

2009

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Recommended Citation

David A. Skeel Jr., *Bankruptcy Boundary Games*, 4 Brook. J. Corp. Fin. & Com. L. (2009).

Available at: <http://brooklynworks.brooklaw.edu/bjcfcl/vol4/iss1/1>

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ARTICLES

BANKRUPTCY BOUNDARY GAMES

*David A. Skeel, Jr.**

INTRODUCTION

A century ago, securities law and corporate reorganization were flip sides of the same coin. When a company sold stock and bonds to the public, an investment bank—usually J.P. Morgan or another of a small handful of dominant banks—underwrote the issuance with the help of its Wall Street lawyers.¹ If the company later defaulted, the same Wall Street investment bank formed a committee to represent the investors who held the bonds or stock it had underwritten. It then negotiated over the terms of a reorganization with the company’s managers and with the banks that had underwritten other securities on their behalf.² Equity receivership, as corporate reorganization was known then, was simply one facet of corporate and securities law.

The legislative reforms of the New Deal drove a sharp wedge between these two previously connected areas of law. The most significant blow was struck by the Chandler Act of 1938,³ which purposely ended the old equity receivership practice.⁴ In addition to displacing a debtor’s managers, the Chandler Act prohibited the investment banks and lawyers that had represented a debtor prior to bankruptcy from participating in the bankruptcy case.⁵ Within a few years, Wall Street corporate reorganization practice had largely disappeared. The main source of continuity between securities law and bankruptcy practice was the Securities and Exchange Commission (SEC), which was given a prominent role in corporate reorganization by the Chandler Act.⁶

During this same era, Congress also passed the nation’s two major securities acts, which put securities law on federal footing and laid the groundwork for what quickly became an immensely complicated area of

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1. The historical details in this paragraph and the next are treated at greater length in DAVID A. SKEEL, JR., *DEBT’S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA* (2001).

2. *Id.* at 63–69.

3. Chandler Act, Pub. L. No. 75-696, 52 Stat. 840 (1938) (repealed 1978).

4. Congress had earlier amended the Bankruptcy Act of 1898, 30 Stat. 544, by adopting section 77, 47 Stat. 1467, 1474–82 (1933), to govern railroad reorganization, and section 77B, 48 Stat. 912, 912–22 (1934), to govern other reorganizations. But, these amendments had largely codified existing receivership practice.

5. Chandler Act § 158(3).

6. Chandler Act §§ 167–288.

law.⁷ The ever increasing complexity of securities law further reinforced its separation from the similarly complex bankruptcy process. As with the separation between bankruptcy and other related regulatory regimes,⁸ the isolation of bankruptcy from securities law has created boundary issues in areas where they overlap. The drafters of the Bankruptcy Code could have responded to the overlapping domains by: (1) overriding the securities law in order to promote bankruptcy principles, (2) allowing both sets of rules to apply, or (3) deferring to the securities laws. One can find evidence of each of these three approaches in the Bankruptcy Code.

First, with some issues, such as the securities law rules dealing with offerings of corporate securities, the drafters have concluded that bankruptcy law adequately addresses the concerns that animate the securities laws. For example, when a debtor issues new stock or debt in connection with a reorganization plan, the debtor is excused from complying with the requirements imposed by the Securities Act of 1933.⁹

The second stance, coexistence, is perhaps best illustrated by the antifraud provisions of the securities laws. Although Congress has enacted a welter of bankruptcy-specific antifraud laws,¹⁰ bankruptcy does not displace securities law antifraud provisions such as § 10(b)¹¹ and Rule 10b-5 which prohibit insider trading and inaccurate disclosure.¹² Consequently, securities law provisions intersect with the bankruptcy framework in an awkward fashion at times.¹³

This Article is concerned with the last of the three responses, deference to the securities laws. Regarding another set of issues, Congress has concluded that ordinary bankruptcy principles should give way where there is an area of overlap between bankruptcy and securities law. Thus, the normal operations of bankruptcy law for corporate debtors are suspended in

7. The Securities Act of 1933 was one of the laws enacted during Franklin D. Roosevelt's first hundred days; the Securities and Exchange Act of 1934, which established the SEC, followed a year later. See, e.g., JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 13 (1982).

8. For a detailed analysis of another boundary, the separation between bankruptcy and state corporate law, see David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471 (1994).

9. 11 U.S.C. § 1145(a) (2006).

10. See, e.g., Leah Lorber & Bruce A. Markell, *Bankruptcy Crimes and the Federal Sentencing Guidelines*, 7 FED. SENT'G REP. 49 (1994) (describing bankruptcy crime provisions).

11. 15 U.S.C. § 78j(b) (2006).

12. 17 C.F.R. § 240.10b-5 (2009).

13. A particular issue is the application of Rule 10b-5 to the members of creditors' committees. Institutions that actively trade are wary of serving on the committee for fear that privileged information they receive as committee members would expose them to insider trading liability if they bought or sold securities of the debtor during the case. The standard prophylactics are the use of a "Chinese Wall" and, more recently, so-called "Big Boy" letters. See, e.g., Daniel Sullivan, Comment, *Big Boys and Chinese Walls*, 75 U. CHI. L. REV. 533, 541-46 (2008).

order to effectuate other important principles, such as the smooth functioning of the securities markets.

In Parts I, II, and III of this Article, I consider three of these issues in turn: (1) the exclusion of brokerage firms from Chapter 11 reorganization, (2) the protection of settlement payments from avoidance as preferences or fraudulent conveyances, and (3) the exemption of derivatives from the automatic stay and other basic bankruptcy provisions. I begin each part by discussing the provision and the concern it was designed to address. I then identify and assess important unintended consequences of the provisions. For instance, investment banks Drexel Burnham (Drexel) and Lehman Brothers (Lehman) both evaded the brokerage exclusion when they filed for bankruptcy; the settlement provision has been invoked in several high profile contexts that do not fit neatly within the core cases for which it was designed; and the application of the special derivatives protections has magnified the very systemic risk concerns they were designed to alleviate.¹⁴

Part IV of this Article explores the implications of the awkward interaction between bankruptcy and securities law. I begin by speculating about how bankruptcy courts will handle each of these issues if Congress does not alter the current rules. I then consider how Congress might intervene in these areas to address some of the problems that have arisen. I focus extensively on the most complex of the issues, bankruptcy's special protections for derivatives and other financial contracts. After surveying possible alternatives to the existing framework, I propose and defend two strategies for reform: the first and more novel approach would apply the stay in cases involving systemically important firms, but not in other cases; and the second proposal would impose the stay in all cases by removing the existing exemptions. The choice between these two approaches depends upon the overall structure of financial services regulation.

The frictions between bankruptcy and securities law have increased with the growth in financial innovation in the past several decades, but the wall of separation between these two areas is rapidly eroding at the same time. If the erosion translates to less deference to the securities industry and more careful oversight of the bankruptcy-securities law intersection by Congress, it may, despite the erratic history to date, justify cautious optimism about the future integration of these long estranged bodies of law.

I. THE BROKERAGE EXCLUSION FROM CHAPTER 11

Since its original enactment in 1978, the Bankruptcy Code has excluded brokerages from Chapter 11 based on a concern for the protection of customer accounts and a perception that the rules governing customer

14. For further discussion of these issues, see *infra* Parts I, II, & III.

accounts would make a Chapter 11 reorganization prohibitively complex.¹⁵ The drafters of the provisions seem to have contemplated that troubled brokerages would be liquidated in Chapter 7, and that the liquidation would be coordinated with the insurance scheme for brokerage customers established by the Securities Investor Protection Act of 1970 (SIPA).¹⁶

With the benefit of twenty-twenty hindsight, we can see that the brokerage exclusion was designed particularly with the brokerages of the 1960s in mind: brokerages that were set up as simple partnerships, and generally provided brokerage and advisory services.¹⁷ The investment banking business had not yet been transformed by initial public offerings (IPOs) and the shift to proprietary trading as a major source of investment bank profits.¹⁸ Unlike their 1960s predecessors, most current investment banks have a complex capital structure consisting of multiple (sometimes hundreds or thousands) entities.

The two major investment bank bankruptcies since the implementation of the exclusion have shown that, at least in the current environment, the special rules are quite easily evaded. When Drexel filed for bankruptcy in 1990, it filed a Chapter 11 petition for its holding company and kept its brokerage subsidiary out of bankruptcy until it had time to move all of the customer accounts.¹⁹ Lehman used roughly the same strategy in 2008, putting its holding company in Chapter 11 and foregoing bankruptcy for its brokerage subsidiaries.²⁰

Lehman added a clever twist to the strategy used by Drexel. Lehman's principal objective when it filed for bankruptcy was to quickly complete a sale of its brokerage operations to Barclays.²¹ However, there was one small problem with the sale. The power of the debtor to propose, and of the bankruptcy court to approve, sales free and clear of existing liabilities only

15. 11 U.S.C. § 109(d) (2006). The Bankruptcy Code includes special provisions for the protection of customer accounts in Chapter 7. *See* 11 U.S.C. §§ 741–67 (2006).

16. For an overview of the background and structure of SIPA, see Hugh L. Sowards & James S. Mofsky, *The Securities Investor Protection Act of 1970*, 26 BUS. LAW. 1271 (1971).

17. *See id.* at 1271–72 (describing SIPA as a response to the brokerage failures of the late 1960s and early 1970s).

18. Alan D. Morrison and William J. Wilhelm, Jr. explain the shift to proprietary trading as a response to technological change that diminished the value of the tacit knowledge that had traditionally been investment banks' stock in trade. ALAN D. MORRISON & WILLIAM J. WILHELM, JR., *INVESTMENT BANKING: INSTITUTIONS, POLITICS, AND LAW* 225 (2007). This, and the need for capital, made the traditional partnership structure less attractive than shifting to corporate form. *Id.*

19. Kenneth M. Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts?*, 35 J. CORP. L. (forthcoming 2010) (manuscript at 12), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1362639.

20. *See generally id.* (discussing the Drexel and Lehman bankruptcies in more detail).

21. *Id.* (manuscript at 9).

extends to property of the bankruptcy estate.²² Because the brokerage subsidiary had not filed for bankruptcy, its assets were not part of Lehman's bankruptcy estate. Thus, the assets technically were not subject to the bankruptcy court's power to authorize a sale.

To square the circle, Lehman coordinated with the SEC to set up a Securities Investor Protection Corporation (SIPC) proceeding for its North American brokerage operations simultaneously with the sale of its brokerage assets to Barclays.²³ The brokerage entered liquidation just soon enough to whitewash the assets on their way to Barclays.²⁴ Objectors challenged this maneuver at the hearing on Lehman's sale, arguing that the brokerage was never property of the bankrupt entity's estate and, therefore, the bankruptcy court lacked the power to authorize a "free and clear" sale of the assets of any subsidiary that had not been put into bankruptcy.²⁵ But the court overruled the objections and permitted the sale to go through.²⁶

The Lehman sale was a tribute to bankruptcy lawyers' ingenuity in circumventing a framework that once made sense, but is anachronistic in the current investment banking environment. The sale to Barclays was in the best interests of Lehman and its creditors, as the value of Lehman's brokerage operations would have vanished otherwise.²⁷ If the bankruptcy laws permitted an investment bank to file for Chapter 11, the fancy footwork used to make the sale possible would have been unnecessary. The brokerage exclusion might be justified, despite this effect, if its original rationale that Chapter 11 would be a quagmire, but Chapter 7 meant an orderly unwinding, held true. But the Drexel and Lehman experiences suggest that investment banks are likely to be sold rather than reorganized

22. 11 U.S.C. § 363(b)(1) (2006) ("The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, *property of the estate . . .*") (emphasis added).

23. See generally Ben Hallman, *A Moment's Notice*, AM. LAW., Dec. 1, 2008, at 87, available at <http://www.law.com/jsp/tal/PubArticleTAL.jsp?id=1202426213501> (describing Lehman's bankruptcy filing and the early sales).

24. *Id.*

25. See E-mail from Martin J. Bienenstock, Partner, Dewey & Leboeuf L.L.P., to David A. Skeel, Jr., S. Samuel Arsht Professor of Corporate Law, University of Pennsylvania Law School (Jan. 29, 2009, 13:58 EST) (on file with author).

26. *Id.* (describing the objection and the court's dismissal).

27. Whether value in an absolute sense would have disappeared is not quite as clear. If the brokerage operations had independent franchise value as a unit, that value might have been undermined by delay. But if the value was simply a function of human capital of individual employees, the principal effect of delay might have been distributive, with Lehman losing their value and another bank gaining it without compensating Lehman. Relatedly, questions arose as to whether Lehman had obtained an adequate price, and Lehman also alleged that Barclays had fraudulently retained \$5 billion in securities it was obligated to return. See, e.g., Michael J. de la Merced, *Lehman's Estate is Suing Over Unit's Sale*, N.Y. TIMES, Nov. 17, 2009, at B8. These spats go to the terms of the deal; they do not necessarily reflect a destruction of value and do not call into question the need for a prompt sale.

in a Chapter 11 proceeding, and that Chapter 11 is an effective venue for achieving this goal.²⁸ In each case, the Chapter 11 filing proceeded in two steps: an effort to rapidly sell assets whose value was time sensitive, followed by a more leisurely disposition of the firm's other assets.²⁹

In Part IV, I will consider the obvious implications of this experience.³⁰ For present purposes, the principal point is that the brokerage exclusion has functioned quite differently than its drafters seem to have envisioned. Congress imagined that when investment banks filed for bankruptcy, they would be liquidated under the watchful eye of the SEC or a bankruptcy trustee.³¹ Both Drexel and Lehman sidestepped the trustee and used Chapter 11 rather than Chapter 7. As we shall see, the disconnect between ostensible purpose and actual use is a recurring pattern in the Bankruptcy Code's securities-oriented provisions.

II. THE SPECIAL PROTECTION FOR SECURITIES SETTLEMENTS

In 1982, Congress added a special provision to the Bankruptcy Code in order to protect margin call or settlement payments made by or to brokers from being challenged as preferences or fraudulent conveyances.³² The intuition is that these are ordinary brokerage operations, not preferences or fraudulent conveyances, and that the possibility of avoidance in the event of a bankruptcy could seriously interfere with the internal functioning of the securities markets. A witness at the principal congressional hearing testified that:

If a firm or a clearing organization had to return margin payments received from a debtor when he had already transmitted those funds to others in the clearing chain, its finances could be seriously undermined to the point

28. Although Drexel was eventually reorganized, most of its assets were sold prior to confirmation of the reorganization plan and the reorganized firm was a far smaller entity. *See, e.g.,* Ayotte & Skeel, *supra* note 19 (manuscript at 12) (noting that the reorganized company, New Street Capital, would manage \$450 million of Drexel's junk bonds).

29. *See, e.g., id.* (manuscript at 9–15) (discussing the two cases).

30. *See infra* Part IV.B.1 (recommending removal of the brokerage exclusion).

31. *See supra* notes 16–17 (describing the desire to protect customers' accounts and the perception that Chapter 11 would be too complex).

32. Originally enacted as 11 U.S.C. § 546(d), the protection is now codified at 11 U.S.C. § 546(e) (2006). Section 546(e) states that:

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 . . . or settlement payment . . . 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.

where it might also be driven into bankruptcy [W]hen these moneys flow through the clearing chain, they are disbursed in many different directions, and there really is no way of tracing where they have gone. Any other firm in the chain would stand to have its own capital exposed if there were an attempt to recover these moneys.³³

Although the warning about ripple effect bankruptcies was no doubt exaggerated, the justification for protecting ordinary settlement operations is compelling. Payments to or from a broker to complete a trade, and for which the broker is simply a middleman, are not the kinds of transactions that the preference and fraudulent conveyance laws are designed to police. But Congress did not explicitly limit the protection in § 546(e) to this context. The provision itself states that a settlement payment made by or to one of a long list of market participants is protected.³⁴ “Settlement payment” is explicitly defined by the Bankruptcy Code,³⁵ but the definition is comically circular, repeating the term “settlement payment” six times.³⁶ As a result, the settlement payment protection can be seen—particularly if one is willing to squint—as applying to issues well outside the context for which it was ostensibly drafted. Two important examples illustrate the extent to which this potential has indeed materialized.

The first example is leveraged buyouts (LBOs). When a number of LBOs quickly failed in the 1980s, bankruptcy courts were faced with the question as to whether the financing of an LBO should be deemed a fraudulent conveyance, given that the company took on substantial debt in connection with the transaction but did not retain the proceeds of the loan.³⁷ If some of the LBOs were indeed fraudulent conveyances, who should be held responsible? In several prominent cases, courts held that the public shareholders of a debtor could not be forced to disgorge the money they

33. *Bankruptcy of Commodity and Securities Brokers: Hearings before the Subcomm. on Monopolies and Commercial Law of the H. Comm. on the Judiciary*, 97th Cong. 165 (1981) [hereinafter *1981 House Hearing*] (testimony of Edmund R. Schroeder, Atty., Barrett, Smith, Schapiro, Simon & Armstrong).

34. 11 U.S.C. § 546(e).

35. 11 U.S.C. § 101 (51A) (2006).

36. According to the definition set forth in the Bankruptcy Code, “The term ‘settlement payment’ means . . . a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, a net settlement payment, or any other similar payment commonly used in the forward contract trade.” *Id.*

37. One of the best analyses of the fraudulent conveyance issue is Douglas G. Baird, *Fraudulent Conveyances, Agency Costs, and Leveraged Buyouts*, 20 J. LEG. STUD. 1 (1991).

received for their stock.³⁸ The courts based their conclusions largely on the Bankruptcy Code's settlement provision.³⁹

Several other cases have questioned this interpretation of the statute, refusing to apply the settlement provision to protect payments to shareholders in an LBO if the broker or other institution never had a beneficial interest in the payments. In *Matter of Mumford*, for example, the Eleventh Circuit held that the involvement of the financial institution was not sufficient to invoke the safe harbor because "the bank here was nothing more than an intermediary or conduit."⁴⁰ The court explained that the "[f]unds were deposited with the bank and when the bank received the shares from the selling shareholders, it sent funds to them in exchange. The bank never acquired a beneficial interest in either the funds or the shares."⁴¹

The second battleground involving the settlement provision was Enron. Shortly before filing for bankruptcy in late 2001, Enron bought significant amounts of its commercial paper at prices well above the prevailing market rate in an effort to protect its credit rating.⁴² It also purchased more than 300,000 shares of its own stock from a swap counterparty and bought the notes of a Collateralized Loan Obligation (CLO) facility—again at above market rates—to satisfy obligations under those arrangements.⁴³ After filing for bankruptcy, Enron challenged all of these purchases, arguing that the commercial paper transactions were in essence preferential payments of its commercial paper obligations, and that the stock and note transactions were constructively fraudulent since Enron paid appreciably more than the prevailing market value.⁴⁴ In each case, the defendants argued that the purchases were settlement payments and, therefore, could not be avoided.⁴⁵

The peculiar dynamics of Enron's plight, namely, its purchase of the paper in a desperate effort to fend off a catastrophic ratings downgrade, created a difficult tension between the settlement payment provision and bankruptcy's preference and fraudulent conveyance provisions. In form, the

38. See, e.g., *Lowenschuss v. Resorts Int'l, Inc. (In re Resorts Int'l, Inc.)*, 181 F.3d 505 (3d Cir. 1999); *Kaiser Steel Corp. v. Pearl Brewing Co. (In re Kaiser Steel Corp.)*, 952 F.2d 1230 (10th Cir. 1991).

39. See *In re Resorts Int'l, Inc.*, 181 F.3d at 516–17; *In re Kaiser Steel Corp.*, 952 F.2d at 1240–41.

40. *Munford v. Valuation Research Corp. (In re Munford, Inc.)*, 98 F.3d 604, 610 (11th Cir. 1996).

41. *Id.*

42. See generally *Enron Corp. v. J.P. Morgan Sec., Inc. (In re Enron)*, 325 B.R. 671 (Bankr. S.D.N.Y. 2005).

43. See *Enron Corp. v. Int'l Fin. Corp. (In re Enron Corp.)*, 341 B.R. 451 (Bankr. S.D.N.Y. 2006).

44. *Int'l Fin. Corp. (In re Enron Corp.)*, 341 B.R. 451; *J.P. Morgan Sec., Inc. (In re Enron Corp.)*, 325 B.R. 671; *Enron Corp. v. Bear Stearns Int'l Ltd. (In re Enron Corp.)*, 323 B.R. 857 (Bankr. S.D.N.Y. 2005).

45. *Int'l Fin. Corp. (In re Enron)*, 341 B.R. at 455; *J.P. Morgan Sec., Inc. (In re Enron Corp.)*, 325 B.R. at 681–82; *Bear Stearns Int'l Ltd. (In re Enron)*, 323 B.R. at 863.

transactions were simply purchases of commercial paper, which look like new market transactions rather than payments to an existing creditor that would implicate the § 547 preference provision. Yet, their effect was to pay existing Enron creditors who would otherwise hold ordinary unsecured claims.

The bankruptcy judge finessed this tension, as well as the uneasy fit between the cases and the core context for which the settlement payment safe harbor was designed, by asking whether the payments were of a type that is “common within the securities trade.”⁴⁶ If so, he concluded, the payments would qualify as settlement payments and come within the safe harbor.⁴⁷ Although he concluded that the CLO note purchases clearly qualified and, therefore, dismissed Enron’s action in that case, the judge refused to dismiss Enron’s avoidance actions with respect to its commercial paper and stock purchases.⁴⁸ In these two cases, the status of the payments was a factual issue that could only be resolved through a hearing or trial.⁴⁹

The Enron decisions further illustrate the uncertainty as to just how far the settlement safe harbor sweeps. Not only was the bankruptcy court unable to resolve two of the three cases prior to trial,⁵⁰ but the court introduced what is arguably a third approach to limiting the boundaries of the settlement payment safe harbor. The judge’s concern for what is “common within the securities trade”⁵¹ is narrower than the sweeping protection afforded in several of the LBO cases, but potentially broader than the “mere conduit” approach used in other LBO cases.⁵²

Much as the transformation of investment banking has rendered the brokerage exclusion obsolete, so too have LBOs and financial innovation introduced unanticipated complexities into the interpretation of the settlement provision. Courts seem to be wrestling with the tension between the broad language of the safe harbor, which weighs in favor of protection,

46. See, e.g., *J.P. Morgan Sec., Inc. (In re Enron Corp.)*, 325 B.R. at 677.

47. See, e.g., *id.*

48. *Int’l Fin. Corp. (In re Enron Corp.)*, 341 B.R. at 459 (holding that Enron’s purchase of notes qualified as settlement payment); *J.P. Morgan Sec., Inc. (In re Enron Corp.)*, 325 B.R. at 677 (holding that the question whether commercial paper purchases are protected by section 546(e) “is a factual issue requiring a trial”); *Bear Stearns Int’l Ltd. (In re Enron Corp.)*, 323 B.R. at 859 (holding that Enron’s purchase of its own stock was not protected if it violated Oregon law).

49. *J.P. Morgan Sec., Inc. (In re Enron Corp.)*, 325 B.R. at 677 (holding that the question whether commercial paper purchases are protected by section 546(e) “is a factual issue requiring a trial”); *Bear Stearns Int’l Ltd. (In re Enron Corp.)*, 323 B.R. at 877 n.9 (whether a “void payment was commonly used in the industry” would “at minimum” require a “factual hearing”).

50. *J.P. Morgan Sec., Inc. (In re Enron Corp.)*, 325 B.R. at 687; *Bear Stearns Int’l Ltd. (In re Enron Corp.)*, 323 B.R. at 879.

51. See, e.g., *J.P. Morgan Sec., Inc. (In re Enron Corp.)*, 325 B.R. at 677.

52. *Munford v. Valuation Research Corp. (In re Munford, Inc.)*, 98 F.3d 604, 610 (11th Cir. 1996).

and the fact that the defendants in such cases are far removed from its core purpose of protecting middlemen in the securities settlement system.

III. THE SPECIAL TREATMENT OF DERIVATIVES IN BANKRUPTCY

A final example of bankruptcy's effort to accommodate securities law is the special protection afforded derivatives and other financial contracts in bankruptcy. The earliest version of these provisions in the Bankruptcy Code was enacted as part of the original 1978 legislation, which exempted commodities and forward contracts from the automatic stay and other core bankruptcy provisions.⁵³ Additional exclusions have been added at regular intervals, most recently in 2005 and 2006.⁵⁴

The amendments have been championed by the principal industry lobbying organization, the International Swaps & Derivatives Association (ISDA), and the U.S. Federal Reserve and Treasury.⁵⁵ These groups argued that if derivatives were not completely protected from the automatic stay, a bankruptcy involving a firm with significant derivatives exposure could snarl the financial system.⁵⁶ As a representative from the Federal Reserve System (the Fed) explained in a 1999 submission to Congress:

[T]he right to terminate or close-out financial market contracts is important to the stability of financial market participants . . . and reduces the likelihood that a single insolvency will trigger other insolvencies due to the non-defaulting counterparties' inability to control their market risk. The right to terminate or close-out protects [financial institutions] . . . on an individual basis, and by protecting both the supervised and unsupervised market participants, protects the markets from systemic problems of "domino failures."⁵⁷

53. Edward R. Morrison & Joerg Riegel, *Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges*, 13 AM. BANKR. INST. L. REV. 641, 644–45 (2005) (citing to Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, §§ 362(b)(6), 548(d)(2)(B), 1978 U.S.C.A.N. (92 Stat.) 2549).

54. In 1982, Congress added the settlement protection discussed in the last part, as well as a protection for margin payments; in 1984, Congress provided special exemptions for repurchase transactions. *Id.* at 644. In 1990, Congress exempted swap transactions; and in 2005, Congress expanded the protections for repos and for netting. *Id.* Several of the exclusions were further expanded in 2006.

In addition to the automatic stay (and related provisions), the exclusions insulate derivatives and other financial contracts from bankruptcy's preference and fraudulent conveyance provisions. In the discussion that follows, I focus on the exemption from the automatic stay because this exemption has garnered the most attention. But, the exemption from preference and fraudulent conveyance attack is also problematic.

55. Ayotte & Skeel, *supra* note 19, at 30.

56. *Id.*

57. *Bankruptcy Reform Act of 1999 (Part III): Hearing on H.R. 833 Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary*, 106th Cong. 172–73 (1999)

Over the years, the testimony has been replete with similar warnings about “domino effect” and “ripple effect” failures unless financial contracts and securities transactions are protected from core bankruptcy provisions.⁵⁸

Most bankruptcy lawyers and judges have little familiarity with the securities markets. As a result, they largely deferred to the testimony of bank regulators and the securities industry each time Congress considered new expansions of the derivatives protections. The testimony of Bruce Bernstein, a prominent bankruptcy lawyer speaking on behalf of the National Bankruptcy Conference (NBC) on a proposal to expand protection for repurchase transactions, is particularly striking in this regard. Bernstein stated that his “experience [in secured lending] has been that markets do have a way of adjusting to shocks or interpretations of relationships that do not necessarily go the way the market thinks they should have gone initially.”⁵⁹ But, he disclaimed any expertise on the implications of the treatment of derivatives, stating that “I really am not expert enough, nor is my crystal ball clear enough, to be able to respond in any certain way,”⁶⁰ and that “[t]he broad, economic policy arguments of these well-informed and highly respected institutions [the Fed and the Public Securities Association] . . . are, quite frankly, beyond the scope of the NBC’s expertise and its normal areas of inquiry.”⁶¹ Fifteen years later, NBC representatives did question the necessity of further expansion of the protections, but by then the die had long since been cast and the testimony had little impact.⁶²

As with each of the issues previously considered, the derivatives protections have given rise to unintended consequences. In the case of derivatives and other financial contracts, the consequences stem less from subsequent market developments than from the provisions themselves. Whereas the provisions originally sought to protect particular parties, they now extend to the entire market for derivatives and other financial

[hereinafter *Bankruptcy Reform Act of 1999 Hearing (Part III)*] (prepared statement of Oliver Ireland, Assoc. Gen. Counsel, Bd. of Governors of the Fed. Reserve Sys.).

58. *See generally id.*

59. *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. 73 (1984) (testimony of H. Bruce Bernstein, Atty., Sidley Austin L.L.P., on behalf of the National Bankruptcy Conf.).

60. *Id.*

61. *Id.*

62. *Bankruptcy Reform Act of 1999 Hearing (Part III)*, *supra* note 57, at 177 (prepared statement of Randal C. Picker, Leffmann Professor of Commercial Law, University of Chicago Law School, on behalf of the National Bankruptcy Conf.) (“There 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. In addition, master netting could deprive a debtor of much-needed cash collateral . . .”). *See also id.* at 46–58 (statement of Kenneth N. Klee, Professor, University of California Los Angeles School of Law, on behalf of the National Bankruptcy Conf.).

contracts.⁶³ Counterparties to a debtor that files for bankruptcy are exempt from the automatic stay, permitted to invoke any termination clause, and are protected from bankruptcy's preference and fraudulent conveyance provisions.⁶⁴

Prior to the recent financial crisis, several commentators pointed out that permitting counterparties to terminate is at least as likely to create systematic problems—by inviting runs in the event of financial distress—as to counteract them.⁶⁵ Regulators' responses to the recent crisis seem to confirm these criticisms. The decision to bail out Bear Stearns, rather than to allow it to file for bankruptcy, stemmed at least in part from the perceived consequences of default and termination for the repo and derivatives markets.⁶⁶ According to a column in the *New York Times*, “[f]ears of so-called counterparty risk arising from credit default swaps on the books of Bear Stearns . . . were central to the investment bank’s unraveling in March [2008] and the rescue engineered by the Federal Reserve Bank of New York and JPMorgan Chase.”⁶⁷ The onset of AIG’s financial distress six months later triggered a simultaneous wave of collateral demands that forced the government to choose between a massive bailout and allowing it to file for bankruptcy.⁶⁸ Largely because of the perceived effect on the credit default swap market, the government opted for a bailout whose cost is estimated at \$180 to \$200 billion as of this writing.⁶⁹ Whether an AIG default would have cascaded through the financial system, as regulators feared, is subject to vigorous debate, but regulators clearly did not trust counterparties’ exemption from the bankruptcy stay to neutralize potential systemic effects.

The experience of Lehman, the one major derivatives player that was allowed to file for bankruptcy, suggests that bankruptcy professionals may

63. I borrow this characterization from an insightful article by Morrison & Riegel, *supra* note 53.

64. See, e.g., 11 U.S.C. § 362(b)(7) (exempting repos from stay), § 559 (exempting repos from invalidation of *ipso facto* clauses), § 546(f) (exempting repos from avoidance) (2006).

65. Key early articles questioning the systemic risk rationale include Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 YALE J. REG. 91, 94 (2005); Shmuel Vasser, *Derivatives in Bankruptcy*, 60 BUS. LAW. 1507, 1541–42 (2005); Robert R. Bliss & George G. Kaufman, *Derivatives and Systemic Risk: Netting, Collateral, and Closeout*, 2 J. FIN. STAB. 55, 67–69 (2006). See also Ayotte & Skeel, *supra* note 19; David A. Skeel, Jr., *Governance in the Ruins*, 122 HARV. L. REV. 696, 738–40 (2008); Frank Partnoy & David A. Skeel, Jr., *The Promise & Perils of Credit Derivatives*, 75 U. CINN. L. REV. 1019, 1049 (2007).

66. See generally Gretchen Morgenson, *A Window in a Smoky Market*, N.Y. TIMES, July 6, 2008, at BU1, available at <http://www.nytimes.com/2008/07/06/business/06gret.html>.

67. *Id.*

68. See William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943, 962 (2010) (the AIG “credit downgrade trigger[ed] additional posting obligations” on its credit default swaps).

69. *Id.* at 974.

respond by creatively interpreting the exclusions to reduce counterparties' ability to exit. Although counterparties of trades with Lehman affiliates that had not filed for bankruptcy should have been able to terminate their contracts and retrieve the collateral securing them, Lehman successfully argued that the collateral, which consisted of various financial assets, had been commingled with the holding company's general accounts, and, therefore, were subject to the automatic stay.⁷⁰ Based on this claim, Lehman retained control of the assets.⁷¹

Particularly with major players in the derivatives markets, the recent stress test of the special exclusion of derivatives and other financial contracts from core provisions of the Bankruptcy Code raises serious questions about the wisdom of the exclusions.

IV. IMPLICATIONS OF THE BOUNDARY GAMES

With each of the issues we have considered, Congress has concluded that, as between the securities markets and the normal operations of the bankruptcy laws, bankruptcy should give way and the markets should prevail. In each case, the special protection has proven problematic. Debtors have sidestepped the requirement that broker-dealers file for Chapter 7 rather than Chapter 11; the settlement protection afforded the securities markets has been the subject of increasing uncertainty; and during the recent crisis, the special treatment of derivatives was a problem rather than a solution. This section considers the future of these provisions. I begin by speculating about implications in the absence of any legislative intervention. I then consider how Congress might alter the existing rules to more effectively manage the boundary between bankruptcy and the securities markets.

A. MANAGING THE GROWING TENSIONS

The increasing friction at the boundary between bankruptcy law and the securities markets is not accidental. Each of the special protections affected relatively few cases when it was first enacted. But with the transformation of investment banking and the explosion of financial innovation, the securities markets, traditional corporate enterprise, and bankruptcy have become increasingly intertwined. Despite the recent financial crisis, this tendency will surely continue.

⁷⁰ *Events of Default: Is the Bankruptcy Provision Guttled?*, WESTLAW BUS. CURRENTS EXTRA, <http://www3.gsonline.com/FORMS/BankruptcyEvents.asp?cid=cibwqa0011jn> (describing suits by Evergreen Solar, Bank of America, Nomura Global and Freddie Mac to retrieve their financial asset collateral).

⁷¹ *Id.*

The exclusion of investment banks from Chapter 11 has been rendered largely (but not completely) irrelevant by the shift in banks' corporate structures and their use of Chapter 11 for holding companies and non-brokerage affiliates. As we have seen, the principal limitations of the strategy stem from the limits on the ability of the brokerage itself, because it is not in bankruptcy, to take advantage of provisions such as § 363.⁷² Given the benefits to both the debtor and its creditors, courts are likely to continue authorizing sales of brokerage assets.

With the settlement safe harbor and derivatives exemptions, the provisions are now drafted so broadly that the market transactions may continue to prevail over the automatic stay and other core bankruptcy provisions. Several commentators have recently defended the breadth of the provisions, predicting that they will reduce uncertainty by curbing bankruptcy judges' discretion to protect some transactions but not others.⁷³

This prognosis may well be correct since it accords with the general Congressional strategy of insulating these markets from ordinary bankruptcy rules. But the breadth of the provisions will magnify the frictions they cause, as the provisions increasingly crop up in contexts in which they were not intended to apply. These frictions will be further exacerbated by doubts as to whether the special derivatives protections are justified, and by the widespread use of derivatives by ordinary businesses. Indeed, after agonizing whether a small business debtor's commodity contract with a natural gas supplier should be characterized as a swap, and thus, exempt from bankruptcy's avoidance provisions, a bankruptcy judge recently refused to construe the exemptions broadly "[b]ecause the contract [was] not clearly within the definition of swap agreement the court will not upset the priority scheme of the Bankruptcy Code by affording the transfers under the contract the protections afforded to swap agreements and swap participants."⁷⁴

If the prediction that bankruptcy courts will balk at giving the derivatives exclusions their full reach in some cases is correct, it raises two possible concerns. The first is the costs of uncertainty.⁷⁵ When bankruptcy courts have raised questions about financial innovations that were thought to be insulated from bankruptcy, the decisions have often had an immediate,

72. 11 U.S.C. § 363 (2006).

73. See, e.g., Morrison & Riegel, *supra* note 53, at 641.

74. *Natural Gas Distributors, L.L.C. v. Smithfield Packing Co., Inc. (In re Natural Gas Distributors)*, 369 B.R. 884, 900 (Bankr. E.D.N.C. 2007), *rev'd*, 556 F.3d 247 (4th Cir. 2009). As of this writing, this decision has been reversed by the Fourth Circuit and remanded to the bankruptcy court for further consideration. *Id.*

75. See Morrison & Riegel, *supra* note 53, at 644.

negative market impact.⁷⁶ If bankruptcy courts do not effectively distinguish between cases where the special protections are or are not warranted, the uncertainty costs could be still higher.

The second concern is not entirely distinct from the first, but has a different focus. The bankruptcy rules are designed to effectively resolve the financial distress of a particular debtor, and bankruptcy judges' decisions tend to reflect this orientation. This approach generally works well, but it may prove problematic if a decision that maximizes the value of the debtor's assets could have costly spillover effects on parties outside the bankruptcy. As we have seen, concerns about spillover effects, especially systemic risk, are a recurrent theme in the legislative history of the special protections for financial contracts.⁷⁷ If bankruptcy judges do not fully take spillover effects into account, and if the risk of these effects is real, the exercising of judicial discretion by courts could benefit debtors and their creditors while inflicting broader damage on the markets.

B. LEGISLATIVE REFORM

Bankruptcy judges and professionals have adapted to many of the problematic effects of the boundary rules we have considered. But the adaptations are invariably imperfect. Next, I explore how Congress could clarify the murky waters if lawmakers were inclined to intervene.

1. The Brokerage Exclusion from Chapter 11

As we have seen, parties have responded to the brokerage exclusion by working around it. Yet, their solution of putting affiliates, but not the brokerage, in bankruptcy is an imperfect proxy for Chapter 11. Technically, the brokerage cannot take advantage of benefits such as § 363. The brokerage exclusion could also interfere with the changes to bankruptcy's treatment of derivatives (discussed below) since any derivatives held by a brokerage subsidiary that did not file for bankruptcy would not be protected. Although the exclusion once could be justified, it no longer serves any real purpose. Congress could appreciably simplify the bankruptcy process for investment banks by repealing the brokerage exclusion.

2. The Safe Harbor for Settlement Payments

The simplest solutions to the uncertainties created by the safe harbor for settlement payments would be either to explicitly limit the safe harbor to its

76. A decision in the LTV Corporation bankruptcy suggesting that an asset securitization would not qualify as a true sale temporarily jolted the securitization market in 2001. *See In re LTV Steel Co.*, 274 B.R. 278 (Bankr. N.D. Ohio 2001).

77. *Supra* text accompanying note 57.

original purpose of protecting securities middlemen in market transaction, or to broadly protect every transaction that takes place through the settlement system.⁷⁸ But neither of these bright line approaches is particularly attractive. If only securities professionals were protected, ordinary market investors could find themselves subject to fraudulent conveyance or preference challenge due to the breadth of the bankruptcy avoidance provisions.⁷⁹ Explicitly protecting all of these transactions, on the other hand, would shelter the recipients of problematic transfers due to the happenstance of a connection to the financial markets. The volume of transactions that now take place on the financial markets is so great that a blanket protection of them would afford protection to some that do not warrant it.

The current provision provides an escape valve because it does not protect transfers that amount to actual fraud.⁸⁰ But unless fraud is construed liberally, the fraud exception is not broad enough to police potentially problematic transactions.⁸¹ One strategy for legislatively achieving a more workable middle ground would be to amend the safe harbor provision to provide differing levels of protection for market middlemen and other participants in the market. Lawmakers could provide blanket protection for market middlemen, absent fraud, while protecting investors and other participants unless they knew or should have known that they were the beneficiary of a preference or fraudulent conveyance. As bankruptcy old-timers will recognize, this standard echoes one of the requirements for avoiding a preference under the old Bankruptcy Act.⁸²

78. Interestingly, if Congress eliminated the safe harbor altogether, securities middlemen might well be protected by courts from preference or fraudulent conveyance attack. To the extent the middleman is simply a conduit for settlement payments, he is not really the recipient of a transfer.

79. The preference and constructive fraud provisions use a strict liability approach that does not take motive or knowledge into account—this is the principal source of their breadth. See 11 U.S.C. §§ 547(b), 548(a)(1)(B) (2006).

80. 11 U.S.C. § 546(e) (2006).

81. For an example of elastic interpretation of the fraud under § 546(e), see *Gredd v. Bear Stearns Sec. Corp. (In re Manhattan Inv. Fund Ltd.)*, 359 B.R. 510, 516–27 (Bankr. S.D.N.Y. 2007). In that case, the court concluded that the debtor, a hedge fund, had functioned as a Ponzi scheme, and thus that any transactions with the fund were potentially fraudulent. *Id.* at 518. The court also concluded that settlement payments to Bear Stearns, its prime broker, could therefore be challenged as fraudulent conveyances. *Id.* at 523–26. For an extensive critique of *In re Manhattan Inv. Fund Ltd.*, see Peter S. Kim, *Navigating the Safe Harbors: Two Bright Line Rules to Assist Courts in Applying the Stockbroker Defense and the Good Faith Defense*, 2008 COLUM. BUS. L. REV. 657, 676–79 (2008).

82. Under former section 60, the trustee was required to show that the recipient of an alleged preferential transfer knew or should have known the debtor was insolvent at the time of the transfer. Bankruptcy Act of 1898, Ch. 541, § 60, 30 Stat. 544 (repealed 1978). This requirement was criticized as making it too difficult to avoid preferences. See, e.g., Chaim J. Fortgang & Lawrence P. King, *The 1978 Bankruptcy Code: Some Wrong Policy Decisions*, 56 N.Y.U. L. REV. 1148, 1165–66 (1981) (describing the complaint).

Consider how this rule might function in an LBO. In many of these cases, insiders and large shareholders negotiate the terms of the buyout. If the debtor later files for bankruptcy and the trustee challenges the LBO as fraudulent, any brokers who handled the payments would be protected. The old shareholders also would be protected unless the trustee could show that they knew or should have known the transaction could be avoidable as a fraudulent transfer. The trustee might well be able to make this showing with respect to the insiders, but most likely not to the ordinary investor. Consequently, most ordinary investors would be protected.

The chief shortcoming of this approach is the difficulty in determining when the recipient knew or should have known that she was the recipient of a potentially avoidable transfer. But, given the cost of pursuing an avoidance action, a trustee or debtor-in-possession would rarely pursue these avoidance actions unless significant money was at stake and strong evidence existed showing that the recipient was aware that the payment she received was problematic.

3. Imposing a Stay on Derivatives and Other Financial Contracts

If lawmakers reform the current exemption of derivatives from the automatic stay, their most plausible strategies are to (1) adopt a transaction or product-based approach by exempting some financial contracts from the automatic stay but not others; (2) apply the automatic stay in the bankruptcy of some kinds of firms but not others; and/or (3) apply the automatic stay to all financial contracts, thus ending their special treatment. Next, I consider the intuition underlying each of the three approaches.

With respect to the first, the case for exempting some products is stronger than for others. Subjecting repos to the automatic stay might significantly interfere with the repo market, since repo loans are extended on a very short term basis.⁸³ The case for exempting credit default swaps, on the other hand, is weaker.⁸⁴ Under this approach, Congress would revisit

83. On the other hand, if the repo creditor is fully collateralized, any harm from the stay should be limited. Gary Gorton has recently argued that repo financing is analogous to traditional deposit banking, and should be protected by a government guarantee analogous to deposit insurance. *See, e.g.,* Gary Gorton, Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007 (May 9, 2009) (unpublished manuscript at 4), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1401882&rec=1&srcabs=1436913. Although such a reform seems unlikely, if it were adopted it would further reduce the consequences of a stay for repo lenders.

84. Proponents of special treatment of swaps emphasize the standard systemic risk concern that preventing counterparties from terminating could cause “ripple effect” failures. *Bankruptcy Reform Act of 1999 Hearing (Part III)*, *supra* note 57, at 172–73 (prepared statement of Oliver Ireland, Assoc. Gen. Counsel, Bd. of Governors of the Fed. Reserve Sys.). They also argue that a party who depended on a swap for hedging purposes might have difficulty replacing the hedge and would run the risk of ending up with a duplicative hedge if the debtor later assumed its contract. *Id.* None of these contentions are especially persuasive, however. The counterparty itself can

each of the exemptions and remove the least compelling. In a sense, it would reverse the historic pattern of continuously expanding the special treatment of derivatives, and winnow down the protected list.

The second approach would distinguish among types of debtors, rather than focus on particular products. For instance, one commentator has recently argued that the automatic stay should apply if the debtor is not a financial institution, but counterparties should retain their exemption with financial institution debtors.⁸⁵ The reasoning is that a derivative may be important to a nonfinancial debtor's going concern value and, therefore, should be protected.⁸⁶ A second proposal, which I have outlined briefly elsewhere, would draw a different line, distinguishing between ordinary and systemically important financial institutions.⁸⁷ Under this proposal, the stay would apply only to systemically important institutions. This proposal draws on the experience of the recent financial crisis, which seems to confirm concerns that the absence of a stay could magnify the systemic effects of a large financial institution's default.⁸⁸

The final approach would reverse the special protections altogether, based on a view that the arguments for exempting the derivatives and other financial contracts from bankruptcy no longer seem compelling. Exempting derivatives counterparties from the stay reduces their incentive to monitor the debtor and does not seem to provide a bulwark against systemic risk.

While each of these approaches has drawbacks, each proposal seems preferable to the existing framework. Let me briefly expand on the two that seem most compelling: the stay for systemically important institutions and the blanket stay.⁸⁹ The proposal for a stay on systemically important institutions might proceed in two steps.⁹⁰ First, the Fed would be instructed

minimize their risk through the simple expedient of limiting its exposure to any given debtor, for instance, and the counterparty often would be able to sell a duplicative hedge to a third party. Moreover, the uncertainty could be reduced under a rule that required the debtor to make prompt decisions on assumptions, much as bank regulators do in a bank insolvency.

85. Stephen J. Lubben, *Derivatives and Bankruptcy: The Flawed Case for Special Treatment* 3–5 (Seton Hall Public Law Research, Working Paper No. 1265070, 2008), available at <http://ssrn.com/abstract=1265070>.

86. *See id.*

87. David A. Skeel, Jr., *Give Bankruptcy a Chance*, WKLY. STANDARD, June 29–July 6, 2009, at 25.

88. *See* Sjoström, *supra* note 68, at 962. The AIG “credit downgrade trigger[ed] additional posting obligations” on its credit default swaps. *Id.*

89. Lubben's contention that derivatives held by nonfinancial entities should be stayed is sensible, but is subject to two limitations. *See* Lubben, *supra* note 84, at 3–5. First, and most obvious, it does not address the need for a stay in insolvencies involving nonbank financial institutions. Second, it could be circumvented. A financial institution that wished to evade the stay could interpose another financial institution between itself and the debtor.

90. For another, somewhat analogous proposal for singling out systemically important institutions, see Lee C. Buchheit & David A. Skeel, Jr., *Some Bankruptcies are Worth It*, N.Y. TIMES, May 19, 2009, at A25. Under this approach, lawmakers would provide for a transition

to designate the financial institutions it deems to be systemically important. As the regulator most concerned with systemic risk, and having conducted “stress tests” of the leading banks in early 2008, the Fed is the logical choice to determine which institutions are systemically important, and to do so in advance. Second, if a systemically important institution filed for bankruptcy, its derivatives and other financial contracts would be subject to the automatic stay.⁹¹

The bankruptcy-plus-stay proposal for systemically important institutions would reduce the danger that an institution would dismember itself prior to bankruptcy in response to collateral calls, as AIG threatened to do, as well as reduce the threat that mass cancellation of contracts and collateral sales would drive down asset prices and increase the damage to other institutions. The proposal might also curb the perceived need for bailouts, give counterparties and creditors a greater incentive to monitor, and encourage the managers of a systemically important institution to plan for the possibility of bankruptcy, rather than trying to portray bankruptcy as a looming catastrophe in order to secure rescue funding.⁹² The most obvious concern with the proposal stems from its singling out of institutions that are systemically important. This special treatment could reward institutions that were given the “systemically important” designation, and perpetuate a status that creates serious distortions in the markets.⁹³ In practice, however, the proposal seems equally likely to discourage firms, rather than invite them, to attain “systemically important” status. Because the counterparties of a designated firm would be subject to the stay if the firm filed for bankruptcy, the proposal would increase counterparties’ incentives to deal with non-designated institutions if they wished to avoid the possibility of a stay in the event their counterparties encountered financial distress. The incentive to deal with non-designated institutions could help to erode the dominance of the derivatives industry by a handful of financial institutions.

The other strategy, a blanket stay on derivatives and other financial instruments, avoids the line drawing concerns created by approaches that apply the stay to some firms but not to others. The chief objections to the stay, as we have seen, stem from the consequences of preventing counterparties from exiting their contracts.⁹⁴ The value of the contracts and of any collateral is extremely volatile. Accordingly, counterparties could be

period prior to bankruptcy during which the institution could attempt to raise money or arrange for a sale of its assets.

91. In order to make the stay fully effective, Congress also would need to reverse the brokerage exclusion from Chapter 11, as discussed in Part IV.A. Otherwise, the stay would not protect any derivatives or other financial contracts held by the brokerage entity.

92. See, e.g., Ayotte & Skeel, *supra* note 19; Skeel, *supra* note 87, at 25.

93. See, e.g., Peter J. Wallison, *Too Big to Fail, or Succeed*, WALL ST. J., June 18, 2009, at A17.

94. See *supra* text accompanying note 57.

damaged by the uncertainty as to whether the debtor will assume or reject their contract, and the cost of re-hedging contracts that the debtor rejects could be devastating if the contract is substantial.

Although these are legitimate concerns, they must be weighed against the very substantial benefits of the stay. The prospect of a stay would give counterparties an added incentive both to carefully monitor the debtor and to avoid overexposing themselves to a single counterparty. Moreover, the costs of the stay could be reduced by assessing the value of the collateral as of the date of the bankruptcy filing and by setting tight deadlines on the debtor's decision to assume or reject the contract.

Between the limited and blanket stay, the determination as to which is preferable depends importantly on the nature of financial regulation. The case for a stay that targets systemically important institutions is strongest in a regulatory regime that singles out systemically important firms for distinct treatment.⁹⁵ There are many reasons for concern about such a regime. For example, the perception that some firms are too big to fail is likely to distort capital markets, as lenders favor the firms that are thought to be protected. If the regulatory framework does make such distinctions, however, the targeted stay could curb the incentive to acquire systemically important status to some extent. In a regime that does not single out systemically important firms, a blanket stay is likely to be most compelling. It has the virtue of simplicity, and does not introduce the boundary issues that would arise with a distinction between systemically important and other institutions. Both approaches are, however, preferable to the current exemption from the bankruptcy stay.

CONCLUSION

The securities market exclusions from core provisions of the bankruptcy laws have an awkward history. In each case, lawmakers swept with a broad brush, giving a wide berth to the operations of the securities markets, and they did so at a time when the special treatment was quite uncontroversial. Nearly everyone was happy to leave the markets alone. With the rapid evolution of the markets in the past several decades, however, the provisions are no longer on the periphery of the bankruptcy process, and they have given rise to a steady stream of unintended consequences. Debtors have sidestepped the brokerage exclusion from Chapter 11, the settlement safe harbor has been invoked in contexts well

95. The financial reforms proposed by the Obama administration in the first half of 2009 would have precisely this effect. The administration released a lengthy white paper outlining its financial reform proposals in June 2009. See U.S. DEP'T OF THE TREAS., FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION (2009), available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

outside the transactions it was originally designed to protect, and the exemption from the stay for derivatives and other financial contracts performed much differently than advertised when Bear Stearns, Lehman and AIG failed.

In addition to speculating about the future of these provisions as bankruptcy judges continue to apply them under new or unanticipated conditions, I outlined possible legislative responses to each. The case for reversing the exclusion of brokerages from Chapter 11 seems straightforward and compelling. It also seems clear that Congress should reverse course on its relentless expansion of special protections for financial contracts, although the best strategy is debatable. The case for a legislative rewrite is weakest for the settlement safe harbor, but here too reform might reduce the current confusion.

Although the current treatment of the provisions we have considered is marked by evasion and confusion, there are grounds for encouragement going forward. The penchant for broad exclusions has been tied in important respects to the sharp line between securities law and bankruptcy law dating back to the New Deal. Largely unfamiliar with the securities markets, bankruptcy lawyers and judges generally accepted the doomsday claims of banking regulators and securities industry interest groups like ISDA, who insisted that Armageddon would ensue in the absence of special protections. However, the line between securities markets and bankruptcy is rapidly eroding. This development, coupled with the harsh light the recent financial crisis has cast on the earlier claims about the virtues of unregulated derivatives markets, make it more likely that these issues will be addressed in a balanced and better integrated fashion.