold asset at the original price plus an agreed-upon amount.[162] Prior to BAPCPA, the Bankruptcy Code specified potential "subjects" of a repurchase agreement, such as certificates of deposit and United States securities.[163] BAPCPA amended the definition of "repurchase agreement" in section 101(47) to include protections for repurchase agreements of transfers of mortgage loans and mortgage related securities, and transfers of interests in mortgage loans and mortgage related securities. The definition now reads in part,

> The term "repurchase agreement" . . . (A) means [] (i) an agreement, including related terms, which provides for the transfer of one or more certificates of deposit, mortgage related securities (as defined in section 3 of the Securities Exchange Act of 1934), mortgage loans, interests in mortgage related securities or mortgage loans, . . . with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, . . . mortgage loans, or interests of the kind described in this clause, at a

[160] *See 1999 Hearing*, *supra* note 23, at 386–87 (statement of Seth Grosshandler, Partner, Cleary, Gottlieb, Steen, & Hamilton) (discussing how Bankruptcy Reform Act of 1999 would expand definition of "swap agreement," ensuring that swaps that are "[fundamentally] equivalent to other contracts" protected by safe harbor provisions would be entitled to same protections); H.R. REP. NO. 109-648, pt. 1, at 3 (2006) (illustrating Congressional intent to update laws so "newer forms of contractual arrangements" were given same protections with regarding "financial netting").

[161] *See In re Nat'l Gas Distributors*, 556 F.3d at 258–59; *see also In re* Casa de Cambio Majapara S.A. de C.V., 390 B.R. 595, 598–99 (Bankr. N.D. Ill. 2008) (displaying struggle to interpret section 546(g) after BAPCPA); Sarah Curley & Elizabeth Fella, *Where To Hide? How Valuation of Derivatives Haunts the Courts—Even After BAPCPA*, 83 AM. BANKR. L.J. 297, 306 (2009) (commenting on confusion *Hutson* encountered with definition of swap agreements).

[162] *See* Bevill, Bresler & Schulman Asset Mgmt. Corp. v. Spencer SOL Ass'n (*In re* Bevill, Bresler & Schulman Asset Mgmt. Corp.), 878 F.2d 742, 743 (3d Cir. 1989) (explaining nature of repurchase agreement); *In re* Nat'l Forge Co., 344 B.R. 340, 352 n.7 (W.D. Pa. 2006) (defining standard repurchase agreement). *See generally* 11 U.S.C. § 101(47)(A)(i) (2006) (codifying definition of repurchase agreement).

[163] *See* 11 U.S.C §101(47) ("'[R]epurchase agreement'" . . . means an agreement . . . which provides for the transfer of certificates of deposit, eligible bankers' acceptances, or securities that are direct obligations of . . . the United States . . . .").

> date certain not later than 1 year after such transfer or on demand, against the transfer of funds[.][164]

In *Calyon New York Branch v. American Home Mortgage Corp. (In re American Home Mortgage, Inc.)*,[165] the Delaware bankruptcy court examined whether a contract for the purchase and sale of bundle of mortgage loans was a "repurchase agreement" under newly-amended section 101(47) of the Bankruptcy Code, and if so, whether the entire contract including a servicing provision was entitled to protection under sections 555 and 559 of the Bankruptcy Code.[166]

The debtors argued that the transaction at issue, a purchase and sale of mortgage loans through their agent Calyon New York Branch ("Calyon"), was in the nature of secured financing and should not be considered a repurchase agreement under the Bankruptcy Code definition. The bankruptcy court found, however, that the BAPCPA amendments clearly modified the definition of repurchase agreements to explicitly include "mortgage related securities . . . mortgage loans [and] interest in mortgage related securities or mortgage loans"[167] and thus, it rejected the debtors' argument.[168]

The 2005 amendments to repurchase and reverse repurchase agreements were "intended to *eliminate any inquiry* under section 555 . . . as to whether a repurchase or reverse repurchase transaction is a purchase or sale transaction or a secured financing."[169] Because the contract was for the purchase and resale of mortgage loans, it was—*by definition*—a repurchase agreement.[170] No further inquiry was required—the Safe Harbor Provisions sections 555 and 559 applied "period."[171]

> The Court finds that Congress said what it meant and meant what it said in drafting the definition of repurchase agreement, i.e., if the criteria established in the statute are meant [sic] the contract is a repurchase agreement. No further inquiry or consideration of other contractual provision is required.[172]

The *American Home* court's decision was consistent with the legislative history, which provided that although repurchase obligations under a commercial loan do not make the loan participation agreement a repurchase agreement, "a repurchase agreement involving the transfer of participations in commercial mortgage loans with a simultaneous agreement to repurchase the participation on demand or at a

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164 11 U.S.C. § 101(47)(A)(i).
165 379 B.R. 503 (Bankr. D. Del. 2008).
166 *Id.* at 512, 518.
167 *Id.* at 513 (citing 11 U.S.C. § 101(47) (2006)).
168 *Id.* at 518.
169 *Id.* at 516 (emphasis added).
170 *Id.* at 518.
171 *In re* Am. Home Mortgage, Inc., 379 B.R. 503, 517–19 (Bankr. D. Del. 2008).
172 *Id.* at 516.

date certain one year or less after such transfer, . . . would constitute a 'repurchase agreement'. . . ."[173]

The *American Home* court determined that Calyon, as a commercial bank and one of the largest financial institutions, was a "financial participant" under the new definition in section 101(22) of the Bankruptcy Code.[174] Additionally, the contract at issue was a "securities contract" under the newly-amended definition in section 741(7), because that definition was also amended to include "repurchase or reverse repurchase transactions on . . . mortgage loan[.]"[175] Under the newly amended statute, therefore, Calyon was entitled to the protections in section 555 as well as section 559 for "the exercise of a contractual right by a financial institution . . . to cause the liquidation, termination, or acceleration of a 'securities contract.'"[176]

The court noted that "interestingly," the 2005 amendments to the definitions of "repurchase agreement" and "securities contract" made "the analysis of repurchase agreements under sections 555 and 559 and the effect of the safe harbor . . . virtually identical."[177]

Prior to 2005, parties whose contracts did not fit the definition of "repurchase agreement" under section 559 might have tried to utilize the protections for "securities contracts" under section 555 instead, attempts which would often lead to litigation.[178] Now, because the analysis is "virtually identical" it is clear that the amendments to these sections *did* eliminate the arbitrary differences in these sections and thus provided certainty about the enforcement of rights under these transactions.

Yet, the amendments to the definitions of "repurchase agreement" and "securities agreement" did not change the fact that Congress had limited the safe harbor protections in sections 555 and 559 to the exercise of rights under those specific agreements only. In addition to seeking protection to exercise its rights under the repurchase agreement itself, Calyon sought to exercise termination rights with respect to the servicing portion of the agreement, which allowed the debtor to designate the servicer of the loan. For support of its argument, Calyon contended that the definition of "repurchase agreement" includes "*related terms*" to that agreement.[179] Additionally, the definitions of "repurchase agreement" and "securities contract" include "any interest in a mortgage loan."[180] The court rejected Calyon's argument holding that the servicing provision was severable from the rest

[173] H.R. REP. NO. 109-31, pt. 1, at 128 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 189.

[174] *In re Am. Home Mortgage*, 379 B.R at 519.

[175] *Id.* at 519 (citing 11 U.S.C. § 741(7) (2006)).

[176] *Id.*

[177] *Id.*

[178] *See id.* at 519 (noting analyses of repurchase agreements under sections 555 and 559, now identical, were different prior to 2005 amendments). *See generally* 5 COLLIER ON BANKRUPTCY, ¶¶ 555.02, 559.02 (Alan N. Resnick et al. eds., 15th ed. rev. 2006).

[179] 11 U.S.C. § 101(47)(A)(1) (2006) (emphasis added).

[180] 11 U.S.C. § 741(7)(A)(i) (2006).

of the agreement and that the agreement itself was not a "repurchase agreement," nor a "securities contract."[181] First, the court held that the servicing was separate and apart from "ownership" in the underlying mortgage, and thus, it could not be an "interest in a mortgage loan" for purposes of the definitions of repurchase agreement and securities contract.[182] Second, the court held that the servicing provision was not a "related term" because servicing was a separate asset from the repurchase agreement.[183] As a separate asset of the debtor, it should not receive safe harbor treatment intended for repurchase agreements. Additionally, the court noted that because the reference to "related terms" preceded the 2005 amendments to section 101(47) when protections for mortgage loans were added, "related terms" could not have been meant to include servicing of mortgage loans.[184]

American Home established a bright line rule with respect to what transactions are within the definition of a "repurchase agreement" or a "securities contracts" in addition to who may be a "financial participant," thus, likely reducing litigation as to these issues. Further, the court indicated that neither in their purpose nor in their effect do the Safe Harbor Provisions protect the exercise of rights under non-safe harbored transactions merely because such rights are included in safe harbored agreements. The Safe Harbor Provisions do not extend to contracts or portions of contracts that themselves are not expressly within the statutory definitions.

C. Revisions to Section 645(g) Clarify Protections for Pre-petition Transfers

Prior to the 2005, section 546(g) protected from avoidance any pre-petition transfer "under a swap agreement, made by or to a swap participant, in connection with a swap agreement[.]"[185] This protection was interpreted as requiring the counterparty to prove that the transfer was both "under" *and* "in connection with" the swap agreement.[186] "Under" meant "according to the method [specifically] prescribed" in the swap.[187] If a transfer was not "under," or *specifically prescribed in the swap,* it was not protected by section 546(g). In 2005, Congress through BAPCPA amended section 546(g) to specifically protect transfers "under *or* in connection with any swap agreement and that is made before the commencement of the case[.]"[188] In doing so, Congress appears to have expressly overridden the previously-interpreted limitation of protections for only those transfers that were

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[181] *In re Am. Home Mortgage*, 379 B.R. at 520.
[182] *Id.* at 522–23 (citing I SHORTER OXFORD ENGLISH DICTIONARY 1408 (6th ed. 2007)).
[183] *Id.* at 523.
[184] *Id.*
[185] 11 U.S.C. § 546(g) (2000).
[186] *See, e.g., In re* Interbulk, Ltd., 240 B.R. 195, 202 (Bankr. S.D.N.Y. 1999) (highlighting statute's conjunctive phrasing).
[187] *Id.* (finding pre-petition attachment was not protected by section 546(g) because it was not obtained "according to the method prescribed in the agreement itself" and, thus, was not "under" swap agreement).
[188] 11 U.S.C. § 546(g) (2006) (emphasis added).

specifically prescribed in the swap and expand the protection to any transfer "related to" a swap.

The amended statute was interpreted as having been deliberately changed by the Bankruptcy Court for the Northern District of Illinois in *Casa de Cambio Majapara S.A. de C.V. v. Wachovia Bank* (*In re Casa de Cambio Majapara*).[189] In that case, a creditor had sought and received an attachment resulting from a pre-petition default with respect to spot transactions.[190] The *Casa de Cambio* court found that the attachment was at least "related to" and "in connection with the swap agreement" and therefore, it was protected from avoidance by section 546(g).[191] The court found that because of the amendment to section 546(g), it was plainly clear that Congress no longer required that the transfer also be "under" the swap agreement or "according to the method prescribed by the agreement itself."[192] Congress' clear and deliberate amendment to section 546(g) therefore had its intended effect and a counterparty now may have more success than it previously would have had in seeking to invoke the statute's protection.

D. The Scope of the Exercisable Rights Did Not Change With the Amendments

The express language of Safe Harbor Provisions is limited in that they protect the "exercise of any contractual right" by the designated counterparty to "cause the liquidation, termination or acceleration of one or more [swap agreements, forward contracts, repurchase agreement, etc.] because of a condition of the kind specified in section 365(e) of this title."[193] Additionally, prior to the BAPCPA amendments, several courts had expressly held that the protections for the exercise of "contractual rights" are not "unqualified" and are limited to the *termination, liquidation, and/or acceleration* of safe harbored contracts and even then *only* to the extent that the contractual right is triggered by a condition specified in section 365(e)(1): (i) the insolvency or financial condition of the debtor at any time before the closing of the case; (ii) the commencement of a case under this title; or (iii) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.[194]

With BAPCPA, Congress amended the definition of "contractual right" in sections 555, 556, 559, 560 and 561 to include rights whether or not evidenced in

[189] 390 B.R. 595 (Bankr. N.D. Ill. 2008).
[190] *Id.* at 596–97.
[191] *Id.* at 599 (internal quotations omitted); *see also* 11 U.S.C. § 546(g).
[192] *In re Casa de Cambio Majapara*, 390 B.R. at 598.
[193] *See* 11 U.S.C. § 560 (2006); *see also* 11 U.S.C. §§ 555–556, 559, 561 (2006).
[194] *See In re* Amcor Funding Corp., 117 B.R. 549, 551 (D. Ariz. 1990) (finding liquidation of debtor's contracts for reasons not specified on section 365(e) was not protected by safe harbors); *In re* Enron Corp., 306 B.R. 465, 472–73 (Bankr. S.D.N.Y. 2004) (denying counterparty right to commence state court action under section 560); Campbell, *supra* note 52, at 8 (acknowledging contractual right must be triggered by condition specified in section 365(e)(1)).

writing, arising under common law, under law merchant, or by reason of normal business practice.[195] Counterparties may argue that the change was intended to protect the exercise of *all* rights in a safe-harbored agreement. But in *Calpine Energy Services, L.P. v. Reliant Electric Solutions, L.L.C.* (*In re Calpine Corp.*), the Bankruptcy Court for the Southern District of New York had a chance to address the scope of exercisable rights under the Safe Harbor Provision and its holding shows no break from the prior case law.[196]

In *Calpine*, the creditor Reliant sought to enforce a provision in a Master Agreement (which the parties agreed was a "forward contract") that required Calpine to dispute any calculation of termination amounts within two days of receiving the notice of the amount due after termination upon an event of default.[197] The court found that the Master Agreement and underlying forward contracts were entitled to safe harbor protection under section 556 of the Bankruptcy Code and consequently Reliant's termination was proper.[198] As to Calpine's obligation to formally dispute the calculations, however, the bankruptcy court held that the Safe Harbor Provisions of section 556 did not extend to require Calpine to perform those obligations.[199] The court found that the obligation to dispute calculations made after termination was merely ancillary to termination—not *all* "contractual rights" are protected by the Safe Harbor Provisions.[200]

"[S]ection 556 . . . is limited to enforcing *only* those terms that trigger termination upon the occurrence of one of the three specified conditions listed in section 365(e)(1) . . . [and] rights that are merely ancillary or incidental to an *ipso facto* clause are not enforceable under section 556 of the Code."[201] Although Reliant argued that the protest clause "goes to the very heart of the termination process," the *Calpine* court found the clause to be unenforceable because it was not part of the actual "termination"—the act of closing out the transactions.[202] "[T]he plain language of section 556 of the Code does not lend itself to such an expansive reading, nor does this Court believe such a reading would be appropriate."[203] Consistent with pre BAPCPA and FNIA case law, therefore, only contractual rights

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[195] 11 U.S.C. § 560 (2006); H.R. REP. NO. 109-31, pt. 1, at 133 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 193; *see* Hance, *supra* note 111, at 746 (discussing Congress's expansion of contractual rights under Bankruptcy Code).

[196] *In re* Calpine Corp., No. 05-60200, Adv. No. 08-1251, 2009 WL 1578282, at *7 (Bankr. S.D.N.Y. May 7, 2009) ("Unfortunately, the plain language of section 556 of the Code does not lend itself to such an expansive reading, nor does this Court believe such a reading would be appropriate.").

[197] *Id.* at *1–*2.

[198] *Id.* at *6–*7 ("[S]ection 556 of the Code allows a creditor to exercise a pre-petition contractual right to terminate a forward contract based upon the debtor's filing of a bankruptcy petition. However, by its terms . . . is limited to enforcing only those terms that trigger termination [under section 365(e)(1)].").

[199] *Id.* at *7.

[200] *Id.* at *6.

[201] *Id.* (emphasis added); *see In re* Am. Home Mortgage Holdings, Inc., 388 B.R. 69, 88 (Bankr. D. Del. 2008) (acknowledging non-debtor is protected by safe harbor provision if "triggered by a condition of the kind specified in section 365(e)(1) of the Bankruptcy Code").

[202] *In re Calpine Corp.*, 2009 WL 1578282, at *7.

[203] *Id.*

to *terminate, liquidate and accelerate* because of a condition specified in section 365(e) will be protected by the Safe Harbor Provisions.

The *Calpine* holding is consistent with the legislative history which reflects that

> [f]or the purposes of . . . sections 555, 556, 559, 560 and 561, it is intended that the normal business practice in the event of a default of a party based on bankruptcy or insolvency is to terminate, liquidate or accelerate securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements and master netting agreements with the bankrupt or insolvent party.[204]

It is these "contractual rights" to "terminate, liquidate, or accelerate" that were intended to be protected by sections 555, 556, 559, 560 and 561—extraneous rights or those "ancillary" to the termination, liquidation or acceleration of a safe harbored contract are not within the ambit of the safe harbors.

IV. REMAINING AMBIGUITIES

In the above analysis regarding courts' decisions as to what is in included in the defined terms and categories of the specific safe harbored contracts, as well as the scope of protections provided, it is clear that the amendments did clear up some prior confusion. Nevertheless, arguably there is still room for interpretation—especially, for example, as was noted by *National Gas*, with respect to the lengthy list of undefined types of "swap agreements." Additionally, despite the holding of *Calpine* (and the prior jurisprudence)[205] parties are, in some cases, attempting to argue that the amended Safe Harbor Provisions expanded the scope of exercisable rights. This section examines some of the open questions and areas that may prompt counterparties to contend that uncertainties remain despite the BAPCPA and FNIA amendments.

A. Scope of Setoff Rights in Safe Harbor Provisions: Does it Encompass Cross-Affiliate Netting?

One area where counterparties may argue that the Safe Harbor Provisions created new rights is with respect to cross-affiliate setoffs or netting.[206] Cross-

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[204] S. REP. NO. 106-49, at 56 (1999).

[205] *See In re* Amcor Funding Corp., 117 B.R. 549, 551 (D. Ariz. 1990) (refusing to protect liquidation of debtor's securities for reasons not specified in section 365(e) of Bankruptcy Code); *In re Calpine Corp.*, 2009 WL 1578282, at *6 (reading section 556 as protecting rights triggered by occurrences explicitly mentioned in section 365(e)(1)); *In re* Enron Corp., 306 B.R. 465, 473 (Bankr. S.D.N.Y. 2004) (interpreting section 560 as not permitting exercise of "unqualified right" in terminating swap agreements).

[206] *See* Motion of Occidental Power Services, Inc. and Occidental Energy Marketing, Inc. to Effectuate Setoff and Settle Outstanding Derivative Contracts and For Related Relief (Docket No. 4238) at 6–8, *In re*

affiliate netting is the notion that a counterparty may set off any obligation owed by it or any of its affiliates to the defaulting party with an obligation owed by the defaulting party to the counterparty or any of its affiliates.[207]

Generally, a creditor's setoff rights in bankruptcy are governed by section 553 of the Bankruptcy Code, which allows the offset of mutual pre-petition debts by permitting "entities that owe each other money to apply their mutual debts against each other, thereby avoiding 'the absurdity of making A pay B when B owes A.'"[208] Courts have routinely held that under the plain language of the statute, a setoff is *only* permissible if there is mutuality between the parties, which means the debts and credits are held in the same right, between the same parties, standing in the same capacity.[209] In light of this "same parties" requirement, many courts have expressly held that triangular or non-mutual setoffs are improper under section 553.[210] Despite this express language, a counterparty may argue that it may enforce cross-affiliate setoff rights (either in a contract or under common law) under the Safe Harbor Provisions.[211]

Lehman Bros. Holdings Inc., No. 08-13555 (JMP) (Jointly Administered) (Bankr. S.D.N.Y June 29, 2009); Debtors' Objection to Motion of Chevron Products Company for Reconsideration of this Court's Opinion Dated January 9, 2009 Regarding Contractual Netting (Docket Nos. 2853, 2873) at 2, *In re* SemCrude L.P., No. 08-11525, Mem. Order of Mar. 19, 2009 (Bankr. D. Del. 2009) (denying reconsideration), 2009 WL 492795 (arguing opposing party's position that express netting agreement is outside scope of section 553(a) because of Safe Harbor Provisions).

[207] This describes "triangular" netting, meaning two or more counterparty affiliates attempt to net their obligations with respect to a single debtor. Counterparties may also attempt to assert "square" netting in which they attempt to net their obligations and the obligations of their affiliates against the debtor's obligations and the obligations of the debtor's affiliates. *See In re* U.S. Aeroteam, 327 B.R. 852, 863 (Bankr. S.D. Ohio 2005) (stating such "triangular" transactions occur when "a creditor . . . set[s] off its debt to a debtor with the latter's debt to a third party"); *see also* Sherman v. First City Bank of Dallas (*In re* United Sciences of America), 893 F.2d 720, 723 (5th Cir. 1990) (positing section 553(a)'s mutuality requirement protects against such transactions); Campbell, *supra* note 52, at 33 (stating parties attempt to execute such transactions through express contractual agreements).

[208] Citizens Bank of Md. v. Strumpf, 516 U.S. 16, 18 (1995) (quoting Studley v. Boylston Nat'l Bank, 229 U.S. 523, 528 (1913)); *see* 11 U.S.C. § 553(a) (2006) (pertaining to setoff of pre-petition debts of creditor to debtor in bankruptcy proceeding); Studley v. Boylston Nat'l Bank, 229 U.S. 523, 528 (1913) (describing setoff as "right which one party has against another to use his claim in full or partial satisfaction of what he owes to the other").

[209] *See* 11 U.S.C § 553(a) (2006) ("[T]his title does not affect any right of a creditor to offset a mutual debt owing by such creditor to debtor . . . ."); *see also* Westinghouse Credit Corp. v. D'Urso, 278 F.3d 138, 149 (2d Cir. 2002) (noting mutual debts may arise through different transactions, but must be "due to and from the same persons in the same capacity"); *In re* Westchester Structures, Inc., 181 B.R. 730, 740 (Bankr. S.D.N.Y. 1995) (stating debt mutuality is necessary before setoff can take place).

[210] *See, e.g., In re United Sciences of America, Inc.*, 893 F.2d at 723 ("The mutuality requirement is designed to protect against 'triangular' set-off; for example, where the creditor attempts to set off its debt to the debtor with the latter's debt to a third party."); Elcona Home Corp. v. Green Tree Acceptance, Inc. (*In re* Elcona Homes Corp.), 863 F.2d 483, 486 (7th Cir. 1988) ("[T]he statute itself speaks of 'a mutual debt' . . . and therefore precludes 'triangular' set offs") (emphasis omitted); *In re U.S. Aeroteam, Inc.*, 327 B.R. at 864 ("[A] 'triangular setoff,' when A attempts to offset an obligation owed to B against B's debt to C, is prohibited because there is no mutuality of debt between two parties.").

[211] *See* Motion of Occidental Power Services, Inc. and Occidental Energy Marketing, Inc. to Effectuate Setoff and Settle Outstanding Derivative Contracts and For Related Relief (Docket No. 4238) at 6–8, *In re* Lehman Bros. Holdings Inc., No. 08-13555 (JMP) (Jointly Administered) (Bankr. S.D.N.Y June 29, 2009);

Potential arguments that a counterparty could make in support of cross-affiliate netting are that: (1) parties may contract around the mutuality requirement and such contractual rights should be protected by the Safe Harbor Provisions' protections for the exercise of "contractual rights" despite the automatic stay (and despite section 553(a)'s strict mutuality requirement); or (2) cross-product netting in section 561 extends to permit cross-affiliate netting of more than one party.

In the non-derivative context, the Delaware bankruptcy court recently held that parties may not contract around section 553 to create mutuality through the use of such cross-affiliate setoff provisions.[212] The counterparty in that case, Chevron Products Company, argued that it could avoid payment to one debtor on account of obligations owed it by the debtor's two affiliates. For support, Chevron argued that the parties' contracts contained cross-affiliate netting provisions that allowed them to contract around the mutuality requirement. The Delaware bankruptcy court denied stay relief holding there was no contractual exception to the mutuality requirements in section 553 of the Bankruptcy Code and that mutuality for purposes of section 553 cannot be created by contract and, thus, the cross-affiliate netting provision in that case was not enforceable.[213]

Chevron did not raise the issue of whether its contracts were derivative contracts or whether the Safe Harbor Provisions provided an exception to the requirement of strict mutuality in section 553 until after it was denied stay relief, and then, did so in the context of its motion for reconsideration.[214] Reconsideration was denied because Chevron failed to raise the argument that the safe harbors might protect its cross-affiliate setoff in its original motion—"at no point was it ever alleged that the agreements at issue were governed by a different statutory scheme pertaining to 'safe harbored' agreements" and consequently, the decision on the stay motion, "construes only § 553, [and] does not construe §§ 556, 557 or 561, and does not address directly any issue relating to 'safe harbored' contracts."[215] Accordingly, the question of whether the Safe Harbor Provisions provide an exception to the mutuality requirements of section 553 remains open.

Chevron Product Company's Motion for Reconsideration of this Court's Opinion Dated January 9, 2009 Regarding Contractual Netting at 3, *In re* SemCrude L.P., No. 08-11525, Mem. Order of Mar. 19, 2009 (Bankr. D. Del. 2009) (denying reconsideration), 2009 WL 229703 (arguing that agreements "are exceptions to and 'safe harbors' from section 553"); Martin J. Bienenstock et al., *Are Triangular Setoff Agreements Enforceable in Bankruptcy?*, 83 AM. BANKR. L.J. 325, 337–39 (2009) (discussing safe harbor protection of triangular setoffs).

[212] *See In re* SemCrude, L.P., 399 B.R. 388, 398–99 (Bankr. D. Del. 2009) (holding "no exception to the 'mutual debt' requirement in section 553 can be created by private agreement").

[213] *Id.*

[214] *See* Chevron Product Company's Motion for Reconsideration of this Court's Opinion Dated January 9, 2009 Regarding Contractual Netting at 3, *In re* SemCrude L.P., No. 08-11525, Mem. Order of Mar. 19, 2009 (Bankr. D. Del. 2009) (denying reconsideration), 2009 WL 229703 (arguing agreements were forward contracts or swap agreements that "are exceptions to and 'safe harbors' from section 553").

[215] *In re* SemCrude, L.P., No. 08-11525, Mem. Order at ¶ 6 (Bankr. D. Del. Mar. 19, 2009) (order denying Chevron's Motion for Reconsideration), *available at* , http://jweinsteinlaw.com/pdfs/Semcrude%20Reconsideration%20Order.pdf.

In looking for some inkling of Congress' intention to protect, or to not protect, non mutual setoffs and cross-affiliate netting, there is a notable absence of any mention in the legislative history for BAPCPA about either (i) altering counterparties' setoff rights in the Safe Harbor Provisions, or (ii) requiring setoffs to remain subject to the standard mutuality limitations for all setoffs in section 553(a). It is clear, however, that at least until the 2006 FNIA amendments, Congress had intended to maintain the mutuality requirement for setoffs in the Safe Harbor Provisions. Prior to 2006, each of sections 362(b)(6), 362(b)(7), 362(b)(17), and 362(b)(27) explicitly stated that setoffs protected from the automatic stay were "of a *mutual* debt and claim under or in connection with" a safe harbored agreement.[216] Additionally, the legislative history for the original provisions that permitted setoffs under both forward contracts and swap agreements reflects that Congress never intended that the exceptions to the automatic stay would protect setoffs that were not of mutual obligations between only two parties or that they would go beyond those setoffs already permitted by section 553 of the Bankruptcy Code. In testifying before Congress in support of the protections for setoffs under swap agreements in 1990, Marc C. Brickel, Chairman of ISDA, stated that the exception to the automatic stay for the netting provisions "does not interfere with the basic operation of the Bankruptcy Code, since the Code already preserves the right of setoffs, although requiring a court hearing."[217] And Congress noted that the protections for setoffs with respect to forward contracts were to allow a forward contract merchant who has a series of transaction with the "same customer" to net or setoff all its obligations.[218]

But, in 2006, when Congress rewrote each of 362(b)(6), 362(b)(7), 362(b)(17) and 362(b)(27) to make "technical changes" to conform the Bankruptcy Code's language to the FDIA and FCUA, it deleted the word "mutual" in each of these exceptions to the automatic stay.[219] These changes have prompted counterparties to argue that the deletion of the word "mutual" was Congress' express recognition of cross-affiliate setoffs in the Safe Harbor Provisions.[220] There is no discussion in the legislative history of FNIA regarding the deletion of the word mutual. What can be found, however, is Congress' statement that financial netting is the process of

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[216] 11 U.S.C. § 362(b)(6), (b)(7), (b)(17) (2000); 11 U.S.C.A. § 362(b)(27) (West 2005).

[217] *Interest Swap Hearing*, *supra* note 6, (statement of Mark C. Brickel, Chairman of the International Swap Dealers Assoc.).

[218] H.R. REP. NO. 101-484, at 4 (1990), *reprinted in* 1990 U.S.C.C.A.N. 223, 226.

[219] *See* 11 U.S.C. § 362(b)(6) (extending automatic stay exception to agreements used to offset payment amount, termination value, or transfer obligation); § 362(b)(7) (allowing automatic stay exception to apply to financial participant exercising contractual right); § 362(b)(17) (mandating stay exception applies to transfer obligations under one or more swap agreement); § 362(b)(27) (2006) (articulating master netting agreement can be used to offset transfer obligations).

[220] *See In re* SemCrude, L.P., 399 B.R. 388, 398–99 (Bankr. D. Del. 2009) (rejecting parties' argument and finding plain language of § 553(a) does not expressly state there is exception to mutual debt requirement for parties and their affiliates); *see also* Bienenstock, et al., *supra* note 211, at 342 (arguing cross-affiliate netting agreements or triangular setoff agreements can create mutual debt under section 553(a) and there is no public policy against this practice).

"settling mutual obligations at their net value as opposed to each obligation's gross dollar value."[221] This statement, combined with the multiple references to the FNIA amendments as purely "technical," implies, therefore, that the omission of the word "mutual" was not intended to result in the protection of "non-mutual" netting, but rather was inadvertent and "netting" still requires the offsetting of mutual obligations.

1. Counterparties May Argue that the Protections for Master Netting Agreements in Section 561 Extend to Cross-Affiliate Netting

Counterparties may argue that the protections in section 561 for master netting agreement participants permit cross-affiliate netting.[222] On its face, section 561 contains no provision allowing non-mutual setoffs in direct conflict with the traditional mutuality requirement contained in section 553(a). The clear language of section 561 does not address the setoff of non-mutual debts, nor does it state that a party may use the contracts of its affiliates to set off debts or claims owed to or from a debtor and its affiliates. Like the other Safe Harbor Provisions, section 561 expressly addresses the exercise of certain rights by *a single party*—there is no plural designation.[223]

As stated above, it was widely recognized in the industry and by the proponents of legislation that section 561 was intended to cover cross-product netting, which is distinguishable from cross-affiliate netting, in that cross-product netting is a mutual netting across *two* parties' contracts.[224] Congress viewed cross-product netting as a mutual setoff process—"netting permits a wide variety of financial transactions between *two parties* to be netted, thereby maximizing the present and potential future risk-reducing benefits of the netting arrangement between the parties."[225] And

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[221] H.R. REP. NO. 109-648, pt. 1, at 3 (2006) (explaining financial netting reduces risk by processing financial contracts on net basis).

[222] *See* Chevron Product Company's Motion for Reconsideration of this Court's Opinion Dated January 9, 2009 Regarding Contractual Netting at 11, *In re* SemCrude L.P., No. 08-11525, Mem. Order of Mar. 19, 2009 (Bankr. D. Del. 2009) (denying reconsideration), 2009 WL 229703 (arguing parties were entitled to mutuality for setoff of debts between multiple affiliated debtors and creditors); *see also* Morrison & Riegel, *supra* note 111, at 649 (indicating Code was amended under section 561 to allow master netting agreements and expand contractual rights).

[223] 11 U.S.C. § 561 (2006).

[224] *See* Rhett G. Campbell, *Financial Market Contracts and BAPCPA*, 79 AM. BANKR. L.J. 697, 705 (2005) ("The additions dealing with cross-product netting are intended to allow such netting among all types of financial products."); *see also* Thomas J. Giblin, *Financial Markets in Bankruptcy Court: How Much Uncertainty Remains After BAPCPA?*, 2009 COLUM. BUS. L. REV. 284, 311 (noting cross-product netting is allowed if included within netting agreement and also stating it does not matter if protected rights relate to multiple products or different transactions); Morrison & Riegel, *supra* note 111, at 649 (noting that "although cross product netting enjoyed uneasy legal status prior to 2005" it is protected if exercised under master netting agreement).

[225] H.R. REP. NO. 109-31, pt.1 at 125 (emphasis added) (discussing cross-product master agreements reduce systematic risks when large financial participant become insolvent).

Congress specifically stated that the rights contained in the Safe Harbor Provisions would be "subject to limitations contained in other provisions of the Bankruptcy Code," which presumably would include the limitations in section 553(a).[226]

The history of the enactment of section 561 suggests that it does not purport to create *new* rights. As mentioned, one reason proponents lobbied for section 561 was because it only extended parties' ability to net obligations that were *already netable* under one safe harbored contract across many safe harbored contracts.[227] Specifically, the purpose was to extend existing setoff rights of mutual pre-petition claims to contracts across products between a counterparty and a debtor.

> [N]etting has been a feature of both the bankruptcy code and bank insolvency laws for a number of years . . . . Cross product netting simply extends those benefits to get one net amount for all contracts that are *already netable* by permitting a wide variety of financial transactions between *two parties* to be netted, thereby maximizing the present and potential future risk-reducing benefits of the netting arrangement between the parties.[228]

Section 561 did not implicitly or expressly intend to allow cross-affiliate netting and a counterparty may encounter difficulty establishing that right under the Safe Harbor Provisions.[229]

2. The Amendments to Section 553(a)(2)(B) and 553(a)(3) Muddy the Waters

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[226] *Id.* at 133 (indicating rights under master netting agreement are subject to limitations under Code).

[227] *1999 Hearing*, *supra* note 23, at 392 (statement of Seth Grosshandler, Partner, Cleary, Gottileb, Steen & Hamilton) ("It is unclear whether cross-product netting is permitted [under current law] . . . when the contracts involved are swaps and repurchase agreements.").

[228] *Id.* at 21 (statement of Rep. James A. Leach) (emphasis added).

[229] After this article was written, but before it was published, the bankruptcy court for the Southern District of New York addressed the interplay between section 553 and sections 560 and 561 of the Bankruptcy Code in the context of a creditor's attempt to set off prepetition obligations against postpetition deposits in the debtor's bank account. *See In re* Lehman Brothers Holdings Inc., 2010 WL 1783395, *3 (Bankr. S.D.N.Y. May 5, 2010) (Peck, J.). Bankruptcy Judge Peck held that by their plain terms sections 560 and 561 do not nullify the mutuality requirement in section 553(a), which permits setoffs of only prepetition mutual debts. *Id.* at *4-6. Further, the legislative history of sections 560 and 561 indicates that their purpose was to prevent cherry-picking and permit setoffs absent relief from the automatic stay--not to permit a party to exercise a setoff extant of the requirements in section 553(a). *Id.* at *7-8. Moreover, Judge Peck gave no credence to the argument that the "technical" amendments of the FNIA in 2006 were intended to remove the mutuality requirement and create a "fundamental change in creditor rights." *Id.* at *8. Although the matter at issue there did not concern "cross affiliate" setoffs, and the counterparty has filed a notice of appeal, the decision is likely to have a profound impact on the ability of parties to avoid the mutuality requirement in section 553(a) on the basis of a "contractual right" under section 560 and 561. *See* Notice of Appeal filed by Swedbank, A.B., dated May 6, 2010, *In re* Lehman Bros. Holdings, Inc., 08-13555 [Docket No. 8831].

Confusion arises from the new amendments to section 553(a)(2)(B) and 553(a)(3), which prohibit a setoff if it was acquired by virtue of (i) a transfer of a claim (a) within the 90 days preceding the petition date and (b) while the debtor was insolvent, or (ii) the incurrence of a debt (a) within the 90 days preceding the petition date, (b) while the debtor was insolvent, and (c) for the purpose of obtaining a right of setoff.[230] The BAPCPA amendments added to the end of both 553(a)(2)(B)(ii) and 553(a)(3)(C) the following language: "except for the a setoff of the kind described in 362(b)(6), 362(b)(7), 362(b)(17), 362(b)(27), 555, 556, 559, or 561."[231] Under this language, a counterparty could argue that "affiliates can transfer claims or obligations to each other and then subtract the aggregate value of their claims against the debtor from the total amount of their obligations to the debtor, effectively exercising multi-party . . . netting."[232]

The statutory exceptions in 553(a)(2)(B)(ii) and 553(a)(3)(C) are confusing because they do not create exceptions for "transfers of claims" or the "incurrence of debt." Rather they protect "setoffs" that would result from such a transfer or incurrence—"a setoff of a kind described in 362(b)(6), 362(b)(7), 362(b)(17), 362(b)(27), 555, 556, 559, or 561."[233] Certain of those sections (e.g. 555, 556) do not even mention setoffs.[234] With respect to those sections that *do* mention the exercise of setoff rights, the "setoffs of the kind" in these Safe Harbor Provisions are setoffs of "termination values or payment amounts" that arise "under or in connection with" the exercise of the contractual right to "terminate, liquidate or accelerate" the specified safe harbored agreement.[235] For anyone critically analyzing the protections in section 553(a)(2)(B)(ii) or 553(a)(3)(C), the questions become:

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[230] *See* 11 U.S.C. § 553(a)(2)–(3) (2006); *see also* Morrison & Riegel, *supra* note 111, at 649 n.55 (describing this as 90-day "mini-preference" rule).

[231] 11 U.S.C. § 553(a)(2)(B)(ii), (a)(3)(C); *see In re* Ingersoll, Inc., Nos. 03 B 72223, 05 A 96087, 2009 WL 2215101, at *3 (Bankr. N.D. Ill. July 23, 2009) (recognizing section 553 had new restrictions added to it through BAPCPA); Mark D. Sherrill, *Put Off by Setoff: Do the BAPCA Amendments to §553 Do More Harm Than Good?*, AM. BANKR. INST. J., Feb. 2007, at 56 (stating BAPCPA amendments to section 553 "appear simple").

[232] Morrison & Riegel, *supra* note 111, at 649 n.55; *see also* Campbell, *supra* note 52, at 52 (describing technique as "affiliate netting").

[233] 11 U.S.C. § 553(a)(2)(B)(ii), (a)(3)(C) (2006); *see In re* SemCrude, L.P., 399 B.R. 388, 393 (Bankr. D. Del. 2009) ("The Code section that governs setoff in bankruptcy, section 553, does not create a right of setoff . . . ."). *See generally* Sherrill, *supra* note 231, at 57 ("[L]iteral readings of §§ 553(a)(2) and (3) lead to puzzling consequences.").

[234] *See* 11 U.S.C. §§ 555–556 (2006) (governing liquidation, termination, and acceleration of various contracts); *see also* Campbell, *supra* note 52, at 34 ("[§§ 555–556 have] an absence of express language preserving setoff rights"); Sherrill, *supra* note 231, at 57 ("Setoff may be a part of the process of liquidating . . . contracts, but it is not directly addressed in [11 U.S.C. §§ 555–556 (2006)] . . . .").

[235] *See* 11 U.S.C. § 362(b)(6)–(7), (17), (27) (2006) (permitting offset of "termination values or payment amounts"); 11 U.S.C. §§ 559–561 (2006) (permitting offsets of "termination values or payment amounts arising under or in connection with the termination, liquidation or acceleration of one or more" protected agreements); *see also* Hance, *supra* note 111, at 756–57 (noting Congress widened safe-harbor in response to uncertainty about netting and setoffs).

when does this protected "setoff" happen, and are the protections limited to mutual netting?

As mentioned above, Congress expected, for purposes of sections 555, 556, 559, 560 and 561, that the "normal business practice" would be to immediately terminate, liquidate or accelerate a safe harbored contract "in the event of a default" (for a condition of the kind listed in section 365(e)).[236] It seems that the setoff, which is protected under sections 362(b)(6), 362(b)(7), 362(b)(17), 362(b)(27), 555, 556, 559, or 561 would, therefore, happen *upon* termination,[237] which itself occurs for a reason specified in section 365(e)—the insolvency or financial condition of the debtor or the filing of a bankruptcy petition. If termination happens upon the filing of a debtor's bankruptcy petition, then the counterparty and the debtor presumably would arrive at a net sum owed either to or from the debtor at that time. If a counterparty were then to transfer its net claim after that time and *after* the debtor's filing of a bankruptcy petition, any setoff right created would be void as expressly prohibited under section 553(a)(2)(A). And because the transfer of the claim happened after the debtor's filing of bankruptcy petition, there is no safe harbor exception.[238]

An issue may arise, however, when parties terminate, not because the debtor files a bankruptcy petition, but as a result of the debtor's financial condition within the 90 days *prior* to the commencement of the debtor's bankruptcy case, or because of a debtor's parent filing.[239] At that time (as in the example above), a counterparty could terminate and liquidate all of its transactions with the debtor and determine a net sum owed to or from the debtor. Such mutual netting in connection with the termination and liquidation of a swap agreement would be protected by section 560. But, then, if a counterparty is in-the-money, but aware of the debtor's impending own bankruptcy, that counterparty may attempt to assign or to transfer that claim to a third-party affiliate (which may be out of the money) for the purpose of creating a setoff right. Shortly after the transfer or assignment, the debtor counterparty files its own bankruptcy petition. The transfer or assignment may have been in exchange for consideration, which could be the full value of the claim. The result being that the counterparty and the transferee may benefit from a dollar-for-dollar realization of that claim, through the creation and effectuation of the purported setoff right—in priority over other unsecured creditors.

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[236] H.R. REP. NO. 109-31, pt. 1, at 133 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 193.

[237] *See* H.R. REP. NO. 101-484, at 6 (1990), *reprinted in* 1990 U.S.C.C.A.N. 223, 228 (finding intent of 11 U.S.C. § 560 was to allow non-debtor swap participant or trustee to terminate swap agreement so mutual agreement is needed for swap agreement after filing bankruptcy petition).

[238] *See* 11 U.S.C. § 553(a)(2)(A) (codifying requirements for setoff); *see also In re* County of Orange, 183 B.R. 609, 615 (Bankr. C.D. Cal. 1995) (noting section 553 preserves common-law right of set off and burden rests with party asserting such right); *In re* Petraglia, 156 B.R. 474, 476 (Bankr. W.D. Pa 1993) (stating purpose of section 553 is "to preserve a creditor's right to setoff a matured debt in a bankruptcy context to the extent that it is permitted by state law").

[239] *See In re* Lehman Bros. Holdings, Inc., 422 B.R. 407, 411 (Bankr. S.D.N.Y 2010) (noting that parent LBHI's filing preceded many of its affiliate's filings by several weeks).

While ordinarily this trafficking of claims in an effort to improve one's position by virtue of creating a setoff right would be prohibited by section 553(a)(2)(B), a counterparty may argue that the newly-added exceptions to subsection 553(a)(2)(B)(ii), "setoff[s] of the kind described in sections 362(b)(6), 362(b)(7), 362(b)(17), 362(b)(27), 555, 556, 559, or 561," are applicable to protect the setoff right created by the claim transfer. The same question arises under section 553(a)(3) for setoffs created by the incurrence of debt for the purpose of creating setoff rights after the parties close out their transactions with a debtor. One would think that the transfer or claims or incurrence of debt to a third party *after* the close-out of the counterparty's own transactions with a debtor is akin to a post-petition transfer of claims, to which no safe harbor exception applies.[240] One could also argue that because, on their face, sections 362(b)(6), 362(b)(7), 362(b)(17), 362(b)(27), 555, 556, 559, and 561 do not appear to permit anything other than mutual netting in connection with the close of one party's transactions with a debtor, that the "setoffs of a kind" described in those sections do not extend to multi-party netting.

The legislative history for sections 553(a)(2)(A) and 553(a)(3) does not resolve this question and makes no mention of Congressional intent to protect party's rights to transfer claims or permit multi-party netting, but it does note that Congress added the exceptions to section 553 as an effort to "clarify that the acquisition by a creditor of setoff rights in connection with swap agreements, repurchase agreements, securities contracts, forward contracts, commodity contracts and master netting agreements cannot be avoided as a preference."[241] A literal reading would indicate that the *acquisition* of rights in a derivative contract, which would permit a "setoff of the kind in sections 362(b)(6), 362(b)(7), 362(b)(17), 362(b)(27), 555, 556, 559, or 561[,]" should be protected by the exceptions in 553(a)(2)(B) and 553(a)(3).[242] One could conclude that this means that if a counterparty enters into a new derivative or financial transaction in the 90 days prior to the debtor's bankruptcy and *acquires setoff rights* by virtue of entering such new contract, those setoff rights are not avoided by sections 553(a)(2)(A) or 553(a)(3). The protections for the *acquisition of setoff rights* via contract in the 90 days prior to bankruptcy could be distinguished from the *transfer of claims* to create setoff rights *after* termination and close out of the derivative transaction or financial contract. Such conclusion would be consistent with the overall policy against the trafficking of claims against a debtor and the clear prohibition on post-petition transfer of claims,

[240] 11 U.S.C. § 553(a)(2)(A).

[241] *See* H.R. REP. NO. 109-31, pt. 1, at 134 (discussing further "section also adds setoff of the kinds described in sections 555, 556, 559, 560 and 561 of the Bankruptcy Code").

[242] *See* 11 U.S.C. § 553 (a)(2)(B)(ii), (a)(3)(C) (codifying exceptions added by Congress); B.F. Goodrich Employees Fed. Credit Union v. Patterson (*In re* Patterson), 967 F.2d 505, 509 (11th Cir. 1992) (clarifying state law determines validity of set off right, not section 553); *In re* Lawndale Steel Co., 155 B.R. 990, 994 n.4 (Bankr. N.D. Ill. 1993) (indicating trustee cannot use avoiding powers to set off judgment under section 553).

without safe harbor exception, in section 553(a)(2)(A). But the ambiguity of section 553(a)(2)(A) and 553(a)(3) may make it difficult to establish this position.

Additionally, the placement of the new language in sections 553(a)(2)(B) and 553(a)(3) has been criticized as confusing.[243] In both cases, "except for the a setoff of the kind described in 362(b)(6), 362(b)(7), 362(b)(17), 362(b)(27), 555, 556, 559, or 561" has been added to the last subsection of sections 553(a)(2) and 553(a)(3) implying (under a literal interpretation) that it modifies only the portion of the subsection immediately preceding it.[244] Thus, arguably only the solvency prong of 553(a)(2)(B) and the intent prong of 553(a)(3)(C) would be affected by the existence of a financial contract. While this leads to absurd results, it would nevertheless create complications with regard to any creditor seeking to use 553(a)(2) or 553(a)(3) to effect cross-affiliate setoff rights. If Congress intended to protect cross-affiliate netting by the transfer of claims and incurrence of debt in derivative transactions and financial contracts, a more logical placement for the exemption would have been at the beginning of each subsection.[245] Moreover, it seems there would be some reflection of that intent in the legislative history or in the direct language of the statute.

B. Ambiguous Drafting Of the Credit Support Provisions Can Lead to Confusion

The broadened definition of each of the safe harbored categories of products or contracts, for example "swap agreement" in section 101(53B)(vi), now includes "security agreement[246] or arrangement or other credit enhancement related to [such product]."[247] Also, a security agreement that is "related to" a swap agreement under the new definition section 101(53B)(vi) is itself a "swap agreement."

A broad reading of this language could lead one to believe that an entity that is a counterparty to a security agreement that is "related to" a swap agreement, but that is not a counterparty to an actual swap, would nevertheless be a "swap participant" entitled to protections under sections 362(b)(17) and 560.[248] Section 362(b)(17) permits a swap participant to exercise "any contractual right (as defined in section 560) under any security agreement or arrangement or other credit enhancement

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[243] *See* Sherrill, *supra* note 231, at 57 ("A bit more thought in the placement and syntax of the new language may have avoided unnecessary litigation and unpredictable consequences in years to come.").

[244] *Id.* (acknowledging literal application means subsection (a)(2)(B)(ii) would not apply to safe-harbor contracts).

[245] *Id.* at 56–57 (stressing such a change would, however, highlight fact that amendment created exception to exception).

[246] "Security agreement" is defined in section 101(50) as "an agreement that creates or provides for a security interest," and "security interest" is in turn defined in section 101(51) as a "lien created by an agreement." 11 U.S.C. § 101 (2006).

[247] 11 U.S.C. § 101(53B)(A)(vi) (defining term "swap agreement").

[248] *See In re* Casa de Cambio Majapara S.A. de N.V., 390 B.R. 595, 598 (Bankr. N.D. Ill. 2008) (construing phrase "related to" broadly); *see also* Campbell, *supra* note 224, 704–05 (noting broadness of term "related to" and observing ambiguity of "how far the 'related to' language will reach"). *See generally* Morrison & Riegel, *supra* note 111, at 648 (analyzing changes of definitions in Bankruptcy Code).

forming part of or related to any swap agreement" despite the automatic stay. "Contractual right," as defined in section 560, can include any right "whether or not evidenced in writing, arising under common law," or "by reason of normal business practice."[249]

A counterparty could potentially argue that under section 362(b)(17) it may enforce *any and all* of its contractual rights arising under a security agreement "related to" a swap agreement whether stated or under common law.[250] As support for its argument, the counterparty would argue that while "contractual right" under section 560 is limited to termination, liquidation, acceleration, offset and netting for a reason specified in section 365(e)[251]—the plain language of section 362(b)(17), in contrast, *does not specify* such a limitation, it merely cross references section 560 for the definition of "contractual right." Taking it a step further, a counterparty to a security agreement, which is in itself not a swap under any industry standard but is considered a swap under section 101(53B)(vi), could argue that section 362(b)(17) allows it to exercise *any* contractual right under its security agreement despite the automatic stay and the prohibitions on *ipso facto* clauses in the Bankruptcy Code.[252]

This interpretation could result in a counterparty receiving protection for *any* right arising out of common law or normal business practice and would not confine its protections to the exercise of merely the close out, setoff and transfer rights. This result would be dramatically inconsistent with the intentions of the drafters of the statute. The legislative history states that the inclusion of "security agreement" in the definition of a swap "ensures that any such agreement, arrangement or

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[249] 11 U.S.C. § 560 (2006).

[250] *See* Memorandum of Law of American Family Life Assurance Company of Columbus in Support of Motion for Summary Judgment at 21–22, *In re* Lehman Bros. Holdings Inc., 422 B.R. 407 (Bankr. S.D.N.Y. 2010) (No. 09–01261) (asserting that under related security agreement Trustee has right to distribute all available assets pursuant to section 362(b)(17)); *see also* Lehman Bros. Special Fin., Inc. v. BNY Corporate Tr. Servs. Ltd. (*In re* Lehman Bros. Holdings, Inc.), 422 B.R. 407, 421 (Bankr. S.D.N.Y. 2010) (granting summary judgment for the plaintiffs and finding that the safe harbor provisions of section 560 do not protect payment priority provision in related noteholder priority payment agreement); Plaintiff Lehman Brothers Special Financing Inc. and Lehman Brothers Holdings Inc.'s Motion for Summary Judgment at 25-40, *In re* Lehman Bros. Holdings Inc., 422 B.R. 407 (Bankr. S.D.N.Y. 2010) (No. 09–01261), 2010 WL 271161 (arguing sections 560 and 262(b)(17) do not protect modification of payment provisions according to plain language and Congress' intent); Stipulation of Dismissal of All Claims, *In re* Lehman Bros. Holdings Inc., Nos. 08–13555 (JMP) (Jointly Administered), No. 09-01242 (Bankr. S.D.N.Y. December 29, 2009); *cf.* Kettering, *supra* note 6, at 1714 n.536 (noting "contractual right" may have no limit in section 560 when referred to in section 362(b)(17)).

[251] *See In re* Calpine Corp., Nos. 05-60200, 08-1251, 2009 WL 1578282, at *6–*7 (Bankr. S.D.N.Y. May 7, 2009) (listing conditions rendering contractual rights to terminate executory contract unenforceable); *see also* Adam R. Waldman, Comment, *OTC Derivatives & Systemic Risk: Innovative Finance or the Dance Into the Abyss?*, 43 AM. U. L. REV. 1023, 1070–71 (1994) (discussing section 560 in conjunction with section 362(b) and indicating "[the] primary impact of this provision is to eliminate the applicability of § 365(e) to 'swap agreements'"); *cf.* Nevin M. Gewertz, Comment, *Act or Asset? Multiplicitous Indictments under the Bankruptcy Fraud Statute, 18 USC § 152*, 76 U. CHI. L. REV. 909, 928 (stating in bankruptcy context enforceable legal agreements may be voided and giving section 365(e)'s invalidation of ipso facto clauses as example).

[252] *See* 11 U.S.C. § 560.

enhancement is itself deemed to be a swap agreement, and therefore eligible for treatment as such for purposes of *termination, liquidation, acceleration, offset and netting* under the Bankruptcy Code, the FDIA and the FCUA."[253] It does not speak of rights extrinsic to the basic rights of *termination, liquidation, acceleration, offset, and netting*. Furthermore, with respect to rights of setoff, "the references to 'setoff' in these provisions, . . . are intended to refer also to rights to foreclose on, and to set off against obligations to return, collateral securing swap agreements[.]"[254]

A court looking at this issue, may find under the recent decision *In re Calpine*,[255] and the relevant prior jurisprudence, that the scope of exercisable rights under the Safe Harbor Provisions was intended to be, and indeed remains, limited.[256] Counterparties raising these types of arguments, therefore, can anticipate possible resistance. Nevertheless, given the ambiguity of the statute, counterparties may seize upon the inartful language to attempt to expand the scope of previously exercisable rights.

CONCLUSION

The BAPCPA and FNIA amendments were extensive in addressing numerous provisions that needed updating and clarification. In many ways, BAPCPA and FNIA addressed the markets' concern and clarified many of the past ambiguities—by broadening the definitions to include newer products, major market players, collateral arrangements and the addition of protections for cross-product netting. Nevertheless, debates about the types of agreements that are protected, the scope of rights, and the ability of parties to exercise setoff rights that would otherwise be prohibited by the Bankruptcy Code, continue to arise. Perhaps it is naïve to presume that with any legislation parties will not try to argue for an advantageous interpretation. Even with Congress legislates with the goal of providing "clarity," unanticipated ambiguity can surface from the very legislation intended to clarify. There will be more questions—and more challenges—ahead as parties resolve their disputes under the new Safe Harbor Provisions.

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[253] H.R. REP. NO. 109-31, pt. 1, at 12 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 189 (emphasis added).

[254] *Id.* at 132.

[255] 2009 WL 1578282, at *6–*7 (holding section of agreement unenforceable "because it was a post-petition obligation under an executor contract and was not a contractual right to terminate a forward contract based upon a condition of the kind specified in section 365(e)(1) of the Code").

[256] After this article was written but prior to its publication, the Bankruptcy Court for the Southern District of New York, in *In re Lehman Brothers Holdings Inc.*, rejected this type of argument raised by a counterparty and determined that section 560 does not protect the exercise of *all* contractual rights and does not extend to the protection of rights in an agreement related to a swap agreement. *In re* Lehman Bros. Holdings, Inc., 422 B.R. 407, 421 (Bankr. S.D.N.Y. 2010) (granting summary judgment for the plaintiffs and finding that the safe harbor provisions of section 560 do not protect payment priority provision in related noteholder priority payment agreement). "Because the provisions of section 560 deal expressly with the liquidation, termination or acceleration (not the alteration of rights as they then exist) and refer specifically to "swap agreements," it follows that the Noteholder Priority provisoin and Condition 44 [which modified the debtor's payment priority] do not fall under the protections set forth therein." *Id.*; *see* 11 U.S.C. § 560 (2006).

APPENDIX I

Amendments from Pub. L. No. 109-8 Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

As amended, the affected Code sections read as follows (new material is *italicized* and removed material is ~~stricken~~):

I. 11 U.S.C. § 101 Definitions

In this title the following definitions shall apply:

~~(22) the term "financial institution"—~~

~~(A) means—~~

~~(i) a Federal reserve bank or an entity (domestic or foreign) that is a commercial or savings bank, industrial savings bank, savings and loan association, trust company, or receiver or conservator for such entity and, when any such Federal reserve bank, receiver, conservator, or entity is acting as agent or custodian for a customer in connection with a securities contract, as defined in section 741 of this title, the customer; or~~

~~(ii) in connection with a securities contract, as defined in section 741 of this title, an investment company registered under the Investment Company Act of 1940; and~~

(22) 'financial institution' means--

(A) a Federal reserve bank, or an entity (domestic or foreign) that is a commercial or savings bank, industrial savings bank, savings and loan association, trust company, federally-insured credit union, or receiver, liquidating agent, or conservator for such entity and, when any such Federal reserve bank, receiver, liquidating agent, conservator or entity is acting as agent or custodian for a customer in connection with a securities contract (as defined in section 741) such customer; or

(B) in connection with a securities contract (as defined in section 741) an investment company registered under the Investment Company Act of 1940;

(22A) The term 'financial participant' means—

(A) an entity that; at the time it enters into a securities contract, commodity contract, swap agreement, repurchase agreement, or forward contract, or at the time of the date of the filing of the petition, has one or more agreements or transactions described in paragraph (1), (2), (3), (4), (5), or (6) of section 561(a) with the debtor or any other entity (other than an affiliate) of a total gross dollar value of not less than $1,000,000,000 in notional or actual principal amount outstanding on any day during the previous 15-month period, or has gross mark-to-market positions of not less than $100,000,000 (aggregated across counterparties) in one or more such agreements or transactions with the debtor or any other entity (other than an affiliate) on any day during the previous 15-monh period; or

(B) a clearing organization (as defined in section 402 of the Federal Deposit Insurance Corporation Improvement Act of 1991).

(25) *The term* "forward contract" ~~means a contract~~ means—
(A) *a contract* (other than a commodity contract) for the purchase, sale, or transfer of a commodity, as defined in section 761(8) of this title, or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade, or product or byproduct thereof, with a maturity date more than two days after the date the contract is entered into, including, but not limited to, a repurchase transaction, reverse repurchase transaction, consignment, lease, swap, hedge transaction, deposition, loan, option, allocated transaction, unallocated transaction, ~~or any combination thereof or option thereon~~ *or any other similar agreement*;
(B) any combination of agreements or transactions referred to in subparagraphs (A) and (C);
(C) any option to enter into an agreement or transaction referred to in subparagraph (A) or (B);
(D) a master agreement that provides for an agreement or transaction referred to in subparagraph (A), (B), or (C), together with all supplements to any such master agreement, without regard to whether such master agreement provides for an agreement or transaction that is not a forward contract under this paragraph, except that such master agreement shall be considered to be a forward contract under this paragraph only with respect to each agreement or transaction under such master agreement that is referred to in subparagraph (A), (B), or (C); or
(E) any security agreement or arrangement, or other credit enhancement related to any agreement or transaction referred to in subparagraph (A), (B), (C), or (D), including any guarantee or reimbursement obligation by or to a forward contract merchant or financial participant in connection with any agreement or transaction referred to in any such subparagraph, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562.
~~(26) "forward contract merchant" means a person whose business consists in whole or in part of entering into forward contracts as or with merchants in a commodity, as defined in section 761(8) of this title, or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade;~~
(26) The term 'forward contract merchant' means a Federal reserve bank, or an entity the business of which consists in whole or in part of entering into forward contracts as or with merchants in a commodity (as defined in section 761) or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade.
(38A) The term 'master netting agreement'—
(A) means an agreement providing for the exercise of rights, including rights of netting, setoff, liquidation, termination, acceleration, or close out, under or in connection with one or more contracts that are described in any one or more of paragraphs (1) through (5) of section 561(a), or any security agreement or arrangement or other credit enhancement related to one or more of the foregoing,

including any guarantee or reimbursement obligation related to 1 or more of the foregoing; and
(B) if the agreement contains provisions relating to agreements or transactions that are not contracts described in paragraphs (1) through (5) of section 561(a), shall be deemed to be a master netting agreement only with respect to those agreements or transactions that are described in anyone or more of paragraphs (1) through (5) of section 561(a).
(38B) The term 'master netting agreement participant' means an entity that, at any time before the date of the filing of the petition, is a party to an outstanding master netting agreement with the debtor.
(46) The term "repo participant" means an entity that, ~~on any day during the period beginning 90 days before the date of~~ *at any time before* the filing of the petition, has an outstanding repurchase agreement with the debtor.~~;~~
(47) *The term* "repurchase agreement" ~~(which definition also applies to a reverse repurchase agreement) means an agreement, including related terms, which provides for the transfer of certificates of deposit, eligible bankers' acceptances, or securities that are direct obligations of, or that are fully guaranteed as to principal and interest by, the United States or any agency of the United States against the transfer of funds by the transferee of such certificates of deposit, eligible bankers' acceptances, or securities with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, eligible bankers' acceptances, or securities as described above, at a date certain not later than one year after such transfer or on demand, against the transfer of funds;~~ *(which definition also applies to a reverse repurchase agreement)—*
(A) means
(i) an agreement, including related terms, which provides for the transfer of one or more certificates of deposit, mortgage related securities (as defined in section 3 of the Securities Exchange Act of 1934), mortgage loans, interests in mortgage related securities or mortgage loans, eligible bankers' acceptances, qualified foreign government securities (defined as a security that is a direct obligation of or that is fully guaranteed by, the central government of a member of the Organization for Economic Cooperation and Development), or securities that are direct obligations of or that are fully guaranteed by, the United States or any agency of the United States against the transfer of funds by the transferee of such certificates of deposit, eligible bankers' acceptances, securities, mortgage loans, or interests, with a simultaneous agreement by such transferee to transfer to the transferor there of certificates of deposit, eligible bankers' acceptance, securities, mortgage loans, or interests of the kind described in this clause, at a date certain not later than 1 year after such transfer or on demand, against the transfer of funds;
(ii) any combination of agreements or transactions referred to in clauses (i) and (iii);

(iii) an option to enter into an agreement or transaction referred to in clause (i) or (ii);
(iv) a master agreement that provides for an agreement or transaction referred to in clause (i), (ii), or (iii), together with all supplements to any such master agreement, without regard to whether such master agreement provides for an agreement or transaction that is not a repurchase agreement under this paragraph, except that such master agreement shall be considered to be a repurchase agreement under this paragraph only with respect to each agreement or transaction under the master agreement that is referred to in clause (I, (ii), or (iii); or
(v) any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in clause (i), (ii), (iii), or (iv), including any guarantee or reimbursement obligation by or to a repo participant or financial participant in connection with any agreement or transaction referred to in any such clause, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562 of this title; and
(B) does not include a repurchase obligation under a participation in a commercial mortgage loan;
(53B) ~~"swap agreements" means—~~
~~(A) an agreement (including terms and conditions incorporated by reference therein) which is a rate swap agreement, basis swap, forward rate agreement, commodity swap, interest rate option, forward foreign exchange agreement, spot foreign exchange agreement, rate cap agreement, rate floor agreement, rate collar agreement, currency swap agreement, cross-currency rate swap agreement, currency option, any other similar agreement (including any option to enter into any of the foregoing);~~
(A) means—
(i) any agreement, including the terms and conditions incorporated by reference in such agreement, which is—
(I) an interest rate swap, option, future, or forward agreement, including a rate floor, rate cap, rate collar, cross-currency rate swap, and basis swap;
(II) a spot, same day-tomorrow, tomorrow-next, forward, or other foreign exchange or precious metals agreement;
(III) a currency swap, option, future, or forward agreement;
(IV) an equity index or equity swap, option, future, or forward agreement;
(V) a debt index or debt swap, option, future, or forward agreement;
(VI) a total return, credit spread or credit swap, option, future, or forward agreement;
(VII) a commodity index or a commodity swap, option, future, or forward agreement; or
(VIII) a weather swap, weather derivative, or weather option;
(ii) any agreement or transaction that is similar to any other agreement or transaction referred to in this paragraph and that—

(I) is of a type that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap markets (including terms and conditions incorporated by reference therein); and
(II) is a forward, swap, future, or option on one or more rates, currencies, commodities, equity securities, or other equity instruments, debt securities or other debt instruments, quantitative measures associated with an occurrence, extent of an occurrence, or contingency associated with a financial, commercial, or economic consequence, or economic or financial indices or measures of economic or financial risk or value;
(iii) any combination of agreements or transactions referred to in this subparagraph;
(iv) any option to enter into an agreement or transaction referred to in this subparagraph;
(v) a master agreement that provides for an agreement or transaction referred to in clause (i), (ii), (iii), or (iv), together with all supplements to any such master agreement, and without regard to whether the master agreement contains an agreement or transaction that is not a swap agreement under this paragraph, except that the master agreement shall be considered to be a swap agreement under this paragraph only with respect to each agreement or transaction under the master agreement that is referred to in clause (i), (ii), (iii), or (iv); or
(vi) any security agreement or arrangement or other credit enhancement related to any agreements or transactions referred to in clause (i) through (v), including an guarantee or reimbursement obligation by or to a swap participant or financial participant in connection with any agreement or transaction referred to in any such clause, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562, and
(B) is applicable for purposes of this title only, and shall not be construed or applied so as to challenge or affect the characterization, definition, or treatment of any swap agreement under any other statute, regulation, or rule, including the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Investor Protection Act of 1970, the Commodity Exchange Act, the Gramm-Leach, Bliley Act, and the Legal Certainty for Bank Products Act of 2000.
(53C) *The term* "swap participant" means an entity that, at any time before the filing of the petition, has an outstanding swap agreement with the debtor.~~;~~

II. 11 U.S.C. § 362(b) Changes to Section 362(b)
The filing of a petition under section 301, 302, or 303 of this title, or of an application under section 5(a)(3) of the Securities Investor Protection Act of 1970, does not operate as a stay—

(6) under subsection (a) of this section, of the setoff by a commodity broker, forward contract merchant, stockbroker, financial institution, *financial participant,* or securities clearing agency of any mutual debt and claim under or in connection with commodity contracts, as defined in section 761 of this title, forward contracts, or securities contracts, as defined in section 741 of this title, that constitutes the setoff of a claim against the debtor for a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, arising out of commodity contracts, forward contracts, or securities contracts against cash, securities, or other property held by, *pledged to, under the control of,* or due from such commodity broker, forward contract merchant, stockbroker, financial institution, *financial participant,* or securities clearing agency to margin, guarantee, secure, or settle commodity contracts, forward contracts, or securities contracts;
(7) under subsection (a) of this section, of the setoff by a repo participant *or financial participant,* of any mutual debt and claim under or in connection with repurchase agreements that constitutes the setoff of a claim against the debtor for a margin payment, as defined in section 741 or 761 of this title, or settlement payment, as defined in section 741 of this title, arising out of repurchase agreements against cash, securities, or other property held by, *pledged to, under the control of,* or due from such repo participant *or financial participant* to margin, guarantee, secure or settle repurchase agreements;
~~(17) under subsection (a) of this section, of the setoff by a swap participant, of any mutual debt and claim under or in connection with any swap agreement that constitutes the setoff of a claim against the debtor for any payment due from the debtor under or in connection with any swap agreement against any payment due to the debtor from the swap participant under or in connection with any swap agreement or against cash, securities, or other property of the debtor held by or due from such swap participant to guarantee, secure or settle any swamp agreement; or~~
(17) under subsection (a), of the setoff by a swap participant or financial participant of a mutual debt and claim under or in connection with one or more swap agreements that constitutes the setoff of a claim against the debtor for any payment or other transfer of property due from the debtor under or in connection with any swap agreement against any payment due to the debtor from the swap participant or financial participant under or in connection with any swap agreement or against cash, securities, or other property held by, pledged to, under the control of, or due from such swap participant financial participant to margin, guarantee, secure, or settle any swap agreement;
(27) under subsection (a), of the setoff by a master netting agreement participant of a mutual debt and claim under or in connection with one or more master netting agreements or any contract or agreement subject to such agreements that constitutes the setoff of a claim against the debtor for any payment or other transfer of property due from the debtor under or in connection with such agreements or any contract or agreement subject to such agreements against any payment due to

the debtor from such master netting agreement participant under or in connection with such agreements or any contract or agreement subject to such agreements or against cash, securities, or other property held by, pledged to, under the control of, or due from such master netting agreement participant to margin, guarantee, secure, or settle such agreements or any contract or agreement subject to such agreements, to the extent that such participant is eligible to exercise such offset rights under paragraph (6), (7), or (17) for each individual contract covered by the master netting agreement in issue; and

III. 11 U.S.C. § 546 Limitations in Avoiding Powers

(e) Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and (548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, *financial participant*, or securities clearing agency, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

(g) Notwithstanding sections 544, 545, 547, 548(a)(1)(B) and 548(b) of this title, the trustee may not avoid a transfer ~~under a swap agreement~~, made by or to a swap participant *or financial participant,* ~~in connection with a swap agreement~~ *under or in connection with any swap agreement* and that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

(j) Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) the trustee may not avoid a transfer made by or to a master netting agreement participant under or in connection with any master netting agreement or any individual contract covered thereby that is made before the commencement of the case, except under section 548(a)(1)(A) and except to the extent that the trustee could otherwise avoid such a transfer made under an individual contract covered by such master netting agreement.

IV. Changes to Sections 553, 555, 556, 559, 560, 561

11 U.S.C. § 553. Setoff

(a) Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case, except to the extent that—

(1) the claim of such creditor against the debtor is disallowed;

(2) such claim was transferred, by an entity other than the debtor, to such creditor—

(A) after the commencement of the case; or

(B) (i) after 90 days before the date of the filing of the petition; and

(ii) while the debtor was insolvent (*except for a setoff of a kind described in section 362(b)(6), 362 (b)(7), 362(b)(17), 362(b)(27), 555, 556, 559, 560, or 561*); or
(3) the debt owed to the debtor by such creditor was incurred by such creditor—
(A) after 90 days before the date of the filing of the petition;
(B) while the debtor was insolvent; and
(C) for the purpose of obtaining a right of setoff against the debtor *(except for a setoff of a kind described in section 362(b)(6), 362(b)(7), 362(b)(17), 362(b)(27), 555, 556, 559, 560, or 561).*
(b)(l) Except with respect to a setoff of a kind described in section 362(b)(6), 362(b)(7), ~~362(b)(14)~~ *362(b)(l7), 362(b)(27), 555, 556, 559, 560, 561,* 365(h), 546(h), or 365(i)(2) of this title, if a creditor offsets a mutual debt owing to the debtor against a claim against the debtor on or within 90 days before the date of the filing of the petition, then the trustee may recover from such creditor the amount so offset to the extent that any insufficiency on the date of such setoff is less than the insufficiency on the later of—
(A) 90 days before the date of the filing of the petition; and
(B) the first date during the 90 days immediately preceding the date of the filing of the petition on which there is an insufficiency.
(2) In this subsection, "insufficiency" means amount, if any, by which a claim against the debtor exceeds a mutual debt owing to the debtor by the holder of such claim.
(c) For the purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.

11 U.S.C § 555. ~~Contractual right to liquidate a securities contract~~ *Contractual right to liquidate, terminate, or accelerate a securities contract*
The exercise of a contractual right of a stockbroker, financial institution, *financial participant*, or securities clearing agency to cause the ~~liquidation~~ *liquidation, termination, or acceleration* of a securities contract, as defined in section 741 of this title, because of a condition of the kind specified in section 365(e)(1) of this title shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title unless such order is authorized under the provisions of the Securities Investor Protection Act of 1970 or any statute administered by the Securities and Exchange Commission. A~~s used in this section, the term "contractual right" includes a right set forth in a rule or bylaw of a national securities exchange, a national securities association, or a securities clearing agency.~~ *As used in this section, the term 'contractual right' includes a right set forth in a rule or bylaw of a derivatives clearing organization (as defined in the Commodity Exchange Act), a multilateral clearing organization (as defined in the Federal Deposit Insurance Corporation Improvement Act of 1991), a national securities exchange, a national securities association, a securities clearing agency, a contract market designated*

under the Commodity Exchange Act, a derivatives transaction execution facility registered under the Commodity Exchange Act, or a board of trade (as defined in the Commodity Exchange Act), or in a resolution of the governing board thereof, and a right, whether or not in writing, arising under common law, under law merchant, or by reason of normal business practice.

11 U.S.C § 556. **~~Contractual right to liquidate a commodities contract or forward contract~~** ***Contractual right to liquidate, terminate, or accelerate a commodities contract or forward contract***

The contractual right of a commodity broker; *financial participant*, or forward contract merchant to cause the ~~liquidation~~ *liquidation, termination, or acceleration* of a commodity contract, as defined in section 761 of this title, or forward contract because of a condition of the kind specified in section 365(e)(l) of this title, and the right to a variation or maintenance margin payment received from a trustee with respect to open commodity contracts or forward contracts, shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by the order of a court in any proceeding under this title. ~~As used in this section, the term "contractual right" includes a right set forth in a rule or bylaw of a clearing organization or contract market or in a resolution of the governing board thereof and a right,~~ *As used in this section, the term ' contractual right' includes a right set forth in a rule or bylaw of a derivatives clearing organization (as defined in the Commodity Exchange Act), a multilateral clearing organization (as defined in the Federal Deposit Insurance Corporation Improvement Act of 1991), a national securities exchange, a national securities association, a securities clearing agency, a contract market designated under the Commodity Exchange Act, a derivatives transaction execution facility registered under the Commodity Exchange Act, or a board of trade (as defined in the Commodity Exchange Act) or in a resolution of the governing board thereof and a right,* whether or not evidenced in writing, arising under common law, under law merchant or by reason of normal business practice.

11 U.S.C § 559. **~~Contractual right to terminate a repurchase agreement~~** ***Contractual right to liquidate, terminate, or accelerate a swap agreement***

The exercise of a contractual right of a repo participant *or financial participant* to cause the ~~liquidation~~ *liquidation, termination, or acceleration* of a repurchase agreement because of a condition of the kind specified in section 365(e)(1) of this title shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title, unless, where the debtor is a stockbroker or securities clearing agency, such order is authorized under the provisions of the Securities Investor Protection Act of 1970 or any statute administered by the Securities and Exchange Commission. In the event that a repo participant or financial participant liquidates one or more repurchase agreements with a debtor and under the terms of one or more such agreements has agreed to deliver assets subject to repurchase agreements to the debtor, any excess of the market prices received on liquidation of such assets (or if any such assets are not disposed of on the date of liquidation of such repurchase agreements, ·at the prices available at the time of liquidation of such repurchase agreements from a generally recognized source or the most recent closing bid quotation from such a source) over the sum of the stated repurchase prices and all expenses in connection with the liquidation of such repurchase agreements shall be deemed property of the estate, subject to the available rights of setoff. ~~As used in this section, the term 'contractual right' includes a right set forth in a rule or bylaw, applicable to each party to the repurchase agreement, of a national securities exchange, a national securities association, or a securities clearing agency, and a right,~~ *As used in this section, the term 'contractual right' includes a right set forth in a rule or bylaw of a derivatives clearing organization (as defined in the Commodity Exchange Act), a multilateral clearing organization (as defined in the Federal Deposit Insurance Corporation Improvement Act of* 1991), *a national securities exchange, a national securities association, a securities clearing agency, a contract market designated under the Commodity Exchange Act, a derivatives transaction execution facility registered under the Commodity Exchange Act, or a board of trade (as defined in the Commodity Exchange Act) or in a resolution of the governing board thereof and a right,* whether or not evidenced in writing, arising under common law, under law merchant or by reason of normal business practice.

11 U.S.C § 560. ***Contractual right to liquidate, terminate, or accelerate a swap agreement*** **~~Contractual right to terminate a swap agreement~~**

The exercise of any contractual right of any swap participant *or financial participant* to cause the ~~termination of a swap agreement~~ *liquidation, termination, or acceleration of one or more swap agreements* because of a condition of the kind specified in section 365(e)(1) of this title or to offset or net out any termination values or payment amounts arising under or ~~in connection with any swap agreement~~ *in connection with the termination, liquidation, or acceleration of one or more swap agreements* shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title. ~~As used in this section, the term "contractual right" includes a right,~~ *As used in this section, the term 'contractual right' includes a right set forth in a rule or bylaw of a derivatives clearing organization (as defined in the Commodity Exchange Act), a multilateral clearing organization (as defined in the Federal Deposit Insurance Corporation Improvement Act of 1991), a national securities exchange, a national securities association, a securities clearing agency, a contract market designated under the Commodity Exchange Act, a derivatives transaction execution facility registered under the Commodity Exchange Act, or a board of trade (as defined in the Commodity . Exchange Act) or in a resolution of the governing board thereof and a right,* whether or not evidenced in writing, arising under common law, under law merchant, or by reason of normal business practice.

11 U.S.C § 561. ***Contractual right to terminate, liquidate, accelerate, or offset under a master netting agreement and across contracts; proceedings under chapter 15***

(a) Subject to subsection (b), the exercise of any contractual right, because of a condition of the kind specified in section 365(e)(l), to cause the termination, liquidation, or acceleration of or to offset or net termination values, payment amounts, or other transfer obligations arising under or in connection with one or more (or the termination, liquidation, or acceleration of one or more)—

(1) securities contracts, as defined in section 741(7);

(2) commodity contracts, as defined in section 761(4);

(3) forward contracts;

(4) repurchase agreements;

(5) swap agreements; or

(6) master netting agreements,

shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by any order of a court or administrative agency in any proceeding under this title.

(b)(1) A party may exercise a contractual right described in subsection (a) to terminate, liquidate, or accelerate only to the extent that such party could exercise such a right under section 555, 556, 559, or 560 for each individual contract covered by the master netting agreement in issue.

(2) If a debtor is a commodity broker subject to subchapter IV of chapter 7—

(A) a party may not net or offset an obligation to the debtor arising under, or in connection with, a commodity contract traded on or subject to the rules of a contract market designated under the Commodity Exchange Act or a derivatives transaction execution facility registered under the Commodity Exchange Act against any claim arising under, or in connection with, other instruments, contracts, or agreements listed in subsection (a) except to the extent that the party has positive net equity in the commodity accounts at the debtor, -as calculated under such subchapter; and

(B) another commodity broker may not net or offset an obligation to the debtor arising under, or in connection with, a commodity contract entered into or held on behalf of a customer of the debtor and traded on or subject to the rules of a contract market designated under the Commodity Exchange Act or a derivatives transaction execution facility registered under the Commodity Exchange Act against any claim arising under, or in connection with, other instruments, contracts, or agreements listed in subsection (a).

(3) No provision of subparagraph (A) or (B) of paragraph (2) *shall prohibit the offset of claims and obligations that arise under—*

(A) a cross-margining agreement or similar arrangement that has been approved by the Commodity Futures Trading Commission or submitted to the Commodity Futures Trading Commission under paragraph (1) *or* (2) *of section 5c(c) of the Commodity Exchange Act and has not been abrogated or rendered ineffective by the Commodity Futures Trading Commission; or*
(B) any other netting agreement between a clearing organization (as defined in section 761) *and another entity that has been approved by the Commodity Futures Trading Commission.*
(c) As used in this section, the term 'contractual right' includes a right set forth in a rule or bylaw of a derivatives clearing organization (as defined in the Commodity Exchange Act), a multilateral clearing organization (as defined in the Federal Deposit Insurance Corporation Improvement Act of 1991), *a national securities exchange, a national securities association, a securities clearing agency, a contract market designated under the Commodity Exchange Act, .a derivatives transaction execution facility registered under the Commodity Exchange Act, or a board of trade (as defined in the Commodity Exchange Act) or in a resolution of the governing board thereof, and a right, whether or not evidenced in writing, arising under common law, under law merchant, or by reason of normal business practice.*
(d) Any provisions of this title relating to securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements, or master netting agreements shall apply in a case under chapter 15, *so that enforcement of contractual provisions of such contracts and agreements in accordance with their terms will not be stayed or otherwise limited by operation of any provision of this title or by order of a court in any case under this title, and to limit avoidance powers to the same extent as in a proceeding under chapter* 7 *or* 11 *of this title (such enforcement not to be limited based on the presence or absence of assets of the debtor in the United States).*

V. Changes To Definition In Sections 741 and 761

11 U.S.C § 741. Definitions For This Subchapter

In this subchapter—
~~(7) "securities contract" means contract for the purchase, sale, or loan of a security, including an option for the purchase or sale of security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any option entered into on a national securities exchange relating to foreign currencies, or the guarantee of any settlement of cash or securities by or to a securities clearing agency;~~
(7) 'securities contract'—
(A) means—
(i) a contract for the purchase, sale, or loan of a security, a certificate of deposit, a mortgage loan or any interest in a mortgage loan, a group or index of securities, certificates of deposit, or mortgage loans or interests therein (including an interest

therein or based on the value thereof), or option on any of the foregoing, including an option to purchase or sell any such security, certificate of deposit, mortgage loan, interest, group or index, or option, and including any repurchase or reverse repurchase transaction on any such security, certificate of deposit, mortgage loan, interest, group or index, or option;
(ii) any option entered into on a national securities exchange relating to foreign currencies;
(iii) the guarantee by or to any securities clearing agency of a settlement of cash, securities, certificates of deposit, mortgage loans or interests therein, group or index of securities, or mortgage loans or interests therein (including any interest therein or based on the value thereof), or option on any of the foregoing, including an option to purchase or sell any such security, certificate of deposit, mortgage loan, interest, group or index, or option;
(iv) any margin loan;
(v) any other agreement or transaction that is similar to an agreement or transaction referred to in this subparagraph;
(vi) any combination of the agreement or transaction referred to in this subparagraph;
(vii) any option to enter into any agreement or transaction referred to in this subparagraph;
(viii) a master agreement that provides for an agreement or transaction referred to in clause (i), (ii), (iii), (iv), (v), (vi), or (vii), together with all supplements to any such master agreement, without regard to whether the master agreement provides for an agreement or transaction that is not a securities contract under this subparagraph, except that such master agreement shall be considered to be a securities contract under this subparagraph only with respect to each agreement or transaction under such master agreement that is referred to in clause (i), (ii), (iii), (iv), (v), (vi), or (vii); or
(ix) any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in this subparagraph, including any guarantee or reimbursement obligation by or to a stockbroker, securities clearing agency, financial institution, or financial participant in connection with any agreement or transaction referred to in this subparagraph, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562; and
(B) does not include any purchase, sale, or repurchase obligation under a participation in a commercial mortgage loan;
(8) "settlement payment" means a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade; and
(9) "SIPC" means Securities Investor Protection Corporation.

11 U.S.C § 761. Definitions For This Subchapter

In this subchapter

(4) "commodity contract" means—

(A) with respect to a futures commission merchant, contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade;

(B) with respect to a foreign futures commission merchant, foreign future;

(C) with respect to a leverage transaction merchant, leverage transaction;

(D) with respect to a clearing organization, contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization, or commodity option traded on, or subject to the rules of, a contract market or board of trade that is cleared by such clearing organization; ~~or~~

(E) with respect to a commodity options dealer, commodity option;

(F) any other agreement or transaction that is similar to an agreement or transaction referred to in this paragraph;

(G) any combination of the agreements or transactions referred to in this paragraph;

(H) any option to enter into an agreement or transaction referred to in this paragraph;

(I) a master agreement that provides for an agreement or transaction referred to in subparagraph (A), (B), (C), (D), (E), (F), (G), or (H), together with all supplements to such master agreement, without regard to whether the master agreement provides for an agreement or transaction that is not a commodity contract under this paragraph, except that the master agreement shall be considered to be a commodity contract under this paragraph only with respect to each agreement or transaction under the master agreement that is referred to in subparagraph (A), (B), (C), (D), (E), (F), (G), or (HI); or

(J) any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in this paragraph, including any guarantee or reimbursement obligation by or to a commodity broker or financial participant in connection with any agreement or transaction referred to in this paragraph, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562;

APPENDIX II
Financial Netting Improvements Act of 2006
PUB. L. No. 109-390, 120 STAT. 2692
December 12, 2006

The Financial Netting Improvements Act of 2006, Pub. L. No. 109-390, § 5 (2006), amended Bankruptcy Code sections: 101(22)(A), (22A), (25)(A), (53B)(A)-(B); 362(b)(6)-(7), (17) & (27); 546(e)-(g) & (j); and 741(7)(A):

As amended, the affected Code sections read as follows (new material is underscored and removed material is ~~stricken~~

11 U.S.C. § 101. Definitions
In this title the following definitions shall apply:
(22) The term "financial institutions" means—
(A) a Federal reserve bank, or an entity ~~(domestic or foreign)~~ that is a commercial or savings bank, industrial savings bank, savings and loan association, trust company, federally-insured credit union, or receiver, liquidating agent, or conservator for such entity and, when any such Federal reserve bank, receiver, liquidating agent, conservator or entity is acting as agent or custodian for a customer (whether or not a "customer," as defined in section 741) in connection with a securities contract (as defined in section 741) such customer;
(22A) The term "financial participant" means —
(A) an entity that; at the time it enters into a securities contract, commodity contract, swap agreement, repurchase agreement, or forward contract, or at the time of the date of the filing of the petition, has one or more agreements or transactions described in paragraph (1), (2), (3), (4), (5), or (6) of section 561(a) with the debtor or any other entity (other than an affiliate) of a total gross dollar value of not less than $1,000,000,000 in notional or actual principal amount outstanding (aggregated across counterparties) ~~on any day during the previous 15-month period~~ at such time or on any day during the 15-month period preceding the date of the filing of the petition, or has gross mark-to-market positions of not less than $100,000,000 (aggregated across counterparties) in one or more such agreements or transactions with the debtor or any other entity (other than an affiliate) ~~on any day during the previous 15-month period~~ at such time or on any day during the 15-month period preceding the date of the filing of the petition; or
(B) a clearing organization (as defined in section 402 of the Federal Deposit Insurance Corporation Improvement Act of 1991).
(25) The term "forward contract" means —
(A) a contract (other than a commodity contract, as defined in section 761) for the purchase, sale, or transfer of a commodity, as, to in section 761(8) of . this title, or any similar good, article, service, right, or interest which is presently or in the future

becomes the subject of dealing in the forward contract trade, or product or byproduct thereof, with a maturity date more than two days after the date the contract is entered into, including, but not limited to, a ~~repurchase transaction, or reverse repurchase transaction~~, repurchase or reverse repurchase transaction (whether or not such repurchase or reverse repurchase transaction is a "repurchase agreement," as defined in this section)[,] consignment, lease, swap, hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction, or any other similar agreement;

(53B) The term "swap agreement"—

(A) means

(i) any agreement, including the terms and conditions incorporated by reference in such agreement, which is —

(I) an interest rate swap, option, future, or forward agreement, including a rate floor, rate cap, rate collar, cross-currency rate swap, and basis swap;

(II) a spot, same day-tomorrow, tomorrow-next, forward, or other foreign exchange ~~or precious metals~~, precious metals, or other commodity agreement;

(VII) a commodity index or a commodity swap, option, future, or forward agreement; ~~or~~

(VIII) a weather swap, ~~weather derivative, or weather option~~ option, future, or forward agreement;

(IX) an emissions swap, option, future, or forward agreement; or

(X) an inflation swap, option, future, or forward agreement;

(ii) any agreement or transaction that is similar to any other agreement or transaction referred to in this paragraph and that —

(I) is of a type that has been, is presently, or in the future becomes, the subject of recurrent dealings in the swap or other derivatives markets (including terms and conditions incorporated by reference therein); and

(II) is a forward, swap, ~~future, or option~~ future option, or spot transaction on one or more rates, currencies, commodities, equity securities, or other equity instruments, debt securities or other debt instruments, quantitative measures associated with an occurrence, extent of an occurrence, or contingency associated with a financial, commercial, or economic consequence, or economic or financial indices or measures of economic or financial risk or value;

(B) is applicable for purposes of this title only, and shall not be construed or applied so as to challenge or affect the characterization, definition, or treatment of any swap agreement under any other statute, regulation, or rule, including ~~the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Investor Protection Act of 1970, the Commodity Exchange Act, the Gramm-Leach, Bliley Act, and the Legal Certainty for Bank Products Act of 2000~~ the Gramm-Leach, Bliley Act, the Legal Certainty for Bank Products Act of 2000, the securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934) and the Commodity Exchange Act.

11 U.S.C. § 362. Automatic Stay

N.B.: Pub. L. No. 109-390 replaced paragraphs (6), (7), (17), and (27) of subsection (b); the former paragraphs are not reprinted herein.

(b) The filing of a petition under section 301, 302, or 303 of this title, or of an application under section 5(a)(3) of the Securities Investor Protection Act of 1970, does not operate as a stay —

(6) under subsection (a) of this section, of the exercise by a commodity broker forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency of any contractual right (as defined in section 555 or 556) under any security agreement or arrangement or other credit enhancement forming a part of or related to any commodity contract, forward contract or securities contract, or of any contractual right (as defined in section 555 or 556) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such contracts, including any master agreement for such contracts;

(7) under subsection (a) of this section, of the exercise by a repo participant or financial participant of any contractual right (as defined in section 559 under any security agreement or arrangement or other credit enhancement forming a part of or related to any repurchase agreement, or of any contractual right (as defined in section 559) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such agreements, including any master agreement for such agreements;

(17) under subsection (a) of this section, of the exercise by a swap participant or financial participant of any contractual right (as defined in section 560) under any security agreement or arrangement or other credit enhancement forming a part of or related to any swap agreement, or of any contractual right (as defined in section 560) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such agreements, including any master agreement for such agreements;

(27) under subsection (a) of this section, of the exercise by a master netting agreement participant of any contractual right (as defined in section 555, 556, 559, or 560) under any security agreement or arrangement or other credit enhancement forming a part of or related to any master netting agreement, or of any contractual right (as defined in section 555, 556, 559, or 560) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such master netting agreements to the extent that such participant is eligible to exercise such rights under paragraph (6), (7), or (17) for each individual contract covered by the master netting agreement in issue;

11 U.S.C. § 546 Limitations On Avoiding Powers

(e) Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 741 of this title, made. by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

(f) Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer ~~that is a margin payment, as defined in section 741 or 761 of this title, or settlement payment, as defined in section 741 of this title~~, made by or to (or for the benefit of) a repo participant, or financial participant, in connection with a repurchase agreement and that is made before the commencement of the ,case, except , under section 548(a)(1)(A) of this title.

(g) Notwithstanding sections 544, 545, 547, '548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer made by or to (or for the benefit of) a swap participant or financial participant, under or in connection with any swap agreement and that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

(j) Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) the trustee may not avoid a transfer made by or to (or for the benefit of) a master netting agreement participant under or in connection with any master netting agreement or any individual contract covered thereby that is made before the commencement of the case, except under section 548(a)(1)(A) and except to the extent that the trustee could otherwise avoid such a transfer made under an individual contract covered by such master netting agreement.

11 U.S.C. § 741. Definitions For This Subchapter

(7) "securities contract"—

(A) means

(i) a contract, for the purchase, sale, or loan of a security, a certificate of deposit, a ~~mortgage loan or~~ mortgage loan, any interest in a mortgage loan, a group or index of securities, certificates of deposit, or mortgage loans or interests therein (including an interest therein or based on the value thereof), or option on any of the foregoing, including an option to purchase or sell any such security, certificate of deposit, mortgage loan, interest, group or index, or option, and inducting any repurchase or reverse repurchase transaction on any such security, certificate of deposit, mortgage loan, interest, group or index, or option (whether or not such repurchase or reverse repurchase transaction is a 'repurchase agreement,' as defined in, section 101);

(ii) any option entered into on a national securities exchange relating to foreign currencies;
(iii) the guarantee (including by novation) by or to any securities clearing agency of a settlement of cash, securities, certificates of deposit, mortgage loans or interests therein, group or index of securities, or mortgage loans or interests therein (including any interest therein or based on the value thereof), or option on any of the foregoing, including an option to purchase or sell any such security, certificate of deposit; mortgage loan, interest, group or index, or option (whether or not such settlement is in connection with any agreement or transaction referred to in clauses (i) through (xi));
(iv) any margin loan;
(v) any extension of credit for the clearance or settlement of securities transactions;
(vi) any loan transaction coupled with a securities collar transaction, any prepaid. forward securities transaction, or any total return swap transaction coupled with a securities sale transaction;
~~(v)~~(vii) any other agreement or transaction that is similar to an agreement or transaction referred to in this subparagraph;
~~(vi)~~(vii) any combination of the agreements or transactions referred to in this subparagraph;
~~(vii)~~(ix) any option to enter into any agreement or transaction, referred tom this subparagraph;
~~(viii)~~(x) a master agreement that provides for an agreement or transaction referred to in clause (i), (ii), (iii) (iv), (v), (vi), ~~or (vii)~~ (vii), (viii), or (ix), together with all supplements to any such master agreement, without regard to whether the master agreement provides for an agreement or transaction that is not a securities contract under this subparagraph, except that such master agreement shall be considered to be a securities contract under this subparagraph only with respect to each agreement or transaction under such master agreement that is referred to in clause (i), (ii), (iii), (iv), (v), (vi), ~~or (vii)~~ (vii) (viii); or (ix); or
~~(ix)~~(xi) any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in this subparagraph, including any guarantee or reimbursement obligation by or to a stockbroker, securities clearing agency, financial institution, or financial participant in connection with any agreement or transaction referred to in this subparagraph, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562, and