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IMPLEMENTING SYMMETRIC TREATMENT OF FINANCIAL CONTRACTS IN BANKRUPTCY AND BANK RESOLUTION

*Edward J. Janger** *and John A. E. Pottow***

INTRODUCTION

Financial contracts come in many forms and serve many functions in both the financial system and the broader economy. Repos secured by U.S. Treasury securities act as money substitutes and can play an important role as part of the money supply, while similarly structured repos, secured by more volatile collateral, may be used as speculative devices or hedges. Swaps can be used to insure against various types of market risk, from interest rates to oil prices, or they can operate as vehicles for highly leveraged investments. The parties to these instruments are sometimes major financial institutions and, other times, ordinary businesses. Default poses differing risks to the financial system depending upon the type of instrument and the nature of the parties.[1]

Under current U.S. law, however, financial contracts receive one of only two radically different types of treatment in insolvency depending on the identity of the insolvent party: banks and systemically important financial institutions (SIFIs) get one treatment; everyone else gets another.[2]

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1. Where the instrument is an important part of the money supply, such as treasury repos, then protection of liquidity may be crucial. On the other hand, the stable value of the collateral (treasuries) may mean that "systemic" liquidity of such repos will not be threatened by bankruptcy. *See* Edward R. Morrison, Mark J. Roe & Christopher S. Sontchi, *Rolling Back the Repo Safe Harbors*, 69 BUS. LAW. 1015, 1017 (2014) ("Safe harbors for . . . repos can be justified on grounds that have nothing to do with systemic risk management and they are at base sufficiently liquid and likely to retain fundamental value in a crisis that they pose no real systemic risk."). Where the instrument is speculative, delay may have an effect on the value of the instrument to the parties. But since such instruments are not serving as money substitutes, this volatility may not be a systemic concern.

2. *Compare* Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (codified as amended in scattered sections of 12 U.S.C.) (providing resolution procedures for FDIC insured banks), *and* Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, §§ 201–214, 124 Stat. 1376, 1442–1518 (2010) (codified at 12 U.S.C. §§ 5381–5394 (2012)) (providing resolution procedures for systemically significant financial institutions), *with* the Bankruptcy Code, 11 U.S.C. § 109 (2012) (permitting bankruptcy relief for individual and enterprise debtors); *see also* FIN. STABILITY BD., KEY ATTRIBUTES OF EFFECTIVE RESOLUTION REGIMES FOR FINANCIAL INSTITUTIONS (2014), http://www.fsb.org/wp-content/uploads/r_141015.pdf [hereinafter FIN. STABILITY BD., KEY ATTRIBUTES] (focusing on the failure and resolution of financial institutions); INT'L INST. FOR THE UNIFICATION OF PRIVATE LAW [UNIDROIT], PRINCIPLES ON THE OPERATION OF CLOSE-OUT NETTING PROVISIONS (2013) [hereinafter UNIDROIT PRINCIPLES], http://www.unidroit.org/english/principles/netting/netting-principles2013-e.pdf (focusing on insolvency in the ordinary economy).

More specifically, the Federal Deposit Insurance Corporation (FDIC) resolves banks under the Federal Deposit Insurance Corporation Improvement Act (FDICIA),[3] and, unless an orderly resolution can be accomplished in bankruptcy, the FDIC also now has authority to resolve SIFIs under Title II of the Dodd-Frank Act.[4] Everyone else makes use of the Bankruptcy Code.[5]

These two regimes—"bank resolution" and "bankruptcy"—focus on two different types of systemic risk associated with financial contracts. Bankruptcy focuses on the risk to capital markets if financial contracts cannot clear quickly. Bank resolution focuses on bank runs—the danger of the contracts clearing *too* quickly. Specifically, the Bankruptcy Code seeks to preserve the liquidity of certain instruments by exempting them from bankruptcy's automatic stay and avoidance powers,[6] while bank insolvency law seeks to preserve asset value of a struggling bank itself by facilitating orderly transfer of the bank's financial contracts (and other assets) to a solvent party.

The key practical difference between the regimes—stemming from these different orientations—is their respective treatment of contractual early-termination rights. Early termination or *"ipso facto"* clauses treat the filing of bankruptcy as a default per se and allow for immediate termination of a financial contract. They are often accompanied by a "walkaway clause" that extinguishes any net payment obligation of the nonbankrupt party. These clauses may preserve the liquidity and value of particular types of financial instruments for the nonbankrupt party, but they can also work together to destroy the value of any "in the money" derivative position held by the debtor. Bankruptcy law gives effect to early termination rights in the interest of liquidity. Bank insolvency law, by contrast, modifies them in the interest of value preservation and financial market stability.[7]

A primary goal of the bank resolution regime is to promote the stability of the financial system by preventing bank runs (contagion). Bank insolvency law thus briefly stays early contractual terminations that would otherwise be triggered by the commencement of a receivership. This so-called "short stay" stops a run on, and preserves the value of, the bank's

3. *See* FDICIA, 12 U.S.C. §§ 1811–1835a.

4. *See* Dodd-Frank Act §§ 201–214, 12 U.S.C. §§ 5381–5394. The Dodd-Frank Act expresses a preference that SIFIs should be resolved in bankruptcy, but if the FDIC determines that such orderly resolution in bankruptcy is impossible, it grants the FDIC the power to use its "Orderly Liquidation Authority" to address the SIFI's insolvency. Significantly, for reasons discussed below, we think it unlikely that large financial firms will be resolvable in bankruptcy without the statutory revisions we suggest in this Article.

5. *See* 11 U.S.C. § 109(b).

6. *See* discussion *infra* notes 46–49.

7. Defenders of the bankruptcy safe harbors, discussed immediately below, of course would say that their liquidity-preserving function also is in the broader service of financial market stability, which simply underscores the differing perspectives of the two systems toward financial risk.

assets for the benefit of the bank's stakeholders and the economy generally (value preservation). Early termination rights, if exercised, might allow a counterparty to escape its obligations on a financial contract that has value to the debtor. A brief suspension of those rights, however, enables the orderly transfer of the derivatives portfolio to a solvent and creditworthy entity that can then perform the contract. This preserves the financial attributes of the instrument for both parties.[8] This process actually has three steps. First, termination is briefly stayed. Second, the bank's assets are divided into "good" and "bad" assets. Third, the good assets are transferred in a timely fashion from the failed institution to a solvent one capable of performing the contract.[9] Upon transfer, the commencement of the receivership is no longer a basis for exercising the early termination rights as the counterparty is assured the benefit of its bargain under the financial contract.[10] Thus, as a practical matter, in bank resolution, and under the

8. *See* FDICIA, 12 U.S.C. § 1821(e)(9)–(10) (2012) (suspending early termination rights against banks); *see also* Dodd-Frank Act § 210, 12 U.S.C. § 5390(c)(8)–(9) (2012) (suspending early termination rights against SIFIs). Interestingly, when the definition of "qualified financial contract" was expanded in 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act expressly rendered walkaway clauses unenforceable where the FDIC was involved, but left them in place for ordinary debtors. *See* Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) of 2005, Pub. L. No. 109-8, § 902, 119 Stat. 23, 159–60 (codified at 12 U.S.C § 1821 (2012)).

9. The bad assets are left behind for takeover by the FDIC. For an overview of the FDIC resolution process, see FED. DEPOSIT INS. CORP., RESOLUTIONS HANDBOOK 8–14 (2014), https://www.fdic.gov/about/freedom/drr_handbook.pdf [hereinafter RESOLUTIONS HANDBOOK].

10. Section 210(c)(10) of the Dodd-Frank Act provides, for example:

> (B) Certain rights not enforceable
>
> (i) Receivership
>
> A person who is a party to a qualified financial contract with a covered financial company may not exercise any right that such person has to terminate, liquidate, or net such contract under paragraph (8)(A) solely by reason of or incidental to the appointment under this section of the Corporation as receiver for the covered financial company (or the insolvency or financial condition of the covered financial company for which the Corporation has been appointed as receiver)—
>
> (I) until 5:00 p.m. (eastern time) on the business day following the date of the appointment; or
>
> (II) after the person has received notice that the contract has been transferred pursuant to paragraph (9)(A).

Codified at 12 U.S.C. § 5390(c)(10). Section 210(c)(16) further provides:

> The Corporation, as receiver for a covered financial company . . . shall have the power to enforce contracts of subsidiaries or affiliates of the covered financial company . . . notwithstanding any contractual right to cause the termination, liquidation, or acceleration of such contracts based solely on the insolvency, financial condition, or receivership of the covered financial company, if . . . such guaranty or other support and all related assets and liabilities are transferred to and assumed by a bridge financial company . . . or . . . the Corporation, as receiver, otherwise provides adequate protection with respect to such obligations.

Codified at 12 U.S.C. § 5390(c)(16).

Orderly Liquidation Authority of Dodd-Frank (OLA), early termination rights are never actually exercised, and a bank run is averted.

In bankruptcy, there is no such short stay. Quite the opposite—the so-called "bankruptcy safe harbors" identify classes of eligible financial instruments and exempt those instruments from bankruptcy's automatic stay entirely, thus permitting immediate exercise of early termination rights. These safe harbors consequently permit creditors to do three things that would otherwise be prohibited by the automatic stay: (1) terminate the financial contract; (2) exercise setoff rights; and (3) sell any of the debtor's property that serves as collateral to secure the contract.[11] These rights are collectively referred to as "closeout netting."[12] Closeout netting may, broadly speaking, help preserve the liquidity of certain types of financial instruments, but it is inconsistent with the broader goals of Chapter 11 of the Bankruptcy Code, such as debtor value maximization and equal treatment of creditors. Even more troublingly from the perspective of coherent regime integration, it is inconsistent with bank resolution's goals of stopping bank runs and preserving the value of a failing entity's derivatives portfolio. For better or worse, however, Congress has enshrined the safe harbors in the Bankruptcy Code, giving rise to a marked asymmetry between the treatments of financial contracts: suspension of early termination rights in bank resolution, yet enthusiastic vindication of those same rights in bankruptcy.

The entrenchment of this asymmetry is deep-seated; commentators and international institutions alike have endorsed this exceptional treatment of financial contracts in bankruptcy under the safe harbors. Indeed, this right to immediate termination under the safe harbors, in the name of liquidity, seems to be cast by many as nearly essential to preserving financial market stability.[13] For example, the value of this right is extolled in the UNIDROIT Principles on Closeout Netting, as well as in pre-crisis documents, such as the UNCITRAL Legislative Guide and the pre-revision World Bank ICR Standard C10.4.[14]

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11. *See* 11 U.S.C. § 362(b)(6)–(7) (2012) (exempting certain setoff rights against financial contracts from the automatic stay); *see also id.* §§ 546(e)–(g), 555–556, 559 (exempting certain payments by debtor on financial contracts from the trustee's avoidance powers).

12. *See, e.g.*, UNIDROIT PRINCIPLES, *supra* note 2, at 1–2.

13. *See, e.g.*, Philipp Paech, *The Value of Financial Market Insolvency Safe Harbours*, 36 OXFORD J. LEGAL STUD. 1, 28 (2016) ("[S]afe harbours allow for exponentially increased market liquidity based on the highly efficient use of assets for purposes of collateralisation. Literally any type of asset, regardless of its legal nature, can now be turned into cash using repo or derivatives transactions.").

14. *See, e.g.*, UNIDROIT PRINCIPLES, *supra* note 2, para. 5 ("Regulatory authorities (most recently, the *Financial Stability Board* and the *Cross-border Bank Resolution Group* of the Basel Committee on Banking Supervision) strongly encourage the use of such close-out netting provisions (alongside collateral) because of their beneficial effects on the stability of the financial system."); U.N. COMM'N ON INT'L TRADE L., UNCITRAL LEGISLATIVE GUIDE ON INSOLVENCY LAW, recs. 101–07, U.N. Sales No. E.05.V.10 (2005) [hereinafter LEGISLATIVE GUIDE]; *see also*

We align with a growing chorus of commentators who question the accuracy of the assertion that closeout netting enhances market stability.[15] Indeed, recent experience in *Lehman Brothers* demonstrates that immediate termination may actually increase, rather than reduce, systemic risk by exacerbating contagion, and, worse yet, make it virtually impossible for financial firms to restructure in bankruptcy. While respect of setoff rights is essential to allowing financial counterparties to manage their derivatives exposure on a "net" basis, allowing those rights to be exercised immediately can be problematic. "*Respect*" of setoff rights and the "*timing*" of setoff are distinct issues: there is no intrinsic reason that setoff rights need to be instantly exercisable to keep systemic risk at a manageable level. Moreover, while immediate termination may well preserve the liquidity of certain classes of financial instruments, it does so only by permitting a run on the particular debtor's assets, which may destroy the debtor and in turn have its own market-destabilizing effects. Left unprotected by even a brief stay, Lehman could not reorganize, conduct a going concern sale, or preserve the value of its derivatives portfolio. And the collapse of Lehman certainly created significant instability in the financial system. Thus, at least where the firm is large enough, the negative systemic effect of allowing a run on the firm may offset any benefit to be gained by allowing early termination. Some delay in termination might thus be systemically salutary.

Although many join us in doubting the wisdom of the bankruptcy safe harbors, there is little agreement on what should be done. While some advocate outright repeal of these statutory provisions, others note that at least some financial instruments could have their liquidity attributes seriously jeopardized in the absence of some exceptional treatment in bankruptcy.[16] This Article accepts, for the purposes of this discussion at least, that there is a class of financial contracts that require special treatment in bankruptcy for systemic reasons. Precisely which instruments should receive that special treatment, and for which policy reasons, we leave to

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Proposed Revisions to the ICR Standard, WORLD BANK C10.4 (Mar. 17, 2015), http://siteresources.worldbank.org/EXTGILD/Resources/Expert_Group_Working_Draft_As_Of_March_17(Compared_to_Current_Standard).pdf. As discussed in the Symposium Introduction, and in Professor Mokal's contribution, the World Bank Standard C10.4 was recently revised to permit a short-stay approach.

15. For an excellent review of, and addition to, this literature, see Riz Mokal's contribution to this symposium. Rizwaan J. Mokal, *Liquidity, Systemic Risk, and the Bankruptcy Treatment of Financial Contracts*, 10 BROOK. J. CORP. FIN. & COM. L. 15 (2015). For further insights, also see Stephen J. Lubben, *The Bankruptcy Code Without Safe Harbors*, 84 AM. BANKR. L.J. 123 (2010) [hereinafter Lubben, *Safe Harbors*]; Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539 (2011).

16. For example, the "safe assets" described by Anna Gelpern and Erik Gerding in their contribution to this symposium provide an illustration of financial instruments that, if they are to be cash-like, may need some relief from bankruptcy's broad stay. Anna Gelpern & Erik F. Gerding, *Private and Public Ordering in Safe Asset Markets*, 10 BROOK. J. CORP. FIN. & COM. L. 97 (2015).

another day. Instead, we seek to address two problems with the current asymmetric treatment of those instruments subject to the bankruptcy safe harbors. First, as *Lehman* demonstrated, the immediate termination of financial contracts under the bankruptcy safe harbors makes it virtually impossible to resolve financial institutions in bankruptcy; and second, as one of us developed more fully in a previous article, the asymmetry itself creates a variety of arbitrage opportunities and is therefore problematic in its own right.[17]

We therefore explore how best to implement a symmetric "short stay" approach that harmonizes the bank resolution and bankruptcy regimes. In choosing the short stay regime of bank resolution over the bankruptcy "safe harbor" approach as the model for harmonization, we observe that the more orderly bank/SIFI approach has allowed for greater asset value preservation in banking cases than the immediate termination rule in bankruptcy.[18] We also note that the financial markets have, for years, tolerated the short stay of the bank resolution regime without apparent catastrophe to financial market liquidity.[19]

Our goal in advocating this symmetric approach is modest: to offer a technical roadmap toward a treatment of financial contracts in bankruptcy that is symmetric to their treatment under bank insolvency law and workable in the enterprise context. In doing so, we seek to respond to two specific critiques: (1) that any stay in bankruptcy is too long and will have unacceptable systemic risk consequences; and (2) that two days is too short to accomplish an orderly transfer of a derivative portfolio in a case where the debtor is not a bank. While these concerns are important, we think they can be addressed. The key, we contend, to the successful transplant of the bank resolution law short stay into bankruptcy is adequate assurance of future performance of the financial contract portfolio (which can be accomplished through the use of so-called "debtor-in-possession" or "DIP" financing as a financial backstop).

This Article proceeds in three steps. Part I contrasts the bank insolvency treatment of financial contracts with the approach in bankruptcy and notes that the bank resolution regime appears better tailored to preserve the value of these contracts while minimizing disruption to the financial system. Part II explores how the bank resolution approach could be replicated in

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17. *See* Edward J. Janger, *Arbitraging Systemic Risk: System Definition, Risk Definition, Systemic Interaction, and the Problem of Asymmetric Treatment*, 92 TEXAS L. REV. SEE ALSO 217, 223 (2014).

18. *See* Mark Roe & Stephen Adams, *Restructuring Failed Financial Firms in Bankruptcy: Learning from Lehman*, 32 YALE J. ON REG. (forthcoming 2015) (on file with authors) ("Alvarez & Marsal, Lehman's restructuring advisor, estimated that the disorderly close-outs of Lehman's derivative portfolio caused the Lehman estate to lose at least $50 billion in portfolio value, and maybe more.").

19. The one-day stay of FDICIA, 12 U.S.C. § 1821(e)(8)(G)(ii) (2012), has been in effect since 1991 and has not yet caused a market collapse even though numerous banks have failed.

bankruptcy, identifying the changes that would be necessary to current law, both to preserve value and to protect the legitimate expectations of nonbankrupt counterparties (i.e., assuring derivative counterparties the benefit of their bargain while preventing opportunistic breach). Finally, Part III briefly explores whether the same approach could be used, in appropriate circumstances, to allow financial contracts to be assumed and performed by the debtor itself. The Article concludes by detailing the relatively modest set of changes to current bankruptcy law that would be required to implement symmetric treatment of financial contracts in bankruptcy and bank resolution.

I. ASYMMETRIC TREATMENT OF FINANCIAL CONTRACTS – CONTRASTING BANK RESOLUTION WITH BANKRUPTCY

A. The Mechanics of the Bank Resolution Regime

Banks hold financial contracts and derivatives in their portfolios in the form of options, swaps, repos, credit default agreements, and so on. These contracts are sometimes held as assets on a bank's books as a money substitute and are sometimes used as hedges to balance other risks in the bank's portfolio. These contracts all share a common "early termination," or "ipso facto" provision, under which, upon the bankruptcy of either party, the non-bankrupt counterparty can do three things: immediately terminate the otherwise unexpired contract; liquidate any collateral securing the obligation; and setoff any other outstanding contracts with the insolvent party to yield a net position.[20] As explained above, these rights are often referred to collectively as "closeout netting."[21]

Bank insolvency law seeks to minimize the systemic effects of bank failures by preventing bank runs. As such, it recognizes that the immediate exercise of early termination rights by the counterparties of an insolvent bank might exacerbate the systemic effect of bank insolvency in several ways. Cash leaves the bank when parties exercise their rights to exit through closeout netting. If these rights are exercised en masse upon insolvency, the asset-depletion effect is the same as a bank run. In fact, it probably increases the likelihood of a traditional bank run as news of the failure of the bank leaks out. Moreover, if the bank is big and

20. These so-called "walkaway" rights are not specifically addressed by the Bankruptcy Code, but are explicitly covered by the one-day stay of the bank resolution process. *See* AM. BANKR. INST., FINAL REPORT OF THE ABI COMMISSION TO STUDY THE REFORM OF CHAPTER 11, at 106 (2014) [hereinafter ABI COMMISSION REPORT].

21. *See* UNIDROIT PRINCIPLES, *supra* note 2, at 1–2 (using the term "closeout netting" to describe any mechanism that gives rise to netting rights, whether automatically or by declaration, upon the occurrence of a predefined event). Note, however, that there is nothing unusual about these early termination rights. Almost every contract contains a so-called "ipso facto" clause in the boilerplate. The difference is that for all other contracts, the Bankruptcy Code makes those clauses unenforceable. *See* 11 U.S.C. §§ 541(c), 365(c) (2012).

interconnected with many other market participants, the effect of a single failure can become systemic.

To address these concerns of rapid financial asset collapse, the FDIC developed a method for preserving the integrity of a bank's financial contract portfolio while cushioning the effects of a single institution's failure on the banking system.[22] The technique is familiar. When a bank fails, the FDIC shuts it down,[23] usually on Friday, and over the course of the weekend the bank's assets are identified as either "good" or "bad." The good assets are transferred by sale to a solvent counterparty (usually another bank),[24] while the bad assets are held by the bank's government receiver.[25] During the short period of transition—either the weekend, or the weekend plus one to two business days—early termination rights are suspended.[26] Then, if the contracts are transferred to a solvent counterparty before the stay expires, the termination rights remain in abeyance so long as the counterparty performs its obligations under the contract.[27] A run is thereby prevented, and valuable financial contracts are preserved. This same approach was extended beyond banks to cover SIFIs under Title II of the Dodd-Frank Act with the creation of the OLA.[28] Extending the bank resolution approach to SIFIs was not just an endorsement of the efficacy of winding up failed banks while preserving financial contract value, but also a recognition that the regulatory restriction of this regime to banks alone was under-inclusive.

To be sure, the FDIC approach necessarily delays the exercise of early termination rights by some counterparties, but the result is that the value of the bank's portfolio is protected, the nondebtor counterparty receives the benefit of its bargain, and both the integrity of the banking system and the stability of financial markets are preserved.[29] Moreover, experience has

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22. *See* Michael H. Krimminger, *Adjusting the Rules: What Bankruptcy Reform Will Mean for Financial Market Contracts*, FED. DEPOSIT INS. CORP. (Oct. 11, 2005), https://www.fdic.gov/bank/analytical/fyi/2005/101105fyi.html ("The FDIC's power to transfer [financial contracts] to another open bank or to an FDIC-owned bridge bank within a business day after appointment of the FDIC as receiver allows the FDIC the flexibility to choose a resolution strategy that may retain the value in a portfolio of [financial contracts] or maximize its value through more gradual sale. In addition, a transfer of [financial contracts] to another bank or to a bridge bank also may avoid the potential market disruption that could result from an immediate liquidation of a large portfolio.").

23. FDICIA, 12 U.S.C. § 1821(c)(4)–(5).

24. *Id.* § 1821(n).

25. *Id.* § 1821(m).

26. *Id.* § 1821(e)(10)(B)(i).

27. *Id.* § 1821(e)(10)(B)(ii).

28. Dodd-Frank Act, Pub. L. No. 111-203, § 210, 124 Stat. 1376, 1460–1514 (2010) (codified at 12 U.S.C. § 5381–5394 (2012)). Specifically, the stay is codified at 12 U.S.C. § 5390(c)(8)–(9).

29. Mark Roe and Stephen Adams have advocated for the implementation of a ten-day stay (with judicial discretion to extend for another ten days) as a means to protect the value of the debtor's derivatives portfolio while simultaneously protecting the stability of the financial markets. *See* Roe & Adams, *supra* note 18. We are sympathetic to this in principle but worry that for some

shown that derivatives markets are not, and have not been, significantly disrupted by the short stay that goes into effect when a bank fails. Thus, the costs of the temporary delay appear to be offset by the benefit of preserving a valuable portfolio of good contracts.[30]

B. THE BANKRUPTCY SAFE HARBOR APPROACH

1. The Safe Harbors and Their Justification

When financial contracts are held by entities that are neither banks nor SIFIs, the Bankruptcy Code governs, with an approach that is quite different from both the bank insolvency regime and bankruptcy's own treatment of ordinary contracts.

a. Ordinary Executory Contracts

For ordinary contracts, the Bankruptcy Code mirrors the bank insolvency approach: there is no early termination because ipso facto clauses are invalidated by statutory command,[31] and any right to terminate the contract, even if triggered before bankruptcy, is suspended by the automatic stay until the debtor can decide whether to perform (assume) or breach (reject) the contract.[32] If the debtor decides to reject the contract, the costs of breach are treated as a pre-petition claim entitled to the same pro rata distribution as any other unsecured claim against the estate.[33] This right of the debtor to assume or reject a contract preserves valuable contracts for the benefit of the estate, and the treatment of rejection as an unsecured claim for breach damages equitably allocates the loss caused by default with other pre-petition creditors.[34] However, this creates a "limbo" period, while the debtor decides whether to assume or reject, during which the nondebtor is uncertain of its treatment. The principal difference between the treatment of ordinary contracts and financial contracts in bank insolvency law is the potential length of the stay and the uncertainty that it creates.

The limbo period understandably frustrates counterparties to many types of contracts. So, too, does the power of the debtor to cherry pick—to pick and choose which contracts it will perform. Accordingly, the Bankruptcy Code contains a number of exceptions and safeguards to protect various types of contracts where a delay in assumption or rejection would

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instruments a longer stay may be disruptive and, for reasons discussed below, judicial discretion to extend the stay may limit the market stabilization effect of this approach.

30. In sum, this Article assumes that the value to be preserved by preventing intemperate destruction of financial contracts offsets the costs of clearance delay on the particular instruments.

31. 11 U.S.C. § 365(e) (2012).

32. *Id.* § 365(a)–(d).

33. *Id.* § 365(g).

34. For a deeper discussion, see Jay L. Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227 (1989).

cause a particular hardship. Commercial leases are an example of contracts for which the debtor cannot just freely hoard the assumption option without paying rent.[35] The debtor must continue to perform in a "timely" fashion if it wants to preserve the lease; otherwise, automatic rejection provisions come into play.[36] Other contracts can be assumed by the debtor, but not assigned to third parties, such as personal services contracts, where the fact that the debtor will perform the contract itself is an essential part of the deal.[37] Still other types of contracts cannot even be assumed. Contracts to lend money (financial accommodations) are an example, under the theory that to force a lender to honor a pre-petition contract to lend money to a bankrupt borrower would be perverse.[38] Most importantly, however, in all cases where a contract can be assumed and/or assigned by the debtor, the counterparty is entitled to the benefit of its bargain. Specifically, the debtor must cure any breach and give adequate assurance of future performance.[39]

b. Financial Contracts and the Safe Harbors

Financial contracts are perhaps the most extreme example of contracts entitled to special treatment. Under the safe harbors of 11 U.S.C. § 362(h)(6), (7), (17), and 11 U.S.C. §§ 555 and 556, financial contracts may not be assumed or assigned. More importantly, early termination rights are neither suspended by the automatic stay nor "undone" by the ipso-facto-clause invalidation power. Quite the opposite, closeout netting is permitted unfettered by judicial intervention. Moreover, payments made in connection with the closeout of these contracts are insulated from later avoidance under Bankruptcy Code provisions designed to reverse certain pre-bankruptcy transactions (unless they are the product of intentional fraud).[40]

The bankruptcy safe harbors, first added to the Bankruptcy Code in 1982 and expanded through 2005,[41] were thought necessary to address potential systemic effects of the failure of a small—or at least not systemically significant—financial firm.[42] The legislative history reflects concern that the bankruptcy stay might disrupt the clearance of trades and

35. 11 U.S.C. § 365(d).
36. *Id.*
37. *Id.* § 365(c).
38. *Id.*
39. *Id.* § 365(b)(1), (f)(2).
40. *Id.* § 546(e)–(g).
41. With the 1982 amendments, Congress expanded the safe harbors to include the liquidation of derivatives contracts. Stockbroker-Commodity Broker Amendments to the Bankruptcy Code, Pub. L. No. 97-222, 96 Stat. 235 (1982) (amending 11 U.S.C. § 362(b)(6) and adding §§ 555–556). With the passage of BAPCPA, Congress continued this expansion by broadening the definitions of certain financial instruments covered by the safe harbors, such as, "securities contract," "commodities contract," "forward contract," "repurchase agreement," and "swap agreement." *See* BAPCPA § 907, 11 U.S.C. §§ 101(25), (53B), 741(7), 761(4).
42. In 1982, the types of contracts involved would only have been handled by a financial firm, though later expansion of the scope of the safe harbors likely changed that.

payments under derivatives and thereby render certain financial product markets unstable.[43] Specifically, there was perceived risk to the financial system if trades or payments, clearing through a failed financial intermediary, were stayed. This delay in clearance (clearance risk) could endanger the stability of the affected product markets.[44] For this reason, safe harbors were first added to the Bankruptcy Code in 1982 for transactions that were part of the securities clearance process itself and for certain instruments that function as money substitutes.[45] More transactions were included in the scope of the safe harbors in 1984 and 1994, with a significant expansion in the 2005 amendments to the Bankruptcy Code.[46] Each time, the justification (however attenuated it became) was the same: reduction of systemic risk.[47]

Early termination and closeout netting are thought to serve an important function in capital markets. Financial institutions may have a wide variety of contracts with a particular counterparty, some of which are assets and some liabilities depending on whether the instrument is in or out of the money at any given moment. The exposure on and variability of any single contract may be great, but when all the various contracts with a single counterparty are netted, the exposure will usually be much smaller as the gains and losses on individual contracts cancel out. This ability to net is thought to reduce the amount of risk in the economy and concomitantly

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43. *See* Stockbroker-Commodity Broker Amendments to the Bankruptcy Code, Pub. L. No. 97-222, 96 Stat. 235 (1982). *See also In re* Grafton Partners, 321 B.R. 527, 532–33 (B.A.P. 9th Cir. 2005) (Klein, J.) ("Public Law 97-222 was a package of amendments designed to protect the carefully-regulated mechanisms for clearing trades in securities and commodities in the public markets from [the] dysfunction that could result from the automatic stay and from certain trustee avoiding powers.").

44. H.R. REP. NO. 97-420, at 1–2 (1982), *quoted in In re* Grafton Partners, 321 B.R. at 536. The House Report states:

> The commodities and securities markets operate through a complex system of accounts and guarantees. Because of the structure of the clearing systems in these industries and the sometimes 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 possibly threatening the collapse of the affected market. The Bankruptcy Code now expressly provides certain protections to the commodities market to protect against such a "ripple effect." One of the market protections presently contained in the Bankruptcy Code, for example, prevents a trustee in bankruptcy from avoiding or setting aside, as a preferential transfer, margin payments made to a commodity broker.

Id.

45. *See In re* Grafton Partners, 321 B.R. at 536 n.17 (summarizing legislative history of 1982 amendments to the Bankruptcy Code).

46. BAPCPA § 907, 11 U.S.C. §§ 101(25), (53B), 741(7), 761(4).

47. *See* 11 U.S.C. §§ 362(b)(6), (7), (17), (27), 546(e)–(g), 555–556, 559–561. For a more complete discussion of the legislative history of the safe harbor expansion, see Charles Mooney, *The Bankruptcy Code's Safe Harbors for Settlement Payments and Securities Contracts: When Is Safe Too Safe?*, 49 TEX. INT'L L.J. 243, 247–52 (2014).

increase the ability of financial institutions to lend. Early termination, thus, reduces risk in the financial system by allowing such netting.[48]

2. The Costs of the Safe Harbor Approach

The price of this protection for financial market liquidity is the probable failure of the debtor-firm.[49] Any filer with substantial derivatives exposure is likely to be subjected to a run on its implicated assets, unprotected by the automatic stay. Early termination is thus frequently a death sentence as counterparties flee, especially if their contracts are in the money or contain a walkaway clause.[50] Because of the safe harbors, bankruptcy's protective stay cannot halt the exodus. The justification for inflicting this cost on the debtor is that the counterparties get paid and, hence, can continue to manage their own derivatives portfolio as a net exposure. On the other hand, this privileged treatment of financial counterparties increases the risk to everyone else with a stake in the debtor by reallocating value away from the unprivileged creditors and reducing any possibility of rescue. The implicit premise of the Bankruptcy Code's safe harbors is that this cost is tolerable if the failing firm is not itself systemically important. In the case of SIFIs, Dodd-Frank swoops in and the bank resolution regime applies as a backstop. Reorganization of financial firms is therefore functionally impossible in bankruptcy, and reorganization of nonfinancial firms with significant derivatives exposure also may be endangered. Congress appears to have made a policy decision that the otherwise rehabilitative goals of the Bankruptcy Code have to take a back seat to preserving the liquidity of the financial markets. These firms are collateral damage.

The *Lehman* bankruptcy showed the dark side to this approach. On the eve of its bankruptcy, Lehman asked to be converted into a bank holding company.[51] It did this in part because it would have allowed access to the Federal Reserve window for desperately needed financing.[52] Timothy

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48. David Mengle, *The Importance of Close-Out Netting* 1–3 (Int'l Swaps & Derivatives Ass'n, Research Notes No. 1, 2010). For a contrary analysis suggesting closeout netting may magnify risk, see Mokal, *supra* note 15.

49. *See* Roe, *supra* note 15, at 553 ("Prior to its collapse, Lehman owed J.P. Morgan about $20 billion. Four days before Lehman's bankruptcy, J.P. Morgan froze $17 billion of Lehman cash and securities that J.P. Morgan held, and then demanded $5 billion more in collateral. . . . Because of the exception from the Code's automatic stay . . . J.P. Morgan could immediately liquidate the collateral in Lehman's bankruptcy.").

50. Under a walkaway clause, an "out of the money" counterpart is excused from any payment obligations at the time of termination. *See* ABI COMMISSION REPORT, *supra* note 20, at 106.

51. Joe Nocera, *Lehman Had to Die So Global Finance Could Live*, N.Y. TIMES (Sept. 11, 2009), www.nytimes.com/2009/09/12/business/12nocera.html?pagewanted=all&_r=0.

52. *See Frequently Asked Questions – Discount Window Lending Programs*, FED. RES. DISCOUNT WINDOW, https://www.frbdiscountwindow.org/en/Frequently_Asked_Questions.aspx (last visited Feb. 2, 2016).

Geithner rejected this request.[53] This refusal meant Lehman had to use bankruptcy. Since Lehman was subject to the bankruptcy safe harbors, closeout of its financial contracts was not stayed. The concomitant bank run resulting from the exercise of early termination rights by counterparties led to a significant reduction in the value of Lehman's derivatives portfolio. Lehman is now gone.[54] By contrast, immediately after the Lehman failure, Morgan Stanley and Goldman Sachs became bank holding companies and, with financing from various sources, survived.[55] In sum, because Lehman was forced to use traditional bankruptcy, the safe harbors prevented the orderly transfer of its derivatives book.[56] Had it been governed by FDIC-like provisions, a better outcome might have been achieved.[57]

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53. *Id.* ("[Lehman] proposed that it be allowed to become a bank holding company. . . . But Timothy Geithner, then New York Fed president, now Treasury secretary, didn't like the idea of letting an investment bank become a bank holding company — so he said no."); *see also* Jon Hilsenrath, Damian Paletta & Aaron Lucchetti, *Goldman, Morgan Scrap Wall Street Model, Become Banks in Bid to Ride Out Crisis*, WALL ST. J. (Sept. 22, 2008), http://www.wsj.com/articles/SB122202739111460721 (discussing how after *Lehman*, other investment banks were later treated as banks). To be clear, we are not saying the bank resolution regime is generally more lenient than Chapter 11. On the contrary, bank resolution compels liquidation of the failing bank or SIFI and is widely seen as tougher. *See* David Skeel, *The New Synthesis of Bank Regulation and Bankruptcy in the Dodd-Frank Era* 13 (Research Handbook on Corporate Bankruptcy Law, Barry Adler ed., Elgar Press, forthcoming 2015–2016) (on file with authors) ("Unlike ordinary bank resolution, which permits the FDIC to reorganize a bank through a 'conservatorship,' Title II provides only for receivership, which in bank resolutions under the FDI Act is nearly always used to liquidate the troubled bank."). We are simply saying that, with regard to treatment of financial contracts, the bank resolution regime would have been more protective of value.

54. *See* Roe & Adams, *supra* note 18, at 21. ("Alvarez & Marsal, Lehman's restructuring advisor, estimated that the disorderly close-outs of Lehman's derivative portfolio caused the Lehman estate to lose at least $50 billion in portfolio value, and maybe more.").

55. Hilsenrath, Paletta & Lucchetti, *supra* note 53. Dodd-Frank, in effect, now enacts this change for all SIFIs.

56. This view is taken by Morrison, Roe & Sontchi in their article, *Rolling Back the Repo Safe Harbors*, *supra* note 1, at 1029–30.

> [B]y permitting counterparties to "run" on failing institutions . . . the safe harbors accelerate failure and exacerbate the risk of systemic collapse. This is a lesson of the Lehman Brothers bankruptcy: during the days preceding and following the filing, counterparties refused to roll over repos (or demanded larger haircuts) and terminated other financial contracts en masse, effectively draining Lehman of liquidity. Had Lehman not become so dependent on safe-harbored repos—more than one-third of its liabilities were said to be in repo—it might have been better positioned to weather the crisis long enough for a more stable solution to emerge.

Id. at 1030.

Others have argued that the safe harbors did limit contagion. Seth Grosshandler told Congress:

> The effectiveness of the safe harbors in containing contagion was demonstrated during the bankruptcy of Lehman Brothers. None of Lehman Brothers' counterparties (many financial institutions among them) failed because of losses under Safe Harbored Contracts with Lehman. Almost all counterparties exercised their safe-harbored rights to terminate, net and exercise rights against collateral, with only approximately 3% of

The *Lehman* experience has led commentators to suggest that bankruptcy is not a congenial place to restructure financial firms.[58] Title II of Dodd-Frank responds to this problem partially by extending bank insolvency-type treatment to SIFIs.[59] This solves the problem for those institutions, but there is no guaranty that the relevant regulators have identified all such institutions. If a large financial, or nonfinancial, institution that the FDIC has not identified as a SIFI fails, it must file for traditional bankruptcy and will be subject to the safe harbors. This means that for these shadow-SIFIs, Dodd-Frank provides no protection to the financial system. For example, the FDIC recently declared GE Capital Corporation a SIFI.[60] The good news is that GE is now properly characterized. The bad news is that it existed as a mischaracterized entity for a significant period. There are certainly others.

Thus, the problematic treatment of financial contracts in bankruptcy remains an issue for firms whose financial contracts may constitute an important portion of their value. More troublingly, the failure of some of these institutions may have systemic implications.

II. IMPLEMENTING SYMMETRIC TREATMENT OF FINANCIAL CONTRACTS

After *Lehman*, a number of commentators (including one of us) have suggested that the bankruptcy approach to financial contracts ought to be adjusted to mirror the bank insolvency regime.[61] In particular, a short stay could apply to the closeout of financial contracts. In this Part we argue that

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> Lehman's derivatives book remaining outstanding after three months following its bankruptcy petition. If these counterparties were not protected by the safe harbors, these positions would have been indefinitely frozen, causing potentially catastrophic capital and liquidity implications for counterparties in addition to any losses under the contracts.

Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives, Hearing Before the H. Subcomm. on Regulatory Reform, Commercial & Antitrust Law of the H. Comm. of the Judiciary, 113th Cong. 6 (2014) (statement of Seth Grosshandler). These two positions are not necessarily mutually exclusive. Certain financial contracts may merit special treatment, but immediate exercise of early termination rights may not be—or may not have been—the best choice. *See also* Roe, *supra* note 15 (discussing risk amplification); Roe & Adams *supra* note 18, at 25 (advocating for implementation of a ten-day stay in bankruptcy).

57. Worse, because Lehman itself was a systemically important institution, the safe harbors may have enhanced rather than limited systemic contagion, which is why Dodd-Frank created the Orderly Liquidation Authority for SIFIs. *See* Roe, Morrison & Sontchi, *supra* note 1, at 1029–30.

58. *See generally* Roe & Adams, *supra* note 18 (discussing *Lehman*).

59. The resolution rules are set forth in Title II of the Dodd-Frank Act, entitled Orderly Liquidation Authority (OLA). *See* Dodd-Frank Act, Pub. L. No. 111–203, tit. II, 124 Stat. 1376, 1442 (2010).

60. There have been some encouraging developments in the FDIC's recent focus on designating new SIFIs. For example, recently GE Capital Corporation was declared a SIFI. *See* FIN. STABILITY OVERSIGHT COUNCIL, BASIS OF FSOC'S FINAL DETERMINATION REGARDING GENERAL ELECTRIC CAPITAL CORPORATION 1 (2013).

61. *See* Janger, *supra* note 17, at 223.

such symmetric treatment could be implemented in a way that is both sensitive to concerns about liquidity and allows for preservation of the value of a firm's derivatives portfolio (including the risk management function of any hedges). It might also facilitate the rescue of the firm by preventing a tremendous cash drain at the outset of the case.[62] Symmetric treatment is not as simple as just extending the short stay regime from banking law into the Bankruptcy Code, however. Questions remain about how to accomplish an orderly transfer in a short period of time, as well as how to assure performance of contractual obligations during the stay and after assumption and/or assignment. Thus, the remainder of this Article will describe the nuts and bolts required for implementation of a short stay regime in bankruptcy.

While the practical details may be complicated, the conceptual lynchpin that anchors the enterprise is not: the debtor must provide the financial contract counterparty with adequate assurance of performance.[63] When any contract is assumed in bankruptcy, the debtor cannot claim the benefit of that contract without performing its obligations. Thus, for financial contracts as well, the debtor must assure that the financial contract will be performed (i.e., that the counterparty will receive the benefit of its bargain). This principle is symmetric with bank insolvency's protections. When the FDIC stays early termination rights and transfers the contract, it also stands behind the contract or ensures that somebody else will. In the absence of the FDIC or a solvent substitute, derivatives counterparties are legitimately concerned that they will be left high and dry. Having invested in a financial contract with a once-solvent party, they suddenly find themselves facing credit risk.

Bankruptcy's current method for protecting nondebtor parties to financial contracts, explained above, is one of self-help: the safe harbors give the counterparties the right to insist on immediate payment as a way of looking out for themselves. However, as also explained above, that is a potentially costly approach. Accordingly, so long as the debtor can assure the counterparty the benefit of its bargain—as we will discuss below, either by assigning the contract to a solvent counterparty or by providing a credit enhancement from a creditworthy institution—a better approach might be to suspend early termination during a short stay pending assumption and assignment. If a derivatives counterparty can be provided with adequate assurance that the obligation under the derivative will be performed, there is no reason to grant it additional exit rights by allowing immediate closeout netting.

62. The debtor would still need to perform its obligations under the contracts as they came due, but it would be freed of the threat of early termination.

63. As discussed below, care must be taken in identifying the contracts that are entitled to special treatment, but analyzing the policy bases for singling out particular types of contracts for that special treatment is beyond the scope of this Article.

The steps to achieving both market stability and value preservation are: (1) to define the class of contracts entitled to the special treatment; (2) to identify the contracts entered into by the debtor that satisfy those definitions; (3) to require that the obligations under the contract be performed while the termination rights are temporarily suspended during the short stay; and (4) to ensure that adequate assurance of future performance is provided when the contracts are ultimately assumed and/or assigned. We address each step in turn.

A. CLEAR LEGISLATIVE DEFINITIONS OF "ELIGIBLE FINANCIAL CONTRACTS"

In bank insolvency, all contracts receive the same treatment, namely, a short stay of early termination and closeout netting, followed by suspension of those rights for contracts that are assumed by the solvent transferee who continues to perform. To import this approach into bankruptcy, it is necessary to decide which types of contracts should be entitled to this special short-stay treatment. This is preferably a legislative, rather than judicial, question, and it must be asked with careful attention to scope and clarity. Much has been written elsewhere about the problematic definitions of safe-harbored contracts under the current Bankruptcy Code. For example, the definition of "settlement payment," it has been argued, can be read to include the ordinary payments on the contract for the purchase of a bar and grill (even if the payments are in nonpublic stock).[64] In addition, the safe harbor for "securities contracts" has been held to include the typed statements of accounts provided to investors in the Madoff Ponzi scheme.[65] The broad, malleable definitions in current law can give sophisticated parties the option to create bankruptcy-remote transactions wholly divorced from the underlying justifications for the safe harbors.

This loose drafting has led to myriad recommendations to narrow the scope of the safe harbors.[66] As a policy matter, we agree that the rationale for exempting particular types of contracts ought to be based upon clearly identified and empirically grounded systemic-risk concerns that inhere in the type of instrument or the nature of the parties to the contract.[67] More

64. In *In re* MacMenamin's Grill, Ltd., 450 B.R. 414, 425 (Bankr. S.D.N.Y. 2011), Judge Drain sought to exclude these payments from safe harbored treatment by noting that they were payments to the ultimate beneficiary of a private transaction, not "financial markets" transactions with systemic risk implications. After *Enron* and *Madoff*, however, it seems unlikely that this is still good law, at least in the Second Circuit. *See In re* Bernard L. Madoff Inv. Sec. LLC, 773 F.3d 411 (2d Cir. 2014); *In re* Enron Creditors Recovery Corp., 651 F.3d 329 (2d Cir. 2011).

65. *Madoff*, 773 F.3d at 418.

66. *See generally* Morrison, Roe & Sontchi, *supra* note 1 (critiquing safe harbors for repos with volatile collateral); ABI COMMISSION REPORT, *supra* note 20.

67. The World Bank recently adopted its best practice standard C10.4 to reflect this view. WORLD BANK, PRINCIPLES FOR EFFECTIVE INSOLVENCY AND CREDITOR/DEBTOR RIGHTS SYSTEMS C10.4, at 21 (2015) [hereinafter WORLD BANK PRINCIPLES]. We applaud this move.

importantly, as a practical matter, and for reasons set out in the next Subpart, the transactions subject to special treatment must be easy to identify and characterize. This clarity is necessary not just for purposes of financial transparency, but also because decisions about their treatment will have to be made quickly during the pendency of the short stay. More broadly, the list needs to be sufficiently stable to be relied upon by financial market investors. Thus, our first step is to recommend, as a substantive requirement, the establishment of clearly defined set of "eligible financial contracts" subject to the special short-stay treatment in bankruptcy.

B. EXPEDITED JUDICIAL ASSESSMENT OF "ELIGIBLE FINANCIAL CONTRACTS"

Eligibility for special treatment is a legislative judgment that turns on the nature of the instrument and its effect on financial markets, not the intent of the parties. Parties put labels on contracts all the time to secure favorable bankruptcy treatment, but characterization of a contract by the parties as an "eligible financial contract" does not necessarily make it so.[68] There must be some judicial opportunity to monitor compliance with whatever classification is deployed. In the absence of a stay, there is no such opportunity, because any judicial review would be well after the fact. As Judge Peck fairly complained, for example, in *Lehman*, the closeout of financial contracts happened immediately and effectively without judicial scrutiny because of the safe harbors.[69] The first procedural requirement, therefore, is to give the bankruptcy court an opportunity to ensure that contracts are properly characterized as eligible for the shortened stay.

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68. As we have noted, the class of safe harbored contracts may, under current law, be overbroad, and without a doubt, the statute is not clearly drafted. Fixing these problems is beyond the scope of this Article. Imposition of a short stay would have to satisfy a baseline resistance in bankruptcy to accord special treatment to creditors in violation of the system's strong equality norms, but also confront the sense of entitlement current safe harbor creditors likely feel to avoid any stay at all—as soon as they can get their lawyer to file a motion. Compounding this difficulty is the collateral but essential question of properly defining the scope of which contracts are allowed this exceptional treatment. Current bankruptcy law is criticized as getting that cut wrong and so may need some modification. Whatever the optimal definition is, we know one thing that will not work: party self-declaration. *See* Darrell Duffie & David Skeel, *A Dialogue on the Costs and Benefits of Automatic Stays for Derivatives and Repurchase Agreements* 17–23 (Univ. of Pa. Law Sch.: Legal Scholarship Repository, Paper No. 386, 2012), http://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1385&context=faculty_scholarship (discussing various theories on which financial contracts should and should not be subject to the safe harbor provisions).

69. *See* Hon. James M. Peck et al., *The Long and Short of It – Financial Engineering Meets Chapter 11*, Eighty-fifth Annual Meeting of the National Conference of Bankruptcy Judges (Oct. 14, 2011); *see also* Hon. James M. Peck, *Bankruptcy Treatment of Financial Contracts: Lessons for Developing and Emerging Markets*, World Bank Insolvency and Creditor/Debtor Regimes Task Force Meetings (Jan. 11, 2011) http://siteresources.worldbank.org/EXTGILD/Resources/WB_TF_2011_Bankruptcy_Treatment_of_Financial_Contracts.pdf.

This threshold requirement raises its own complications, however, because subjecting financial contracts to bankruptcy court jurisdiction might itself have "systemic" consequences. Any indication that a bankruptcy judge might stay termination of a contract—for whatever length of time—raises concerns about value.[70] Contracts that clear automatically are priced differently (i.e., more favorably to the borrower) from contracts where clearance may be delayed. Collateral also may be volatile, and contracts may move in to or out of the money. If the debtor is allowed to "use" the collateral, that collateral might dissipate or at the very least deteriorate. Also, delay itself has costs. How much delay is too much and how much uncertainty the markets can tolerate are difficult empirical questions.

Luckily, there is data. While we do not know how much time or uncertainty markets will tolerate, we do know that financial markets can and do handle the short, defined delay associated with bank resolution. Herein lies the simplicity of symmetric treatment. It does not ask market participants to face an unknown risk. In other words, if the outer bounds of the delay are congruent with the short stay in bank resolution, there should be no additional market disruption beyond what we have seen with banks.[71] Thus, bankruptcy can craft a solution to this problem by using the bank resolution approach as an outside limit. Just as the FDIC has a weekend plus one-business day to sort a bank's assets into good and bad, form a bridge bank, and find an appropriate assignee, so too would a bankruptcy judge face the same constraint.[72]

The time horizon, however, is just one consideration. The second is the role of a jurist with discretion. Markets can more readily "price" a fixed interval of known duration than an indeterminate delay.[73] Accordingly, the stay should be not just short, but nondiscretionary. That is, the stay must lift at the end of the defined period automatically, regardless of whether the financial contracts were transferred (unless, of course, within the defined

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70. One popular derivatives handbook advises financial risk managers that securing safe harbor treatment is a top priority for handling counterparty risk. *See* PHILIP M. JOHNSON, DERIVATIVES: A MANAGER'S GUIDE TO THE WORLD'S MOST POWERFUL FINANCIAL INSTRUMENTS 47 (1999).

71. There is neither a fixed number of banks and SIFIs nor a static allocation of institutions between the FDIC/OLA regime and bankruptcy's safe harbor regime. Under current law, it is uncertain whether a firm is a SIFI, and even if it is a SIFI, it is up to the FDIC to determine whether it will be resolved in bankruptcy or under the OLA. We therefore fail to see how the market would be adversely affected by extending the short stay regime to cover financial contract debtors who use the bankruptcy system. Indeed, such symmetric treatment might prove cost-reducing in pricing contracts, ensuring that like instruments would receive the same insolvency treatment regardless of counterparty.

72. Recall that the one-business-day stay of the bank resolution process is nondiscretionary and becomes effective immediately upon the appointment of a receiver. FDICIA, 12 U.S.C. § 1821(e)(10)(B)(i) (2012).

73. More precisely, pricing an indefinite delay is likely to be so complex that it would chill the market.

period, the court declares the particular instruments as not properly characterized as "eligible financial contracts"). The court will not have a lot of time, and the stakes are high, but no higher than in bank resolution. Within the assigned period, the debtor and the court would need to identify any mischaracterized contracts and accomplish the transfer to a solvent counterparty. However, seasoned bankruptcy practitioners and judges are more than used to fast timeframes. Many cases are prepackaged, and few bankruptcy cases arrive on the courthouse steps without significant advance planning. Thus, the second step of our proposal involves a short, fixed period (which matches the bank insolvency regime's interval) during which the financial contracts portfolio can both be adjudicated for proper classification and transferred to an appropriate assignee.

C. TIMELY PERFORMANCE OF OBLIGATIONS – SHORT-TERM LIQUIDITY

The symmetric approach strives to maintain market stability notwithstanding bankruptcy. Therefore, counterparties must be assured that, as a practical matter, bankruptcy is not synonymous with nonperformance. The quid pro quo for nonenforcement of early termination or bankruptcy default clauses is that the filing of bankruptcy will not lead to abrogation of the contract. To justify the suspension of early termination rights, the debtor must continue to perform its obligations under the financial contracts, just as is done in the bank and SIFI regimes.[74] Some financial contracts contemplate periodic payments, and some may close out by their own terms during the suspension period. These ordinary course payments should be allowed to continue, even during the short stay, pending transfer.

Note that this treatment is not permitted for ordinary executory contracts in bankruptcy; pre-petition debt is not paid post-petition unless the contract is assumed.[75] Failure to perform will not deprive the debtor of the ability to cure any default and assume the contract.[76] For financial contracts, however, such a limbo period, where the status of the contract is uncertain and no payments are being made,[77] could be problematic, because such

74. This is true both in the bank insolvency regime and under the European Union Collateral Directive. *See* FIN. STABILITY BD., KEY ATTRIBUTES, *supra* note 2, sec. 4.2 ("Subject to adequate safeguards, entry into resolution and the exercise of any resolution powers should not trigger statutory or contractual set-off rights, or constitute an event that entitles any counterparty of the firm in resolution to exercise contractual acceleration or early termination rights provided the substantive obligations under the contract continue to be performed.").

75. 11 U.S.C. § 365(d) (2012).

76. *Id.* § 365(b).

77. "[The Bankruptcy] Code is silent on the rights and obligations of the parties to an executory contract during the limbo period—that is, the period between the filing of the petition and the time of assumption or rejection." *In re* Nat'l Steel Corp., 316 B.R. 287, 305 (Bankr. N.D. Ill. 2004) (quoting GEORGE M. TREISTER ET AL., FUNDAMENTALS OF BANKRUPTCY LAW 247 § 5.04(e) (5th ed. 2004)).

uncertainty would be anathema to counterparties needing to know their cash positions and exposures on a current basis. Symmetric treatment would thus require that the obligations under the contract be performed in the ordinary course, notwithstanding the shortening of the automatic stay.[78]

The harder question is where the debtor will get the liquidity to make these ordinary course payments. Here, we think the bankruptcy regime has robust experience at incentivizing capital infusions to failing debtors, through section 364 of the Bankruptcy Code and its provisions for so-called "DIP" financing. The Code provides generous legal protections to a DIP lender, and debtors rarely file for bankruptcy without having identified a source of post-petition liquidity. There is no reason, at least conceptually, why a DIP lender could not, on the first day of the case, announce that it was backstopping the debtor's financial contracts. Instead of allowing early termination by the nondebtor counterparty, the Bankruptcy Code could allow the debtor to perform its obligations in the ordinary course and require the nondebtor to accept that performance in the absence of a monetary breach. Indeed, it would be as if there were no breach of contract in the first place and hence no basis for termination.

During the short stay, while the identity of the assignee is uncertain and/or the assignment is still pending, the DIP facility could handle the demands of ordinary course closeout of contracts, as well as the periodic payments required under some swaps during the period prior to transfer. This may seem like a huge additional expense until one recognizes that most financial firms try to build a balanced derivatives portfolio. For many debtors, the net exposure of the derivatives portfolio should be relatively small. This should also be true for nonfinancial firms that are using their swaps or derivatives to hedge other risks in their businesses. For example, an airline will hedge the price of jet fuel, or a snack food company might hedge the price of corn sweetener. Just as a firm may conclude that, on balance, it is in the best interest of the business to pay critical vendors, it may similarly conclude that it makes sense to continue managing the derivatives portfolio in the ordinary course. So, while the nominal (gross) exposure may seem quite large, so long as early termination rights are stayed, the daily swings should be manageable.

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78. This treatment is not unusual in bankruptcy cases. Where a debtor seeks to preserve a business relationship, be it an executory contract (*see* 11 U.S.C. § 365), a supplier relationship (*see In re* Tropical Sportswear Int'l Corp., 320 B.R. 15, 20 (Bankr. M.D. Fla. 2005) (permitting partial payment of pre-petition debt to a critical vendor)), or a credit facility (*see In Re* Michael Day Enter., No. 09-55159, 2009 WL 7195491, at *7–8 (Bankr. N.D. Ohio Nov. 12, 2009) (permitting roll-up of lender's pre-petition debt into post-petition DIP loan)), courts have generally allowed the debtor to cure defaults and perform obligations in a timely fashion, even where this is not expressly authorized by statute. *See In re* Kmart Corp., 359 F.3d 866 (7th Cir. 2004) (leaving open the possibility that a bankruptcy court may grant a critical vendor motion under § 363(b)(1) of the Bankruptcy Code despite an apparent lack of express authority under § 105(a)).

At first, memories of 2008 may make this idea seem whimsical. Where Lehman was involved, no bank, or even syndicate, was big enough to provide financing.[79] However, this may not always be the case. Indeed, after Dodd-Frank, the remaining entities using bankruptcy to reorganize should, by definition, not be systemically important. If they are systemically significant, their failure should be dealt with under Dodd-Frank, and resolution under the OLA will be available as a backstop. Thus, unless there has been an error in classification by the Treasury (hopefully a rare occurrence),[80] the DIP loan liquidity described above should not be beyond the capacity of an ordinary lender. Therefore, and third, ordinary course payments should be permitted during the short stay.

D. Adequate Assurance of Future Performance – Acceptable Assignees and Credit Enhancement

As mentioned above, the quid pro quo for temporarily suspending the contractual right to terminate is ensuring that the nondebtor counterparty receives the benefit of its bargain. This raises a second, perhaps more complicated, issue: the need to identify a suitable transferee who is prepared and qualified to assume the debtor's obligations on the contract. In the bank insolvency regime, the FDIC simply sells the assets to another solvent bank.[81] In bankruptcy there is no agency to arrange and facilitate such a transfer. Thus, providing adequate assurance of future performance entails at least two requirements: (1) identifying an acceptable transferee; and (2) facilitating the transfer, perhaps through the issuance of a sweetener or credit enhancement.

1. Assignee Criteria

The process of finding an appropriate and willing assignee of the financial contracts that is acceptable to the nondebtor counterparty may not be simple. Thus, in order to make a transfer work within a short timeframe, easily ascertainable criteria of assignee acceptability are a necessity. These criteria might be stated in a pre-published list of acceptable counterparties or in terms of a minimum bond rating of the proposed assignee. Either way, the criteria would need to be dealt with in advance by legislation, regulation,

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79. *See generally* Steven Rattner, Overhaul: An Insider's Account of the Obama Administration's Emergency Rescue of the Auto Industry (2011) (addressing freeze of DIP financing market during financial crisis).

80. We recognize that we have earlier expressed concern over the accuracy in classifying SIFIs, see *supra*, text accompanying note 60 (observing foot-dragging in recognizing GE Capital as a SIFI), but we believe debtors that are "too big to DIP" are likely to be SIFIs as well.

81. *See* Resolutions Handbook, *supra* note 9, at 8 ("When an FDIC-insured financial institution is about to fail, the FDIC takes immediate action to resolve it by selling the franchise of the failing institution—its deposits, branch locations, and assets.").

contract, or perhaps even court rule, so that the eligibility of a transferee, to the greatest extent possible, can be immediately determined.

2. Assignment – Credit Enhancements

Once the pool of eligible assignees has been determined, it is still necessary to find a willing purchaser. Finding a willing purchaser may require financial enticement. Even if a willing assignee can be identified, it might be only partially willing (i.e., unable or unwilling to take on all of the risk of the portfolio). Some forms of credit enhancement might therefore be necessary in order to give the portfolio risk attributes that are attractive to the market.[82]

The key lies in the assurance of future performance. Indeed, when a debtor files for bankruptcy it chooses which commercial relationships to retain and which to abandon. If the relationship is, on balance, of value to the estate, the debtor will elect to perform its obligations in order to obtain the benefit of return performance. This is the logic of section 365 of the Bankruptcy Code, which grants a debtor the option to pick and choose its desired executory contracts. The debtor is of course required to cure all defaults before it can assume, and must also give assurance of future performance. This approach is similar to the one followed, as a practical matter, with regard to critical vendors, key employees, and others.[83] There is no conceptual reason it could not similarly be applied to financial contracts.

For these financial contracts, the lynchpin to performance is financing. One possible solution to this problem might be to construct a standby credit facility to underwrite the performance of the transferee, funded by the DIP lender. As mentioned just above, DIP lenders operate as the source of liquidity during bankruptcy. They approve expenses that are deemed to be in the estate's best interest. When the debtor seeks to pay critical vendors, the DIP lender loans the money. When the debtor seeks to assume a contract, the DIP lender may lend the cure payments.[84] Accordingly, just as the DIP financing order can be used to guaranty liquidity during the period prior to transfer, it might, in some circumstances, also provide a necessary credit enhancement as a two-fold sweetener. First, the debtor-funded enhancement will thicken the pool of putative assignees, who might see

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82. *Id.* at 18 ("An optional shared loss [Purchase and Assumption] is a resolution transaction where the FDIC, as receiver, agrees to share losses on certain types of assets with the [Acquiring Institution]. . . . During the most recent crisis, the FDIC has offered loss share where the [Acquiring Institution] accepts 20 percent of the losses, or more, depending on the bid.").

83. Some contracts, such as a contract to lend money, are not assumable, 11 U.S.C. § 365(c)(2), but that is not the issue with a repo, for example, where the money has already been lent.

84. *See* Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 515 (2009) ("With respect to creditor control, several papers have documented the frequency of in-bankruptcy lines of credit (DIP financing) during the 1990s.").

some in-the-money potential of the portfolio but nonetheless remain skittish about incurring the risk. Second, and perhaps more importantly, the financial backstop will assuage the contract counterparty that a new, unknown assignee will itself be able to perform.

Of course, in some cases, the purchaser/transferee of a debtor's financial contracts will be sufficiently creditworthy to satisfy the hedge counterparties by reputation alone. If not, however, then just as the DIP financing order might provide liquidity prior to transfer, the DIP lender might find it worthwhile to provide a standby credit facility to ensure that the financial obligations of the contract will be covered by the transferee. Again, assuming a DIP lender who sees value in the continued operations of the debtor, the need for government intervention is unlikely for all but the very largest institutions, which should ideally fall under the SIFI regime already. Thus, and finally, the DIP lender might backstop adequate assurance of future performance, ensure the nondebtor counterparty the benefit of its bargain, and eliminate the justification for early termination.

III. TRANSFER VERSUS ASSUMPTION

While the foregoing list of requirements sketches the basic contours of how financial contract symmetry could be achieved in bankruptcy, an important difference between bank insolvency and bankruptcy persists. Namely, in bank insolvency, the institution is resolved or liquidated.[85] The assets that can be sold are sold, hopefully in a way that preserves value, and the assets that cannot be sold are resolved by the FDIC. In bankruptcy, however, the debtor may continue in business, perhaps in modified form, discharging its pre-petition liabilities pursuant to the plan of reorganization and honoring its post-petition liabilities on a current basis.[86] This creates a survival possibility that does not exist with banks that never "emerge" from FDIC resolution.

Accordingly, in bankruptcy, it may be in the creditor's best interests for a debtor with a good business—perhaps swept under by a liquidity crunch—to continue its operations. When the business includes derivatives as investments or hedges, the debtor may wish to assume its derivative book and continue to perform its obligations. To the extent that these derivatives were being used as hedges against business risks that continue during reorganization, the debtor may well want to continue that operational hedge. Again, an airline, for example, might wish to keep its jet fuel hedges in place, or the snack food manufacturer may not wish to be exposed suddenly to price fluctuations in corn. So long as the obligations continue to be

85. *Compare* the Bankruptcy Code's Chapter 11 reorganization process, 11 U.S.C. § 109(b), *with* the compelled liquidation of FDICIA, 12 U.S.C. § 1821(m)–(n) (2012), the Orderly Liquidation Authority, 12 U.S.C. § 5390, *and* 12 U.S.C. § 5394.

86. *See* 11 U.S.C. § 1141.

performed, and the DIP lender stands behind the contracts, there seems to be no reason to allow early termination; the debtor should be allowed to assume its financial contracts.[87]

CONCLUSION

The modified bankruptcy regime contemplated above seeks to mirror the bank insolvency regime with regard to quick, orderly transfer of financial contracts to a solvent assignee or, in appropriate cases, assumption by the debtor over the period of a short stay that suspends early termination rights. Suspension of those rights, however, should not occur without adequate assurance of future performance. This can be provided either by the creditworthiness of the transferee itself or by credit enhancements that may be implemented through the debtor's DIP loan. Accordingly, the following specific changes to the Bankruptcy Code are recommended:

i. First, a short stay should be added to the safe harbors. Instead of exempting financial contracts from the automatic stay altogether, they should be subject to a short stay that will lift automatically after a defined period, whether or not a transfer of the derivatives book has been accomplished.

ii. Second, the definition of "eligible financial contracts" should be clarified, both so that the systemic reason for special treatment is well understood and justified, and so that the covered contracts can be easily identified when challenged during the short stay period.

iii. Third, the bankruptcy court should be given the power to deny short-stay treatment if an instrument is not properly characterized as an "eligible financial contract," but only if the determination is made within the short, fixed period.

iv. Fourth, bankruptcy management powers should be clarified to enable the debtor to make payments on financial contracts in the ordinary course. Any necessary financing for liquidity to effect this could come from the DIP facility, repayment of which could be accorded the same, or even higher priority to the DIP loan. This backstop would assuage skittish financial counterparties.

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87. One possibility might be to make obligations under financial contracts of equal or senior priority to the DIP loan. This, in essence, would mean that a debtor could not reorganize unless the DIP was prepared to stand behind the financial contracts. Debtors who complain that this could crush reorganization prospects by making DIP financing unattainable can be reminded that the alternative is unilateral early termination and closeout.

v. Fifth, section 365 of the Bankruptcy Code should allow for the assumption of financial contracts, provided that the debtor continues to perform its obligations in a timely fashion and cures any non-ipso-facto defaults.

vi. Sixth, "adequate assurance of future performance" provisions need to be clearly defined to more easily identify acceptable transferees for financial contracts. Bond ratings, pre-certification registers and the like could be deployed as screening mechanisms here. Adequate assurance could be provided either by the transferee itself or through a credit enhancement provided by the DIP lender.[88]

These comparatively modest changes could implement the basic concept of ensuring derivatives counterparties the benefits of their bargains, notwithstanding bankruptcy, in exchange for a short delay in their netting rights. At the same time, these changes would recognize the need for special treatment of particular classes of financial contracts in the name of financial market stability. It is therefore essential that the category of safe-harbored instruments be well defined, easily identifiable, and limited to financial instruments whose importance to the financial system justifies the special treatment.

The debate surrounding the bankruptcy safe harbors for derivatives has been heated. Some take the view that the bankruptcy safe harbors should be repealed wholesale. Others take the view that doing so would trigger a financial Armageddon.[89] While we see the current incarnation of the safe harbors as anachronistic and poorly drafted, we have accepted, for the purposes of argument, that certain financial instruments serve as money substitutes or have other attributes that make their immediate clearance essential to the financial markets. Whatever the importance of that necessary speed, however, financial markets currently tolerate short, defined delays in clearance where bank failures are involved. The short delay in the bank insolvency regime has allowed for the orderly transfer of financial contract portfolios to solvent counterparties, thereby preserving the value of those portfolios to the economy and the failing firm.

These observations are not unique to us, and they have generated a number of proposals for the short stay to be adopted in bankruptcy.[90] We agree, and have sought to take the next step, proposing how the Bankruptcy Code could be changed to implement transfer or assumption during a short stay. We borrow a page from the Dodd-Frank playbook, which implicitly

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88. This might be too detailed for statutory treatment, so perhaps U.S. Trustee administrative guidance could suffice.

89. This debate is reviewed in Mokal, *supra* note 15.

90. *See, e.g.*, Roe & Adams, *supra* note 18.

recognizes the need for some stay assistance to protect SIFIs. But even for SIFIs, some additional legislation within the Bankruptcy Code may be required (a topic tangential to the scope of this Article but worth a quick detour). The FDIC appears to favor a so-called "single point of entry" (SPOE) approach to reorganizing SIFIs in bankruptcy.[91] In fact, a number of bills are pending in Congress to help implement such an approach.[92] Under such a strategy, the breadth of the safe harbors may cause problems. The premise of SPOE is that a financial firm should be restructured by resolving the holding company in bankruptcy while leaving the various subsidiaries outside bankruptcy. Recapitalization of the firm is to be accomplished through a bail-in of debt at the holding company level that would then provide needed liquidity to the subsidiaries. One assumption of the SPOE approach is that any financial contracts will be governed by the so-called International Swaps and Derivatives Association (ISDA) Resolution Stay Protocol. Under the Resolution Stay Protocol, all financial contracts are subject to a short stay as a matter of contract. The key point here is that it is assumed that the subsidiaries would continue to perform all of their obligations, including their obligations under financial contracts, and that any transfer of the contracts to a bridge or trust entity would occur within the stay period, thus avoiding the early termination of any financial contracts. The problem, however, is that the Bankruptcy Code's definition of safe-harbored contracts is not limited to derivatives that are subject to the stay protocol. It is, therefore, possible to imagine that the holding company might be an obligor on safe harbored contracts, or that cross-default provisions might trigger early termination rights that are not subject to the stay protocol. In either of these situations, an inability to handle the financial contracts in an orderly fashion might be catastrophic for the orderly recapitalization of the financial firm. Both bills currently pending in Congress appear to recognize this and would legislate a forty-eight hour stay, but this would apply only to covered financial institutions. These lacunae provide yet another reason why the flexibility of a legislated short stay, coupled with the possibility of assuming financial contracts, could reduce rather than increase systemic risk, and we see little reason for

91. *See* Press Release, Fed. Deposit Ins. Corp., FDIC Board Releases Resolution Strategy for Public Comment (December 10, 2013), https://www.fdic.gov/news/news/press/2013/pr13112.html.

92. The House Judiciary Committee recently voted H.R. 2947, The Financial Institution Bankruptcy Act of 2015, out of Committee, and a bill to create a special Chapter 14 for financial firms is currently pending in the Senate. *See H.R.2947 – Financial Institution Bankruptcy Act of 2015*, U.S. CONGRESS, https://www.congress.gov/bill/114th-congress/house-bill/2947/all-actions?q=%7B%22search%22%3A%5B%22bankruptcy+financial%22%5D%7D&resultIndex=1&overview=closed (last visited Mar. 6, 2016); *S. 1861: Taxpayer Protection and Responsible Resolution Act*, U.S. CONGRESS, https://www.govtrack.us/congress/bills/113/s1861/text (last visited Mar. 6, 2016). Both bills propose a two-day stay on early termination rights along the lines discussed here. It should be noted, however, that these bills only apply to financial firms that are regulated by the Federal Reserve.

treating financial contracts held by financial institutions differently from other enterprises.

In sum, and to restate one final time, our symmetric approach is premised upon both continued performance, during the stay, of any obligations under the financial contract and adequate assurance of future performance by the debtor upon assumption or transfer. Assuring, or even permitting, such performance may not be a simple statutory task. As a practical solution, we have suggested the DIP lender might be called on to provide liquidity and credit enhancement where necessary. This treatment is not, in the end, significantly different from the treatment of critical vendors or other essential contracting parties well familiar in bankruptcy.[93] In short, orderly transfer or assumption of financial contracts will be possible for many debtors, where transfer is feasible, and may, at the risk of ending on a melodramatic note, make the difference between life and death.

93. *See, e.g.*, *In re* Kmart Corp., 359 F.3d 866 (7th Cir. 2004).