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### Resolution of Failed Financial Institutions: Orderly Liquidation Authority and a New Chapter 14

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**RESOLUTION OF FAILED FINANCIAL INSTITUTIONS:  
ORDERLY LIQUIDATION AUTHORITY AND A NEW  
CHAPTER 14**

Studies by the Resolution Project at Stanford University's  
Hoover Institution Working Group on Economic Policy

By

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John B. Taylor

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April 25, 2011

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JOHN B. TAYLOR

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## PREFACE

By John B. Taylor

*Let's write Chapter 14 into the law so that we have a credible alternative to bailouts in practice. We can then be ready to use a rules-based bankruptcy process to allow financial firms to fail without causing financial disruption*

--George P. Shultz<sup>1</sup>

The purpose of this short collection of papers is to demonstrate why the "orderly liquidation authority" in Title II of the Dodd–Frank bill “Wall Street Reform and Consumer Protection Act of 2010” should be supplemented with a new and more predictable bankruptcy process designed specifically for large financial institutions. We call the new bankruptcy law “Chapter 14,” because it is currently an unused chapter number in Title 11 of the U.S. Code on Bankruptcy.

Ken Scott leads off with a useful summary of the key legal and economic differences between the new orderly liquidation authority and the proposed new Chapter 14 bankruptcy process. He shows that the orderly liquidation authority, in the absence of a new bankruptcy process, increases uncertainty, raises due process issues, creates additional incentives to bailout large financial institutions, and increases moral hazard. His short later paper in the collection, “Dodd-Frank: Resolution or Expropriation?” elaborates on the reasons why the new liquidation authority would likely violate constitutional due process in practice. Title II of the Dodd-Frank bill gives the government considerable power and discretion to intervene, take over, and liquidate financial companies with no time for meaningful judicial review or analysis. Even with the best of intentions it is difficult to see how the Federal Deposit Insurance Corporation, the agency assigned by the law to this job, can run such a liquidation process for large, complex

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<sup>1</sup> “A Conversation About Key Conclusions,” in *Ending Government Bailouts As We Know Them*, Kenneth E. Scott, George P. Shultz, John B. Taylor (Eds.), Hoover Press, 2009, p. 287.

financial institutions in a predictable rule-like manner, which is so important for the smooth operation of financial markets.

Chapter 14 would give the government a viable alternative to Title II and thereby avoid these problems. Even if the discretionary bailout option remained in the law through the new “orderly liquidation authority,” government officials, it is hoped, would likely find Chapter 14 more attractive—because of its more predictable rules based features—and thereby choose this option rather than a bailout. At the least there would be a credible alternative to a bailout which would make bailouts less likely. As described in the quote at the start of this preface by former Secretary of Treasury, State, and Labor, George P. Shultz, Chapter 14 would give the government the option of letting a failing financial firm go into bankruptcy in a predictable, rules-based way without causing spillovers to the economy. It would also permit people to continue to use, if possible, the company’s financial services—just as people continue to fly when an airline company is in bankruptcy. Creating this option thus puts incentives in place which tend to drive government officials away from the oft-chosen bailout route.

As Tom Jackson explains in detail in his paper, which represents the outcome of extensive discussions by all members of the Resolution Project over the past year, Chapter 14 would differ from current bankruptcy law under Chapter 7 and Chapter 11 in several ways. It would create a group of judges knowledgeable about financial markets and institutions, which would be responsible for handling the bankruptcy of a large financial firm; a common perception is that bankruptcy is too slow to deal with systemic risk situations in large complex institutions, but under the proposal, there would be capacity to proceed immediately.

In addition to the typical bankruptcy commencement by creditors, an involuntary proceeding could be initiated by a government regulatory agency. Moreover, the government could propose a reorganization plan—not simply a liquidation. The main advantage of this bankruptcy approach is that debtors and creditors negotiate with clear rules and judicial review throughout the process. In contrast, the “orderly liquidation authority” is less transparent with more discretion by government officials and few opportunities for review. Chapter 14 relies more on the rule of law and less on discretion.

Kimberly Summe considers how a bankruptcy approach would compare with the orderly liquidation authority in the case of derivatives portfolios of financial institutions. She focuses on how differently things would have played out at Lehman Brothers if Dodd-Frank had been in

effect in September 2008. She concludes that for any failed “systemically important” financial company captured by Title 11, the orderly resolution authority would not have resulted in any substantial change in the way derivative trades are handled post-bankruptcy. In other words, the workout process for derivatives would not have proceeded much differently had Dodd-Frank been in effect. However, the orderly liquidation authority combined with new requirement to place derivative contracts at clearing houses, would likely lead to a significant probability that such a clearing house would be bailed out by the government.

The studies in this collection represent the collaborative work of the Resolution Project at Stanford University’s Hoover Institution. The group includes Andrew Crockett, Darrell Duffie, Richard J. Herring, Thomas Jackson, William F. Kroener, David Skeel, Kenneth E. Scott, George P. Shultz, Kimberly Anne Summe, and John B. Taylor, with Kenneth Scott serving as chair.

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A Guide to The  
RESOLUTION OF FAILED FINANCIAL INSTITUTIONS:  
DODD-FRANK TITLE II AND PROPOSED CHAPTER 14

Kenneth Scott

Stanford Law School

## I. Background

The “Resolution Project” began in August 2009, in the midst of the financial panic, to consider how best to deal with the failure of major financial institutions. The members of the group, assembled from institutions across the country, were Andrew Crockett, Darrell Duffie, Richard Herring, Thomas Jackson, William Kroener, Kenneth Scott (chair), George Shultz, Kimberly Summe and John Taylor, later joined by David Skeel<sup>1</sup>. A number of meetings and discussions led to papers and then a conference in December 2009, followed by a book: *Ending Government Bailouts* (K. Scott, G. Shultz & J. Taylor, eds. 2010).

A popular conception, in the press and Congress, of the cause of the panic was that when the investment bank Lehman Brothers failed in September 2008, it had to be put into bankruptcy reorganization because (unlike commercial banks) it could not be taken over by FDIC. Whatever its merits, that view provided much of the impetus for the enactment in July 2010 of

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<sup>1</sup> Biographical information may be found on the Project’s website: <http://www.hoover.org/taskforces/economic-policy/resolution-project/members> .

Title II (Orderly Liquidation Authority) of the Dodd-Frank Act, creating a new failure procedure whereby the Secretary of the Treasury could institute the takeover of any so-called “systemically important financial institutions” (SIFIs), outside of the bankruptcy law, with the FDIC becoming the receiver.

The Resolution Project group turned its focus to the development of a proposal for a modified bankruptcy law, denominated as a new Chapter 14<sup>2</sup>, designed exclusively for major financial institutions. This paper is written for a knowledgeable audience and is intended to identify and compare the principal differences in the Dodd-Frank and Chapter 14 procedures, and to outline the reasons why the group believes the latter to be preferable. Section 216 of the Dodd-Frank Act (the “Act”) calls for this sort of an inquiry to be conducted by the FRS Board of Governors and the Administrative Office of the United States Courts, and one of the Resolution Project’s goals is to make a contribution to that analysis and its consideration by the Congress.

## II. Objectives of resolution law for major insolvent financial firms

Any failure law for business firms has a number of objectives, not always fully consistent. One is to provide a mechanism for collective action by creditors to realize on the assets of the firm in an orderly manner, as opposed an individual scramble for whatever could be seized and sold first, and apply the proceeds to claims in accordance with the contractual priorities for which they had bargained and charged. An efficient procedure for maximizing recoveries, involving notices and hearings, contributes to fulfilling expectations and reducing losses, and hence to lower costs of capital for the carrying on of all business enterprises.

A second objective, which could be seen as an adjunct to the first, is to retain the “going-concern-value” of any parts of the business which can still be operated at a net profit through a “reorganization” of the firm, as opposed to the liquidation sale of its various assets. This is particularly significant for financial firms, most of whose value lies in the organization, knowledge and services of its personnel and their relationships to clients, rather than in separately saleable assets like inventory, real estate, buildings and machinery.

A third objective, perhaps uniquely so for “systemically important financial institutions”, is to avoid a breakdown of the entire financial system. What this means, and what it entails, will

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<sup>2</sup> The current version, principally authored by Tom Jackson, is in Appendix A.



be considered toward the end of this paper. So we turn next to an examination of the differences between the Act and Chapter 14, necessarily limiting it to central concepts and omitting a host of (not at all unimportant) details.

### III. Financial institutions covered

#### A. Dodd-Frank

The Act excludes from its coverage banks and (notably) government-sponsored entities (such as Fannie Mae and Freddie Mac)<sup>3</sup>, and includes in its coverage all companies predominately (on the basis of either assets or revenues) engaged in financial activities. From the large universe of financial companies, the Federal Reserve Board (“Fed”) is supposed to give especially intensive supervision to all bank holding companies with over \$50 billion in consolidated assets and those financial companies that the Financial Stability Oversight Council has selected as potentially posing a threat to financial stability in the event of its financial distress<sup>4</sup>. But whether or not so pre-designated or supervised, *any* financial company that the Secretary of the Treasury determines to be in danger of default with serious adverse effects on financial stability<sup>5</sup> may be seized and put into FDIC receivership by petition to the DC district court<sup>6</sup>. Financial companies that are not so singled out would remain under the existing Bankruptcy Code. In other words, application of Title II of the Act is left to administrative discretion, defined only by ‘findings’ that the agency itself makes at the time of action.

#### B. Chapter 14

The new Chapter applies to all financial companies and their subsidiaries with more than \$100 billion in consolidated assets. Counterparties would generally not be left in doubt as to what companies will be subject to a special resolution procedure and what ones will be dealt with under the present Bankruptcy Code provisions. Uncertainty in financial transactions increases risk and costs for everyone, and is to be minimized wherever possible.

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<sup>3</sup> The latter is a major omission, since the CBO now estimates that their losses will cost taxpayers around \$370 billion, far more than assistance to all other financial companies combined.

<sup>4</sup> Act §113(a)(1).

<sup>5</sup> §203(b).

<sup>6</sup> §202(a).

## IV. Commencement of proceedings

### A. Dodd-Frank

The Act creates an elaborate, and potentially cumbersome, bureaucratic process for triggering seizure of a financial company. The Fed and FDIC (or other primary federal regulator) jointly make a recommendation to the Treasury Secretary, based upon consideration of a list of factors that includes the reason why proceeding under the Bankruptcy Code is not appropriate. The Treasury Secretary then determines, among other things, that the firm is a financial company in danger of a default that, if handled under the Bankruptcy Code, would have serious adverse effects on US financial stability<sup>7</sup>.

The Secretary thereupon files a petition in the DC district court to appoint the FDIC as its receiver (unless the company consents). The statute mandates that within 24 hours there be (1) a closed and secret hearing in which the Secretary presents all the accumulated documentation underlying the agency recommendations and his conclusions, and the company can try to organize a rebuttal, (2) consideration of all the evidence by the judge, and (3) an order by the court authorizing the receivership, or a written opinion giving all reasons supporting a denial of the petition. If the district court can not accomplish all that within 24 hours, the petition is granted by operation of law<sup>8</sup>. Apart from the obvious impossibility of an effective rebuttal by the company, much less of findings of fact and a reasoned decision by the court, within such a truncated time frame, this summary procedure raises substantial Constitutional problems under the Due Process Clause which could invalidate the entire Title II mechanism<sup>9</sup>.

### B. Chapter 14

To the involuntary procedure in current bankruptcy law, initiated by unpaid creditors, there is added authority for the financial institution's primary regulator to commence a case both on the grounds applicable to other involuntary petitions as well as on the ground of "balance-sheet" insolvency: its assets are less than its liabilities, or it has unreasonably small capital. This

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<sup>7</sup> §203(b).

<sup>8</sup> §202(a).

<sup>9</sup> For discussion, see K. Scott, "Dodd-Frank: Resolution or Expropriation?" (Sept. 2010), available at <http://ssrn.com/abstract=1673849>.

is analogous to the “in default or in danger of default” concept in Dodd-Frank<sup>10</sup>, but the company has an actual opportunity in a court to challenge the assertion (in closed and secret hearing, should the judge deem appropriate), without a truncated time-frame, if it really disputes the adverse judgments on its financial soundness or believes the administrative valuations of its illiquid (non-traded) assets are erroneous.

Chapter 14 retains the ability of the management of a firm to itself initiate a voluntary proceeding in lieu of having to go into FDIC receivership. If the management sees the firm’s financial position as becoming untenable, it does not have to wait for balance-sheet insolvency or default on obligations, but can inaugurate a reorganization to try to salvage in part its business and retain its jobs. Much recent history indicates the tendency of banking regulators for various reasons not to take over prior to complete insolvency (as the FDIC Improvement Act of 1991 authorized them to do) but to wait until losses to the deposit insurance fund have become substantial despite its supervisory powers and stake as the primary creditor. The Dodd-Frank seizure procedure was designed to require a consensus of many government agencies before taking action. The history of voluntary bankruptcy, on the other hand, is replete with examples of pre-emptive action in which asset values are written down, there is a negotiation to allocate losses among claimants (with stockholders being the first to go), and a reduced business continues in successful operation, sometimes under existing management (which as explained below Dodd-Frank makes very unlikely). Incentives for management to act in a more timely fashion than receivership liquidation are socially valuable.

## V. The resolution procedure

### A. Dodd-Frank: FDIC as receiver

One of the reasons stressed in Congress for enactment of Title II was FDIC’s long experience in liquidating failed commercial banks. But the SIFIs with which the Act is primarily concerned are giant firms—hundreds of billions or even trillions of dollars in size, with a commercial bank as only one part of the complex. FDIC’s experience has been in dealing with numerous small and medium-sized banks, in which it is by far the biggest creditor through the deposit insurance fund, and for which there are often obvious—and larger—institutions ready to

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<sup>10</sup> §203(c)(4).

take over; only in the last several years has it encountered a few very large ones, with a wider variety of assets and claimants<sup>11</sup>. And in the case of a common reassessment type of systemic event (see part VI.A), it might have to take on a number of such institutions at the same time—a situation for which no one has experience or existing capacity.

The Act mandates<sup>12</sup> that the seized financial company shall be liquidated; it may not be reorganized, and the management “responsible” must be immediately removed<sup>13</sup>. It is evident that the mandate was intended to be more punitive than value enhancing. There may be indirect ways to avoid its needless value destruction, but it is certainly not conducive to efficient resolution, which the Act recognizes could take 5 years or more to complete.

More troubling is the power of the receiver to operate without transparency and not observe standard bankruptcy rules intended to adhere to absolute priority of claims and equal treatment of claimants in the same category. (Although many of the relevant Title II provisions have been imported from the Bankruptcy Code, all provisions for hearings and creditor votes were not.) FDIC can transfer assets *and liabilities* as it sees fit to a “bridge” institution where they are fully protected<sup>14</sup>, and depart from equal treatment of receivership claimants if it decides that would be good for the receivership estate<sup>15</sup>. If those dealing with a large financial institution have to calculate the risk they are assuming not only on the basis of business assessments but on the basis, not of reasonably settled legal rules, but of predictions of the exercise of unreviewable political discretion, a major cost and burden is imposed on the operation of financial markets.

## B. Chapter 14

Bankruptcy judges have been handling the liquidation and reorganization of very large and complicated companies for decades. Nonetheless, it should be recognized that giant financial firms pose some particular issues. Therefore, Chapter 14 contemplates the development of a small (since hopefully cases will be few and infrequent) and specialized panel of district court judges and special masters that would oversee these cases. Like FDIC, they

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<sup>11</sup> For a fuller discussion, see D. Skeel, *The New Financial Deal* 117-27 (2011).

<sup>12</sup> §214.

<sup>13</sup> §206.

<sup>14</sup> §210(h)(1).

<sup>15</sup> §210(b)(4).

would have to develop some special expertise with giant SIFIs over time. The details are spelled out in Appendix A.

In a typical Bankruptcy Code proceeding, management (as the “debtor-in-possession” or “DIP”) remains in control of ordinary business operations, and has an exclusive period in which to file a plan of reorganization. Upon creditor petition, the bankruptcy court may turn control over to a “trustee in bankruptcy.” Under Chapter 14, the financial company’s primary federal regulator could initiate the proceeding, and could petition to have the FDIC appointed as a trustee. FDIC would then function under Chapter 14 and therefore have the option (lacking in Title II of the Act) to pursue reorganization to maximize the business’s value for benefit of creditors, rather than being forced to liquidate it. In addition, there would be no period of exclusivity in Chapter 14 in which only management could propose a plan of reorganization; both the FDIC and a creditor’s committee would be given concurrent rights to file such a plan.

Whoever was in charge, resolution under Chapter 14 would be conducted under established (Chapters 11 and 7) bankruptcy rules about absolute priority, avoiding powers, transfers and preferences (except as noted in part VI.C below). Dispositions of cash and of assets outside the ordinary course of business require creditor notice and opportunity for hearing, particularly on the value being received. Plans of reorganization, with their allocation of losses among claimant classes, are subject to approval votes. The resolution would proceed in the open, unlike present FDIC practices.

These requirements constitute safeguards against, not only erroneous administrative judgments, but also political manipulation and favoritism of selected interests. That such concerns are not merely speculative is illustrated by the way the Chrysler bankruptcy was managed under the current bankruptcy code to avoid creditor voting rights<sup>16</sup>. This defect is partially addressed in the new Chapter 14, through the provisions dealing with Debtor-in-Possession financing. In addition, other broader safeguards are included to ensure that sales under Section 363 of the Bankruptcy Code don’t, sub rosa, avoid the safeguards of voting under plans of reorganization and protection of dissenting creditors.

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<sup>16</sup> M. Roe & D. Skeel, “Assessing the Chrysler Bankruptcy,” 108 Mich. L. Rev. 727 (2010).

## VI. Systemic risk – breakdown of the financial system

### A. Concepts of systemic risk – what exactly is the scenario?

Systemic risk is much referred to but typically not defined operationally or modeled in any generally accepted form<sup>17</sup>. At least three different (if at times overlapping) notions can be found<sup>18</sup>. All describe paths to the failure, or failure to function, of a large number of major financial institutions.

Type 1: Macro shocks—massive losses or disruptions simultaneously affecting many key institutions in the economy. Suppose the 9/11 al Qaeda attack had not been aimed at creating the dramatic psychological shock of the collapse of the WTC towers but instead at destroying the records and transactional capacity of the Federal Reserve Bank of NY and the New York and Nasdaq stock exchanges. Or suppose, for a more recent example, the Japanese earthquake, tsunami and nuclear power failure had all been centered on Tokyo instead of 150 miles to its north. Or postulate an abrupt bursting of a price bubble in a widely-held-asset.

Type 2: Chain reactions—“domino” effects from the unexpected failure of a giant institution. Losses from the initial collapse could cause some counterparties to become insolvent in turn, and the process could keep going outward from there. Some have seen the Lehman failure in this light, although in fact no significant counterparty was rendered insolvent.

Type 3: Common reassessments—affecting institutions with similar portfolios, whether or not directly linked. Thus the rescues or collapses in a ten day period in September 2008 of important institutions with large holdings of, or exposure to, (especially subprime) mortgage-backed securities (MBS)—from the giant mortgage firms Fannie and Freddie to Merrill Lynch to Lehman Brothers to AIG—led banks and financial institutions throughout the world to become uncertain of each other’s solvency, and discontinue or sharply raise the price of extensions of credit. With credit flows greatly reduced, the crisis spread from the financial to the real economy, and a severe recession was underway.

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<sup>17</sup> J. Taylor, “Defining Systemic Risk Operationally,” in K. Scott, G. Shultz & J. Taylor eds., *Ending Government Bailouts* (2010).

<sup>18</sup> G. Kaufman & K. Scott, “What is Systemic Risk...”, VII Independent Rev. 371 (2003).

The September 2008 panic thus seems to belong mostly in the third category. Inadequacy of disclosure of specifics of hundreds of billions in loan and securities holdings, and skepticism as to their valuations on balance sheets, contributed greatly to the problem. Growing anxieties about valuations led to MBS becoming nearly untradeable, which the Fed apparently perceived initially as due mainly to insufficient liquidity in the financial system, and it tried to address that issue with a host of new lending facilities beginning in late 2007 and extending through 2008 into 2009<sup>19</sup>. But the September crunch had jolted financial institutions into critically reassessing their counterparties' potential economic insolvency, and more liquidity did not remove that concern. In October 2008 the Treasury converted the TARP program into capital investments of \$10 to \$25 billion in the six largest banks, which were more a signal of implied Government guarantees against their failure than clearly sufficient by themselves to ensure their capital solvency against adverse portfolio outcomes.

#### B. Dodd-Frank

The concept of systemic risk underlying the Title II machinery is not clear in either the Act or its legislative history, but it seems to correspond most closely to trying to prevent a Type 2 chain reaction, in accordance with the often asserted myth that Lehman going into bankruptcy, because the Treasury lacked the power to seize it, caused the panic. Lehman's failure was certainly one of the events that contributed to the September 2008 loss of confidence and panic, as discussed above, but just why would subsequent receivership by the FDIC, instead of the bankruptcy court, have made a difference in that regard? No one would have been reassured about the valuations of MBS in others' portfolios, and the Act does nothing to correct the informational and valuation deficiencies that played a critical role in the credit crisis, beyond authorizing the SEC to require some quite limited additional disclosure about originators and securitizer repurchases and reviews<sup>20</sup>.

The Act requires SIFIs to prepare detailed resolution plans or "living wills" to facilitate their wind-downs, but on the basis that it occurs under the Bankruptcy Code and not a Title II receivership<sup>21</sup>. (And if the problem is actually one of liquidity pressure on an otherwise solvent

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<sup>19</sup> See St. Louis Fed timeline, available at <http://timeline.stlouisfed.org>.

<sup>20</sup> §942.

<sup>21</sup> §165(d)(4).

institution, the Act makes the problem worse by abolishing the Fed's §13(3) emergency authority to act as a lender of last resort to a non-bank financial company.)<sup>22</sup>

Everyone proclaims that they are opposed to bailouts, but most seem to find it unnecessary to define what they are talking about. For my purposes, a bailout occurs when some favored claimants on a failed financial firm are given more than what they would receive in a strict bankruptcy, at the expense of others. The additional money might come from several different sources:

- it might come from the Government: authorized expenditures by the Treasury (as in the Orderly Liquidation Fund), guarantee payments from the FDIC, or non-recourse “loans” by the Fed.
- it might come from an “assessment” on prudent financial companies which did not fail.
- it might come from the receivership estate at the expense of disfavored creditors.

But whatever the source, moral hazard is created: the favored creditors have reduced or no reason to pay attention to the behavior of the debtor (now failed) firm, and the likelihood of such failures is increased.

Therefore, perhaps the unexpressed thought is that the FDIC under Title II would select those financial counterparties that it thought might be endangered and immediately make advances on or pay their claims in full, regardless of their legal priority, as necessary to prevent a feared chain reaction of insolvencies. (This never took place in the actual Lehman bankruptcy case, but put that aside.) Title II gives FDIC power to obtain immediately from the Treasury financing funds equal to 10% of the book value of seized firm<sup>23</sup>, and much more thereafter. Receivership funds may be made available to a bridge institution<sup>24</sup>, which can use them to pay transferred liabilities. The decisions are based on unreviewable agency discretion.

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<sup>22</sup> §1101.

<sup>23</sup> §210(n)(6).

<sup>24</sup> §210(h)(2)(G).



If the final result of asset liquidations and certain creditor payment ‘recoupments’ is that the receiver cannot fully repay its Treasury advances, then a scheme is to be devised to assess the loss on the entire group of SIFIs<sup>25</sup>, whether or not the cause of failure lay in large part on government policies. The intention, stressed throughout the Congressional consideration, is that taxpayers are not to bear the cost of a “bailout” of a financial company. But the real problem with bailouts comes from the protection of creditors, not stockholders (who are significantly or wholly wiped out in most bankruptcies). Shifting losses from taxpayers to an entire industry does not solve the problems arising from weakening or destroying the incentives of a firm’s creditors to watch and restrain its risk taking.

A particular set of creditors deserves special attention in this regard: those who have entered into “Qualified Financial Contracts” (QFCs) with a failed firm. QFCs include repo’s, interest rate and currency swaps, credit default swaps, and other derivatives; their notional amount has reached the hundreds of trillions of dollars. Title II of the Act carries forward most of their preferential treatment under current bankruptcy law. For these creditors, the automatic stay on collecting debts by terminating contracts and seizing and selling collateral is one day; they need not return prior (within 90 days) preferential payments or additional collateral; they have broader setoff rights, and so on. The legal status of Lehman’s derivatives book—930,000 transactions—would be the same under Title II as it was under the Bankruptcy Code, where derivatives were terminated swiftly and efficiently but after two years only 45% of counterparties’ claims had been valued and settled<sup>26</sup>.

These provisions make the covered channels of short term financing of a firm’s operations much safer, and hence cheaper, but they also make its counterparties (who constitute the most sophisticated and best informed of all creditors) much more tolerant of its management’s indulgence of risky strategies. There is an inherent trade-off at stake, and current QFC law leans heavily toward encouraging risk and discouraging market discipline<sup>27</sup>.

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<sup>25</sup>§210(o).

<sup>26</sup> K. Summe, “An Examination of Lehman Brothers’ Derivatives Portfolio Post-Bankruptcy and Whether Dodd-Frank Would Have Made Any Difference” (2011).

<sup>27</sup> M. Roe, “The Derivatives Market’s Payment Priorities as Financial Crisis Accelerator,” 63 Stan. L. Review 539-90 (2011); D. Skeel & T. Jackson, “Transaction Consistency and the New Finance in Bankruptcy,” Penn. ILE Research Paper No. 11-06 (Feb. 2011), available at <http://ssrn.com/abstract=1773631>.

## C. Chapter 14

As compared to the present Bankruptcy Code, limited creditor advances are facilitated if needed to reduce perceived contagion concerns, but on the basis of a court hearing and approval (which can be quite speedy when justified) of the claimed need. Since reorganization is a permitted option, rather than a prohibited one, DIP financing is expressly authorized and can be given the priority of “administrative expenses”.

There is a popular conception that there cannot be a successful reorganization of a failed SIFI, because counterparties would stop dealing with it. But post-petition creditors’ claims, unlike their prior ones, go to the top of the payment priority ladder. If the Government believes that systemic concerns are at stake, it could be authorized to provide subordinated DIP financing (along the lines of the Title II Orderly Liquidation Fund) in amounts more than adequate to cover all new claims and all assumed existing contracts, as explained next.

Chapter 14 makes a distinction in the treatment of QFCs. Repo’s would be treated as secured loans, and the counterparty given the right to immediately sell the collateral *if* highly-marketable securities (but not, for instance, MBS as the 2005 law authorized). This would preserve the use of repo’s as nearly risk-free short term financing, but only under conditions where the sale of collateral would not have drastic market price effects. All other swaps and derivatives with a counterparty would be subject to a three day stay, giving the debtor a window to assume (for example, if ‘in the money’) or reject them all (or transfer them in bulk to a new counterparty), and also to some preference limits. The objective is to make a somewhat different trade-off between efficient institutional financing and creditor monitoring incentives<sup>28</sup>.

## VII. Conclusions

### A. Dodd-Frank

The Act places heavy reliance on agency discretion, not only in the hundreds of regulations yet to be issued dealing with the operation of financial firms and markets, but more specifically in the coverage of Title II resolution jurisdiction and the seizure and administration

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<sup>28</sup> For fuller discussion, see Skeel & Jackson, *op. cit. supra*.

of ‘failed’ firms. To be effective, regulators will somehow have to have better judgment and foresight than was in evidence over the last decade.

Along with the reliance on discretion come low transparency and few checks on errors or abuses of authority. The agencies are supposed to make ‘findings’ to support their actions, but there is no opportunity for meaningful judicial review and legal accountability. Bailouts of the failed firm (that is, its stockholders) are prohibited, but bailouts of creditors are not; there is discretion over the allocation of losses among creditors. Ironically, proponents of Dodd-Frank always refer to its resolution procedure as “orderly,” unlike bankruptcy resolution which is always referred to as “disorderly,” although in what respect is not explained. In reality, both procedures are highly structured, albeit along different lines and with different degrees of predictability.

All of this produces uncertainty, and the associated costs to financial institutions and transactions. The role of market discipline by informed counterparties with financial stakes is diminished.

## B. Chapter 14

There is less reliance on unexplained agency decisions reached in private, and more on judicial hearings and reasoned public opinions. Greater emphasis is placed on preserving or creating private incentives to monitor and check firms accepting risks that outsiders view as excessive or misinformed.

Failure losses are allocated to creditors based on known claim priorities. It is true that a government can always intervene, if believed justified on economic (or political) grounds, to protect chosen creditors—for example, by acquiring or guaranteeing their claims and thus bearing their losses. But the action becomes transparent, may require Congressional authorization, and is open to electoral accountability.

## C. Policy choices

1. Repeal Dodd-Frank, but such a turnaround seems politically unlikely. Or Title II could be extensively amended—conceivable, but complicated.

2. Enactment along the lines of Chapter 14 of an alternative resolution process.

a. For a case of voluntary bankruptcy: management would have an opportunity to take early reorganization action, including “pre-packaged” filings, under a new chapter drafted for a SIFI’s use.

b. In a case of involuntary bankruptcy: the primary regulator could be required to justify to a district court (in a real, if closed, hearing with a rapid—but realistic—timetable for opposition and decision) its preference for an FDIC receivership. Even without enacting a legally binding requirement, a rejection of the new alternative would at least have to be explained in the agency’s recommendation<sup>29</sup> and Treasury Secretary’s determination<sup>30</sup> to seize the firm under Title II of the Act, and therefore might make resort to that action less automatic. And the detailed “living wills” that all SIFIs have to design for a Bankruptcy Code resolution would become directly relevant.

3. Leave Title II of the Act as it is, assume it is not unconstitutional, and just hope it never has to be used. But its mere existence would continue to produce uncertainty and related costs.

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<sup>29</sup> §203(a)(2)(F).

<sup>30</sup> §203(b)(2).

## Bankruptcy Code Chapter 14:

### A Proposal\*

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## **Introduction**

This paper describes several proposed changes to the Bankruptcy Code that are designed for—and limited to—the reorganization or liquidation of the nation’s largest financial institutions. The proposed changes create a new Chapter 14 of the Bankruptcy Code and incorporate features of liquidations under Chapter 7 as well as reorganizations under Chapter 11. In addition, the proposed Chapter 14 contains a number of substantive and procedural changes designed especially for the complexity, and potential systemic consequences, of the failure of these large financial institutions. Through these changes, we believe it is possible to take advantage of a judicial proceeding—including explicit rules, designated in advance and honed through published judicial precedent, with appeals challenging the application of those rules, public proceedings, and transparency—in such a way as to minimize the felt necessity to use the alternative government agency resolution process recently enacted as a part of the Dodd Frank Wall Street Reform and Consumer Protection Act. The new chapter could be adopted either in addition or as an alternative to the new resolution regime of Dodd Frank.

The crucial feature of this new Chapter 14 is to ensure that the covered financial institutions, creditors dealing with them, and other market participants, know in advance, in a clear and predictable way, how losses will be allocated if the institution fails. If the creditors of a failed financial institution are protected (bailed out), then the strongest and most rapidly-responding constraint on risk-taking by the financial institution’s management is destroyed, and their losses are transferred to others.

In the following sections, we explain the features of this new Chapter 14 by (a) outlining existing bankruptcy provisions that we propose to amend or replace, (b) summarizing perceived weaknesses in those provisions that this proposal addresses, and (c) outlining the nature of the statutory provisions that are designed to address these weaknesses. These statutory changes can be encompassed within four basic categories: (1) the creation of a new Chapter 14; (2) the commencement of a Chapter 14 case, (3) the role of the primary regulator in Chapter 14 and special rules regarding debtor-in-possession financing for purposes of “prepayments” to certain creditors, and (4) the treatment of qualified financial contracts in Chapter 14. Following that, we provide, in summary form, a list of the changes we propose and the likely place in either the Bankruptcy Code or in Title 28 (the jurisdictional title) to make those changes.

## ***I. Creation of a New Chapter 14***

### *a. Define Financial Institution*

#### *Current Law*

There is no special definition of a financial institution.

#### *Concerns*

Bankruptcy seems to be undervalued as a potential solution to the liquidation or reorganization of complex financial institutions, including in the 2010 Congressional debate over financial reform, in part because of a view that the default of one or more of the nation's largest and most complex financial institutions is (a) outside the competence of the bankruptcy system, (b) unable to be resolved in a timely fashion in a judicial proceeding, and (c) likely to have systemic consequences that an adversarial system, which depends on parties-in-interest with standing before the court, is ill-equipped to respond to.

#### *Proposal*

In order to craft a bankruptcy process that is responsive to the special needs of the nation's largest financial institutions, it is necessary to create a special set of procedures and rules for such financial institutions. This starts, most fundamentally, with a need to provide, in the Bankruptcy Code, a definition of the financial institutions that would be covered by these special procedures and rules. Because many of the concerns focus on the nation's largest institutions, with no strong sense that existing procedures are insufficient for other financial institutions, the definition should not only define what is a "financial institution" but it should also set a threshold for the size of the institution before invoking the special rules and procedures we propose. The definition we propose would define a "financial institution" for bankruptcy

(and hence Chapter 14) purposes as an institution<sup>1</sup> “that is substantially engaged in providing financial services or financial products,” and includes “any subsidiaries of any such institution.” To eliminate purely “local” financial institutions, the definition would include a minimum asset size of \$100 billion for the combined enterprise—a figure that should have a mechanism for adjustment with changes in the financial system.

*b. Create Chapter 14*

*Current Law*

No such chapter exists.

*Concern*

Because of the special procedural and substantive rules that are perceived to be needed to make bankruptcy a robust alternative to government agency resolution for the nation’s largest financial institutions, there needs to be a mechanism, within the Bankruptcy Code, for (a) incorporating the vast majority of common Bankruptcy Code provisions in Chapters 1, 3, and 5, as well as 7 or 11, while (b) ensuring that those special procedural and substantive rules govern—and amend or override certain common Bankruptcy Code provisions—for such financial institutions.

*Proposal*

In essence, our proposal provides a new bankruptcy process (including certain new substantive rules) for financial institutions for the liquidation or reorganization of these defined financial institutions. At the same time, the Bankruptcy Code’s structure and rules for a liquidation proceeding, in Chapter 7, and for a reorganization proceeding, in Chapter 11, provide a solid starting place, with a wealth of important judicial gloss on statutory terminology, that

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<sup>1</sup> The Bankruptcy Code would use the word “person,” which is defined in §101(41) as including an “individual, partnership, and corporation.” For convenience, this paper will often use the word “institution.”



would be usefully applied in many situations involving a covered financial institution. To accomplish both goals simultaneously, we propose that the proceeding (or “case”) when a covered financial institution invokes (or is placed in) bankruptcy follow the rules of the existing Bankruptcy Code *except* where we propose to change those rules. Particularly because our proposal envisions a different judicial “path,” as we describe below (involving district judges in lieu of bankruptcy judges), to use the existing Bankruptcy Code structure, and attempt to amend various provisions in Chapter 7 and 11 to accommodate our proposal, would be cumbersome. Thus, our proposal is to create a new Chapter 14 in the Bankruptcy Code and require covered financial institutions to *concurrently* file for Chapter 14 *and* Chapter 7 or Chapter 11 (that is, covered financial institutions cannot file for Chapter 7 or Chapter 11 without also filing for Chapter 14), and requiring the resulting liquidation (Chapter 7) or reorganization (Chapter 11) proceeding to be conducted according to the rules, and under the special court supervision, of Chapter 14.

- The essence, then, of this change would be to insert a new subsection into §109<sup>2</sup> that **(a)** limits Chapter 14 to financial institutions (as defined), **(b)** provides that a financial institution “may not be a debtor under chapter 7 or chapter 11 without first (or concurrently) commencing a case under chapter 14,” and **(c)** provides that all proceedings under this simultaneous chapter 7 or chapter 11 “shall be conducted pursuant to the provisions of chapter 14.”

*c. Assign Chapter 14 Cases and Proceedings to Designated Article III District Judges*

*Current Law*

(i) Judges. Because bankruptcy judges are not “Article III” judges (primarily because they do not enjoy life-time tenure, which is a constitutional requirement for Article III judges), the Supreme Court, in *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.* 458 U.S. 50 (1982), struck down certain features of the original jurisdictional grant in the Bankruptcy Code

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<sup>2</sup> All section numbers, unless explicitly indicated otherwise, refer to Title 11, US Code.

of 1978 to bankruptcy judges to hear and decide various cases and controversies that arise in connection with a bankruptcy proceeding. In response to *Northern Pipeline*, Congress enacted the current jurisdictional structure in 28 U.S.C. §157. It provides that bankruptcy cases are “filed” in the district court (comprised of Article III judges), but that a district court may provide (as all have) that “cases under title 11 [the Bankruptcy Code]” and “proceedings arising under title 11,” “shall be referred to the bankruptcy judges for the district.” Those judges may then hear “cases under title 11” and “core proceedings arising under title 11,” with 28 U.S.C. §157(b)(2) attempting to define “core proceedings” in a way that is consistent with what the Supreme Court, in *Northern Pipeline*, said that non-Article III judges could “hear and determine.” Things that are not core proceedings, but are otherwise related to a bankruptcy case, can be heard by a bankruptcy judge, but that judge can only “submit proposed findings of fact and conclusions of law to the district court,” and the district court must issue “any final order or judgment,” 28 U.S.C. §157(c)(1).

(ii) Venue. Bankruptcy cases can be commenced in the district court for the district which is the debtor’s domicile: Its “principal place of business in the United States;” where the “principal assets [of the debtor] in the United States are located;” or in which an affiliate of the debtor has already filed, 28 U.S.C. §1408, although cases can be transferred by a district court to another district “in the interest of justice or for the convenience of the parties,” 28 U.S.C. §1412.

### *Concerns*

The current system ultimately depends on venue, and within venue, essentially random assignment of cases to bankruptcy judges for the district in which the bankruptcy case has been filed. While this is appropriate for the vast majority of business (and individual) bankruptcy cases that, numerically, dominate the system, it is unlikely that the nation’s several hundred bankruptcy judges—all of whom can be presumed to have important knowledge of the Bankruptcy Code itself—will have the requisite financial expertise to deal, in real time, with the nation’s largest financial institutions. To be sure, these institutions are clustered in a few venues, but there is a second concern as well. In addition to the question of financial mastery necessary for complex financial institutions, the general bankruptcy procedure of automatically delegating

bankruptcy cases from the district court to a bankruptcy court places the cases before non-Article III judges. While this is not troubling in the vast majority of bankruptcy cases, the essential need for complete independence from any perception of influence by the financial institution, the government, or a particularly significant creditor, suggests that any bankruptcy system designed for the nation's largest financial institutions would want those institutions to have their cases and ancillary proceedings heard before an Article III judge.

### *Proposal*

Given the limited number of covered financial institutions, and the even more limited number that will be in bankruptcy at any given time, there is considerable merit to “funneling” such cases before a limited set of pre-picked Article III district judges. Our proposal is to funnel cases to the Second and DC Circuits and, there, have a panel of pre-designated district court judges, who have been designated to oversee Chapter 14 cases by the Chief Justice of the United States. These designated district judges would then have the same (and to that extent exclusive) jurisdiction over Chapter 14 cases as district judges currently have over other bankruptcy cases, with the case being assigned to one of the designated judges in the Second or DC Circuit. These judges would be precluded from referring cases and proceedings to bankruptcy judges pursuant to 28 U.S.C. §157(a), but they would have the power, by amendment to Title 28, to appoint a special master from a pre-designated panel of special masters to hear the case and all proceedings under the case that could be heard by a bankruptcy judge.

## ***II. Commencing a Chapter 14 Case***

*a. Allow the Entire Covered Financial Institution (Including Subsidiaries) to be Resolved in Bankruptcy.*

While most entities with a place of business or property in the United States are eligible for bankruptcy, there are exclusions for:

- a domestic insurance company, §109(b)(2), and a foreign insurance company engaged in business in the United States, §109(b)(3)(A)
- a bank, savings bank, cooperative bank, savings and loan association, credit union, and similar entities “which is an insured bank as defined in section 3(h) of the Federal Deposit Insurance Act (collectively, consider these “depository banks”)
- a foreign bank, savings bank, cooperative bank, savings and loan association, credit union (or similar entities) with a branch or agency (as defined in section 1(b) of the International Banking Act of 1978) in the United States

In addition, there is an exclusion from eligibility for Chapter 11 (reorganization) but not for Chapter 7 for stockbroker and commodity brokers, §109(d), as defined in §101(6) and §101(53A). In essence, this forces stockbrokers and commodity brokers into special subchapters of Chapter 7. The important part of the stockbroker subchapter is that the Chapter 7 proceeding can be stayed, and then dismissed, upon the filing of “an application for a protective decree under the Securities Investor Protection Act of 1970.” (“If SIPC completes the liquidation of the debtor, then the court shall dismiss the case.”) For commodity brokers, the Commodity Futures Trading Commission is given a right to be heard, §762(b), and there are special rules for treating customer accounts “separately,” §763, §766. (There is also a subchapter, commencing with §781, for the liquidation of clearing banks, which makes the FRB-designated conservator or receiver the trustee and provides for various methods for the “disposition” of the clearing bank.)

### *Concerns*

Large financial institutions are oftentimes structurally complex, and operate subsidiaries in a number of different areas, including those that are excluded from bankruptcy or are shunted to a special bankruptcy procedure. While the exclusion of depository banks has worked reasonably well for special reasons intimately related to the nature of the guaranteed deposit system, other exclusions, such as those for insurance companies, designed to leave their insolvency to state insurance agencies, never achieved that level of agreement or success and seem strangely disconnected with the broad scope of modern, large-scale, insurance companies. Whatever their intent, these exclusions and special rules significantly complicate the resolution

of a major financial institution, in which bankruptcy is only able to deal with pieces of the (often integrated) whole and needs to coordinate, sometimes in awkward fashion, with nonbankruptcy resolution authorities that also have only a piece of the whole to work with.

### *Proposal*

The Bankruptcy Code would be amended to:

- Eliminate the exclusion in §109(b)(2) and (b)(3)(A) for domestic and foreign insurance companies when Chapter 14 applies, but provide for treatment, to the extent consistent with the broader bankruptcy process for the covered financial institution, of insurance subsidiaries (and those they insure) with nonbankruptcy resolution processes.
- Eliminate the exclusion of stockbrokers and commodity brokers from Chapter 11 when Chapter 14 applies by revising §109(d). In doing this, the special subchapters for stockbrokers (§§741 et seq.) and commodity brokers (§§761 et seq.) in Chapter 7 would be eliminated as well. When Chapter 14 applies, the kinds of rules currently existing for the treatment of customer accounts in the commodity broker subchapter (particularly §763 & §766) would be generalized and made applicable to bankruptcy proceedings (whether liquidations or reorganizations) of stockbrokers and commodity brokers, and SIPC (for stockbrokers) and CFTC (for commodity brokers) would be given a right to be a party to the proceeding.

The proposal does not change the current resolution practice of the FDIC over depository banks.

#### *b. Give the Primary Regulator the Power to File an Involuntary Petition*

### *Current Law*

There is no limitation on the commencement of a “voluntary” case—that is, a case begun by the filing of a petition by the debtor, §301(a). “The commencement of a voluntary case under a chapter of this title constitutes an order of relief under such chapter,” §303(b).

Involuntary cases can be “commenced” by the filing by three or more creditors (some largely irrelevant exceptions exist), §303(b).

### *Concern*

Bankruptcy responds to the parties in a direct relationship with the debtor, such as creditors. Again, while this is appropriate for the vast majority of firms, financial or otherwise, there is a legitimate concern, for the nation’s largest financial institutions, that “systemic” consequences that go far beyond those direct relationships and affect the functioning of the financial system need to be addressed as well.

### *Proposal*

The existing provisions for the commencement of voluntary and involuntary cases would remain in place. There would be added to these provisions, by amending §303(b) and (h), the ability of the primary regulator to commence an involuntary case against a financial institution for the same reasons as currently exist for three or more creditors.

- c. Allow the Primary Regulator to File Based on “Balance Sheet” Insolvency*

### *Current Law*

If an involuntary case is contested, there is a “trial,” and the court “shall order relief against the debtor” only if **(a)** “the debtor is generally not paying such debtor’s debts as such debts become due” (unless the debts are subject to a bona fide dispute), §303(h)(1) or **(b)** a custodian had been appointed or took possession within 120 days of the date of the filing of the petition, §303(h)(2).

### *Concern*

The Bankruptcy Code eliminated various forms of “balance sheet” insolvency as a ground for the commencement of an involuntary case, believing them (among other reasons) to be too subjective. While that is true, for major financial institutions, where there is a special concern of a financial “melt-down” leading to possible systemic consequences, limiting involuntary petitions to situations where the debtor is already failing to pay debts as they become due may be woefully late.

### *Proposal*

Amend §303(h) to provide that the primary regulator would be given the power to commence an involuntary case against a financial institution on the ground that either the financial institution’s assets are less than its liabilities, at fair valuation, or the financial institution has an unreasonably small capital. The financial institution could contest this (as it can any involuntary petition), although the likelihood that the filing wouldn’t, in essence, create a self-fulfilling prophesy is small.<sup>3</sup>

## ***III. Role of the Primary Regulator in Chapter 14; DIP Funding***

### *a. Regulator Standing*

#### *Current Law*

There is no provision for such standing, apart from the situation of stockbrokers and commodity brokers in Chapter 7.

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<sup>3</sup> Even without this power, it is probably the case that the primary regulator has many ways of “forcing” a weak financial institution to file a voluntary petition. Even so, it is important to make the regulator’s power de jure as well as de facto, and this is the cleanest way to do that.

### *Concern*

Under the current system, as exists today, certain parts of a complex financial institution cannot be resolved in bankruptcy. This approach is needlessly complex and fraught with territorial conflicts and disputes as compared with a framework that encompasses the liquidation or reorganization of a covered financial institution “in total” in bankruptcy.

### *Proposal*

The regulators of the business of a covered financial institution, or any subsidiary thereof, would have standing with respect to the financial institution or the particular subsidiary, to be heard as parties or to raise motions relevant to their regulation with the Chapter 14 court.

#### *b. Motions for the Use, Sale, or Lease of Property*

### *Current Law*

Under §363, motions to use, sell, or lease property of the estate (except in the ordinary course of business) are to be filed by the trustee (or, pursuant to §1107, the debtor in possession).

### *Concern*

Because of the importance of preventing systemic consequences, there may be situations in which the government is the only appropriate party to determine that the use, sale, or lease of property of the estate is important and proper; even so, the government’s determination must be subject to court review, to ensure that it is not likely to harm or favor certain creditors of the financial institution that is in bankruptcy.



## *Proposal*

Section 363 should be amended to provide that the primary regulator has the power, in parallel with the trustee or debtor in possession, to file motions for the use, sale, or lease of property of the estate. As is currently the case, approval of such a motion would be subject to the safeguards provided in §363.

### *c. Debtor in Possession (DIP) Financing*

#### *Current Law*

If the business is continuing in operation (which is the ordinary course in Chapter 11, but is plausibly involved in a Chapter 7 for at least a while), the debtor-in-possession, §1107(a), or a trustee appointed in lieu of a debtor-in-possession, §1108, is authorized to obtain unsecured credit and incur unsecured debt, in the ordinary course of business (and without court approval), with such credit/debt having “administrative expense” priority, §364(a). (Administrative expense priorities are the expenses of running the bankruptcy proceeding which (simplifying somewhat) essentially rank *before* pre-bankruptcy unsecured claims but *after* pre-bankruptcy secured claims in priority, §507(a)(2), §725, §726.) Under §364(b), administrative expense priority can also be given to other funding that doesn’t qualify as being in the “ordinary course of business,” but now only upon court approval, after notice and a hearing. If administrative expense priority is insufficient to obtain credit, the court becomes involved and priority can be increased, subject to increasingly rigorous requirements. **(a)** It may be authorized, after notice and a hearing, with priority over other administrative expenses, or with a security interest on property that isn’t already subject to a security interest, or with a junior security interest on property that is already subject to a security interest, §364(c). **(b)** It may be authorized, after notice and a hearing, with a senior or equal security interest on property already subject to a security interest, but the court must now find not only that the financing is not otherwise available but also that the existing secured creditors receive “adequate protection” under §361 of their security interest, §364(d). (The latter is very difficult to establish, because it basically requires a showing that no one is willing to lend without priority over (or parity with) an existing

secured credit *and* the debtor can demonstrate that the existing secured creditor is no worse off than it was before.)

### *Concerns*

There may be situations where liquidity, or other systemic concerns, suggest that the appropriate action—without involving a government bailout of any sort—would be for certain liquidity-sensitive creditors to be “advanced” a portion of their likely bankruptcy distribution, which would be accomplished through DIP financing. It is not clear that §364 currently would allow such a result. Because of the necessity of an estimation of final distribution, this possibility needs to be carefully circumscribed, however.

Because of the importance of the principle, it is perhaps worth outlining the concern with a numerical example. Assume Debtor has assets of \$100 million and unsecured claims of \$300 million. Without any prepayments, the expected distribution, at the end of the bankruptcy proceeding, would be \$0.33 cents on the dollar to the unsecured creditors. If, however, there is a determination that “liquidity-sensitive creditors” (the “LS creditors”), with unsecured claims of \$100 million, should receive advanced payments, and those advanced payments come from funding under §364, the problem of “aggressive” prepayment manifests itself in this way. Assume that the debtor (or the government) persuades the court that a “conservative” payout to the LS creditors would be \$50 million (or \$0.50 cents on the dollar), and the government will provide that funding pursuant to §364. The following changes occur: (a) the LS creditors receive \$50 million (instead of \$33 1/3 million), (b) the government has an administrative expense claim (at minimum) for \$50 million, §364(b). Because of these two changes, Debtor still has assets of \$100 million (the government’s money came and went, leaving the assets as before), but now has an administrative expense claim (to the government) of \$50 million and \$200 million of remaining unsecured claims (i.e., claims that didn’t receive an advance payment). Following ordinary bankruptcy distribution rules, the government would get the first \$50 million of Debtor’s assets, leaving \$50 million for the remaining \$200 million of unsecured creditors. In short, because of the “aggressive” prepayment, the LS creditors received a distribution of \$0.50 on the dollar rather than \$0.33 cents on the dollar, and the remaining

unsecured creditors receive a distribution of \$0.25 cents on the dollar, rather than \$0.33 cents on the dollar. The LS creditors are better off and the remaining creditors are worse off. The government is, financially, indifferent, but it has—through this—accomplished a partial bail-out of the LS creditors. The innocent parties (beyond the taxpayers) in this are the remaining unsecured creditors, whose share of the bankruptcy estate went from \$0.33 on the dollar to \$0.25 on the dollar. To undo this, it is necessary either to “claw back” the difference between \$0.33 and \$0.50 on the dollar from the LS creditors or to require the government’s \$50 million claim to be subordinated to the remaining unsecured creditors to the tune of \$16 2/3 million dollars (one-third of the total)—so the government would receive \$33 1/3 million, and there would be \$66 2/3 million left for distribution to the remaining \$200 million of unsecured creditors. (While this has focused on the government as funder, because the innocent “victims” are the remaining unsecured creditors, a similar concern would arise even if the \$50 million funding to the LS creditors came from a private source.)

### *Proposal*

The proposal would add a provision making it clear that DIP financing is available in Chapter 14 pursuant to §364(b) (non-ordinary-course financing, as well as §364(c) and (d))—all of which require court approval after notice and a hearing—for financing that will permit partial or complete payouts to some or all creditors, where liquidity of those creditors is a concern, and the payments are intended as “advances” for the likely payouts such creditors would receive in a liquidation or a reorganization at the end of the bankruptcy process. To prevent unfair treatment of creditors entitled to particular distributions under the Bankruptcy Code, approval of any such request would be subject to several burden of proof requirements. First, the movant would be required to show the necessity (for liquidity or other systemic reasons) of the payout (including its amount) to particular creditors.<sup>4</sup> Second, the movant would be required to show that such payout is less than a conservative estimate of the amount those creditors would receive in bankruptcy without such prepayment. Third (and logically following from the second), the movant would be required to show that any such prepayment was not likely to favor particular

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<sup>4</sup> Any creditors receiving such advanced payout, at least in the case of a reorganization, would necessarily constitute a separate “class” under §1122(a) for purposes of voting on the plan.

creditors, or classes of creditors, or otherwise undermine the operation of the absolute priority rule embodied in §725, §726, and the plan confirmation requirements of §1129. If the government is the entity providing the funding, it will additionally be required to show that no private funding on reasonably comparable terms is available. Those provisions on burden of proof should be written into the statute, in an analogous fashion to the burden of proof on issues of adequate protection of secured creditors in §364(d)(2).

In addition, it shall be a provision of any such funding that, should the payout exceed the amount that the creditors would have received in the bankruptcy proceeding in the absence of such funding, the entity providing the funding, in clear and explicit fashion, agrees to subordinate its §364 funding claim to the claims of the remaining creditors to the extent of that excess.

*d. Filing Plans of Reorganization*

*Current Law*

In Chapter 11, the debtor may file a plan at any time, including at the time of its voluntary petition (a “prepack”), §1121(a). Any other party in interest (including a creditor or a creditor’s committee), can usually file a plan (there are a couple of largely unimportant exceptions) only if the debtor has not filed a plan within the first 120 days, §1121(c)(2), unless, upon request and after notice and hearing, the court reduces (or increases) that period (which is known as the debtor’s “exclusivity” period).

*Concerns*

Given the concerns with systemic consequences, as well as speed, a presumptive 120-day exclusivity period for the debtor in possession (i.e., existing management, usually selected by the former shareholders, who are now presumably “out of the money”) is cumbersome.

## *Proposal*

In addition to the debtor, in the case of a Chapter 14 proceeding, allow the primary regulator or a creditors' committee to file a plan of reorganization at any time after the order for relief (which occurs upon filing, in a voluntary case, §301(b), and after a court order, in the case of a contested involuntary petition, §303(h)). This would be accomplished either through an amendment to §1121 ("Who may file a plan") or through a provision in Chapter 14 that provided "notwithstanding §1121(c)," the entities listed above could file a plan of reorganization at any time after the order for relief.

## ***IV. Qualified Financial Contracts in Chapter 14<sup>5</sup>***

### *Introduction*

The current—like our proposed—treatment of various forms of qualified financial contracts ("QFCs") is complex and easily misunderstood. In essence, our proposal has three major parts, two of which focus on the automatic stay and one of which focuses on the trustee's avoiding powers (preference law in particular). The first part, which concerns repos, proposes modest changes in current bankruptcy law, mostly to clarify that, for purposes of Chapter 14 (and hence for covered financial institutions), the automatic stay does not apply to repos (which will be treated as a form of secured loans that are automatically "breached" by the debtor upon the commencement of a bankruptcy case) in terms of netting, set-off, or collateral sales by the counterparty of cash-like collateral that is in its possession. The second part, which concerns derivatives, proposes short-term, more significant changes in current bankruptcy law. For three days, the counterparty will be subject to bankruptcy's automatic stay and therefore stayed from exercising any right under an "ipso facto" clause (unless the debtor first explicitly rejects the derivative contract) to enable the debtor to exercise its choice between assumption and rejection

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<sup>5</sup> While our focus is on QFCs in Chapter 14, we believe that these changes are not tied in any specific way to financial institutions covered by Chapter 14. Thus, in our view incorporating these proposals so as to be applicable to any bankruptcy proceeding, whether or not dealing with a covered financial institution in Chapter 14, would be desirable.

of this form of executory contract. After three days, and unless the debtor has previously assumed the derivative, the counterparty will be free to exercise any rights it may have under “ipso facto” clauses (or otherwise) to terminate the derivative and, upon termination (either by action of the counterparty or by rejection by the debtor), the counterparty will have the netting, set-off, and collateral sale rights of a repo counterparty in bankruptcy. The third part, which concerns both repos and derivatives, applies trustee avoiding powers, including preference law, to such transactions, but also provides a “two point net improvement test” safe-harbor for certain payments and collateral transfers that otherwise would be subject to preference attack. These three parts are only briefly summarized here; more detailed consideration of each—such as provisions dealing with the sale of other types of collateral or the enforceability of master agreements—is developed below.

*a. Repos and the Automatic Stay*

*Background*

Before looking at current law, or at the proposal, it is useful to have some background information about the treatment of loans in bankruptcy, and the likely treatment of repos under normal bankruptcy rules (rather than the special rules that have been added governing their treatment).

Loans—situations where a creditor has loaned money to a debtor and awaits a repayment—are considered “claims” in bankruptcy of the debtor. The essence of a “claim” is that it is a liability from the perspective of the debtor. Since the debtor has already received the funds, and the only obligation remaining is the debtor’s repayment, it is a classic liability. The filing of a bankruptcy petition effectively “breaches” (or, to use language we’ll see later, “rejects”) this repayment obligation. This occurs automatically. The creditor does not need to take any action and the debtor is not permitted to “assume” the obligation. The claim is “accelerated” and valued as of the date of the filing of the petition; interest accruing after that date is disallowed unless the debtor has a security interest and is “oversecured.” Thus, if the debtor borrowed \$10,000 from creditor on February 1<sup>st</sup> with repayment on June 1<sup>st</sup> and files for

bankruptcy on April 1<sup>st</sup>, the claim would be for \$10,000 plus accrued but unpaid interest to that date.

The creditor is stopped by the essential nature of bankruptcy as a collective proceeding from taking any steps to collect this claim. The “automatic stay” of §362 prohibits “any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title,” §362(a)(6). This includes any setoff of a prepetition claim against a prepetition obligation that the debtor may owe the creditor, §362(a)(8). [The *right* of setoff is recognized by bankruptcy law, §553, but *exercising* it is prohibited by the automatic stay without first seeking court permission.]

If the loan is secured by collateral, the automatic stay extends to any effort to seize, use, or sell, that collateral, §362(a)(3), (4), (5); this would include collateral in the possession of the creditor. (Indeed, pursuant to §542(a), the secured party may need to turn over the collateral to the debtor if it is the type of property that the debtor may “use, sell, or lease” under §363.) The debtor is relieved of any obligation to post additional collateral. If there is a danger that the existing collateral will decline in value during the bankruptcy proceeding (traditionally, because the debtor is using the collateral, but it would extend to market fluctuations as well), the secured creditor may ask the court for “adequate protection” of its security interest under §361. Under a Supreme Court interpretation of the Bankruptcy Code, the secured party is not compensated for the delay itself—for the “time value” of money—unless the secured party’s collateral is worth more than the amount of the loan outstanding.

In short, in the case, of a secured loan, upon the filing of a petition in bankruptcy **(a)** the loan is “breached” and valued as of that date, **(b)** the collateral is similarly valued as of that date and further decreases in its value are protected, upon request, by “adequate protection,” **(c)** the debtor is relieved of any obligation to post additional collateral, and **(d)** the secured creditor cannot take steps to collect the debt, including by self-help (setoff or selling collateral in its possession), without first getting bankruptcy court permission.

Most repos, despite their form (a sale and repurchase), are in fact considered by practitioners to be secured loans, and it is very probable that virtually all repos would be recharacterized to *be* secured loans by Article 9 of the Uniform Commercial Code. (Article 9

applies to “a transaction, *regardless of its form*, that creates a security interest in personal property,” §9-109(a)(1).) Thus, their *probable* treatment in bankruptcy, apart from “special” rules, would likely be identical to what has been described above in terms of secured loans.

With this as background, we can turn to the current and proposed treatment of repos vis-à-vis the automatic stay in bankruptcy.

### *Current Law*

Under §559, a repo counterparty can terminate a repo notwithstanding a “condition” of the sort that is invalidated by §365(e)(1). Unlike ordinary contract creditors, who cannot enforce so-called “ipso facto” clauses, which allow termination at the event of the commencement of a bankruptcy case or the debtor’s insolvency, repo counterparties are permitted to invoke these provisions, §559. Under §362(b)(7), a repo counterparty also can offset or net out obligations (including transfer obligations) under one or more repo agreements, including a master agreement, notwithstanding the automatic stay. (Although this language, added in 2006, is not crystal-clear, it is clear from prior language and intent that this includes the repo counterparty’s ability to sell the “collateral” (the property that is the subject of the repo) that is in its—or its agent’s—possession.)

### *Concerns*

Current law suggests “special” treatment vis-à-vis the automatic stay for repos when, in fact, ordinary bankruptcy principles would lead to much the same result. At the same time, because of the complete exemption of current law, there is no attention paid to types of collateral. And, even with the special repo rules in bankruptcy, the right of a repo counterparty to marketable securities that are in the possession of the debtor, even upon motion, is unclear.



## *Proposal*

Very little would change, because of two overarching principles. First, repos, as a matter of non-bankruptcy law, are forms of secured loans (see above). Second, because the property that is the subject of repos is usually marketable securities or other cash-like instruments, there is no “firm specific” value to the assets and there is little subjectivity regarding their market value. Putting together these two principles, the following emerges. First, repos are automatically breached upon the filing of a bankruptcy petition. Second, because all repos are breached, no such provision in a master agreement that cross-links repos is necessary to ensure that the breach of one is considered a ground to terminate all (since all have been terminated automatically upon the filing of a bankruptcy petition). Third, because of the highly-marketable attributes of the property that is oftentimes the subject of repos—the “secured property” in the recharacterization of repos as secured loans—there is little reason to prohibit the sale of such property, if it is in the possession of the counterparty, by the automatic stay. Since all the repos are breached by the filing of the bankruptcy petition, the setting off, or netting out, across repos, invades no bankruptcy norm and should also be allowed—although master agreements that allow netting of repos against derivatives or other qualified financial contracts would be limited to netting across repos. These results are all consistent with the current Bankruptcy Code “special rules” involving repos, and thus—despite their linguistic awkwardness—no change in either §559 or §362(b)(7) is necessary. The changes we propose are threefold:

First, our proposal would ensure that the right of collateral sales by counterparties of repos, without court permission, where the debtor is in bankruptcy, is limited to cash-like, or otherwise highly-marketable, securities. (Arguments that the debtor “needs” access to the cash-like assets [by definition, in possession or control of the counterparty], conflates DIP financing, discussed above, with firm-specific collateral, which cash-like collateral is not. Requiring the counterparty to be a DIP financier, with “adequate protection” of its secured interest given in return, is both coercive and defaults to the highest level of DIP financing priority because of the requirement of providing the counterparty with adequate protection. The issue of DIP financing, which our Chapter 14 proposal addresses, should not be conflated with the idea that a secured creditor holding cash-like collateral should be able to sell it because it is neither (a) firm-specific nor (b) subject to valuation manipulations.) Precisely because of the lack of firm-specific value

and the ease of valuation, our proposal is limited to cash-like, or otherwise highly-marketable, securities. If a repo involved (for example) a drill press, that repo's counterparty wouldn't be automatically exempted from the automatic stay (on selling the collateral).

Second, our proposal would give the repo counterparty the right to sell other, non-firm-specific, collateral in its possession upon motion to the court and the court's determination of the collateral's reasonable value.

Third, for situations where the collateral is in the hands of the debtor, not the repo counterparty, we propose to amend §362, for Chapter 14 purposes, to give a right of relief upon petition by a counterparty seeking to sell collateral backing the repos in the possession of the debtor to the extent that collateral consists of highly-marketable securities or other cash-like collateral (which can be easily valued and does not have "firm specific" value) as well as other non-firm-specific collateral upon the court's determination of the collateral's reasonable value.

*b. Derivatives/Swaps and the Automatic Stay*

*Background*

Before turning to current law or our proposals, it is useful, as for repos, to discuss the background treatment of "executory contracts" in bankruptcy, and what the likely treatment of derivatives/swaps in bankruptcy would be vis-à-vis the automatic stay under normal bankruptcy rules.

Derivatives/swaps, analytically, come in two different (but closely-related) forms. In one form, they set (or guarantee) a price on a certain date. As such, they are (as a matter of form) analogous to a contract, entered into on February 1<sup>st</sup>, for the debtor to buy widgets on June 1<sup>st</sup> for \$1,000. A simple future or forward contract—such as a contract to buy oil at a specified price on June 1<sup>st</sup>, takes this form. The second is a protection (against default, a price change, or whatever) over time. An interest rate or currency swap is a familiar example, as are credit default swaps. As such, these contracts are analogous (as a matter of form) to a fire insurance policy on a building. As a matter of bankruptcy law, the widget contract is considered an "executory contract" under §365, since it consists of materially unperformed obligations on both

sides (the buyer needs to pay and the seller needs to deliver). The same would be true of an insurance contract where the debtor had not already paid for the insurance. The fundamental notion of an executory contract is that the debtor has a right to “assume” (i.e., determine that the contract is a net asset) or “reject” (i.e., determine that the contract is a net liability). Upon assumption, the contract is treated as if it was one entered into by the debtor in bankruptcy, and thus the debtor is expected to perform, with any damages resulting from a failure to perform treated as an administrative expense claim, rather than a prepetition claim. Upon assumption, the debtor must comply with the terms of the contract, including the posting of additional collateral. On the other hand, if the debtor decides that the contract is a net liability, the debtor may “reject” the contract, in which case any resulting damage claim is treated as a pre-petition claim whose value is determined as of the filing of bankruptcy, just as in the case of ordinary loans (or repos). This right of the debtor to choose between assumption and rejection cannot be circumvented by a term in the contract that permits the non-debtor party to terminate because of bankruptcy or the financial condition of the debtor. As discussed under repos, clauses that permit this are called “ipso facto” clauses in bankruptcy and are normally unenforceable, see §365(e)(1). The effect of a termination by the non-debtor party pursuant to an ipso facto clause would be to remove the choice of the debtor to “assume” the contract—that is, determine (from the perspective of the bankruptcy estate) that the contract was a net asset. That is prohibited by bankruptcy, as is any setoff right or collateral disposition, because of the operation of the automatic stay, as was discussed under repos.

In short, in the case of executory contracts, in bankruptcy **(a)** the debtor has a right to decide whether to “assume” or to “reject” the contract, **(b)** this right cannot be eliminated by any right of the other party to terminate based on an “ipso facto” clause, **(c)** the automatic stay applies during this interregnum to prohibit the other party to setoff, sell collateral, or otherwise attempt to collect on the underlying obligation, **(d)** if the debtor “rejects,” then analytically the contract is treated just as would be a loan or repo, discussed above, and **(e)** if the debtor “assumes,” then the contract is treated as one “created by” the debtor in bankruptcy, and thus one for which it needs to perform (including additional collateral postings); any breach of that obligation would be equivalent to a breach of a post-petition “administrative expense priority” contract.

There is little doubt that, apart from the special provisions governing derivatives/swaps, they would be considered to be executory contracts, treated as are other executory contracts as described above. With this as background, we can turn to the current and proposed treatment of swaps and derivatives vis-à-vis the automatic stay in bankruptcy.

### *Current Law*

Here, unlike the case with respect to repos, the special rules for derivatives/swaps do, in fact, significantly change the rights of a derivatives/swap counterparty in bankruptcy vis-à-vis the rights of an ordinary secured creditor. Section 560 calls off the application of §365(e)(1)—and thus permits the counterparty to terminate based on an ipso facto clause. The effect of a termination by the counterparty pursuant to an ipso facto clause is to remove the choice of the debtor to “assume” the contract. And, upon termination, a parallel exception, built into §362(b)(17), allows the counterparty “to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such agreements . . . .” This permits “self help” by the counterparty, including selling any collateral that might be in its possession. [If the collateral is not in its possession, there is no comparable exception to the automatic stay that would allow the counterparty to pursue collateral in the possession of the debtor without first gaining court permission, so that is not an issue.] Because of the master agreement provisions, any rejection or termination of any one derivative/swap with a counterparty is grounds for the counterparty’s termination of all the derivatives within the same master agreement, thus precluding the debtor “cherry-picking” which derivatives/swaps with a counterparty to assume (because a net asset) or reject (because a net liability). A provision determining that “breach of one is a ground for the termination of all” is enforceable.

The provisions do seem to require the counterparty, in order to terminate, to take some concrete step towards that (such as notifying the debtor that it is terminating the contract). In the interim, the debtor remains free to assume or reject under §365. (Indeed, *Metavante* suggests that unless the counterparty terminates a derivate/swap in a rather quick time-frame, it loses the right to avoid assumption under §365 by the debtor.)

## *Concerns*

By removing derivatives completely from the automatic stay, a debtor may be precluded from assuming valuable derivatives (subject to a master agreement that may, functionally, require an “all or nothing” determination). Both the FDIC resolution model for depository banks, and the recently-enacted government agency resolution procedures for financial institutions under the Dodd-Frank Act, provide a one-day window in which the debtor (or the government agency) may decide to assume and assign derivatives, which place bankruptcy in a significant disadvantage (from the perspective of the financial institution) as an alternative.

## *Proposal*

Although the debtor should be on a tight time-leash with respect to the decision whether to assume or reject, the fundamental nature of derivatives/swaps as forms of executory contracts suggest that the debtor should have the right to determine whether to assume or to reject them. This means that, during this period, the counterparty should be subject to the automatic stay, as well as precluded from terminating any derivative/swap because of an ipso facto clause. At the same time, whether as a matter of a “vested” provision of a master agreement (that cannot be undone by the debtor rejecting the master agreement itself) or the consequences of a right of set-off that is not excluded from the stay, the counterparty should retain the right to terminate any or all derivatives/swaps with the debtor should the debtor decide to reject, under §365, *any* derivative/swap with the counterparty. Because of that, the debtor cannot “cherry pick”—picking the derivatives/swaps with a particular counterparty that it views as net assets, and assuming them, while rejecting all derivative/swaps that it views as net liabilities. The interplay of the right of the debtor to assume or reject and the counterparty to treat the rejection of one as the rejection of all, leads to a global decision of the debtor (*vis-à-vis* any single counterparty) to assume all, or to reject all, derivatives/swaps with that counterparty.

With pre-bankruptcy planning and wind-down plans, and with recognition of the right (currently one that can be circumvented by a counterparty by the special QFC bankruptcy rules) of the debtor to decide whether to assume or reject, the automatic stay, as well as the normal rules prohibiting termination based on ipso facto clauses, should apply for a period of three days

from the time of the filing of the bankruptcy petition. After that, the debtor's right to assume the derivatives/swaps can be terminated by the counterparty (pursuant to the agreement's termination provisions; until termination by the counterparty has occurred, the debtor continues to have the right to assume). Upon termination, the counterparty enjoys all the rights described above under repos vis-à-vis set-off and collateral sales: E.g., the right of collateral sales (without going to court) in the case of marketable securities and other cash-like collateral in the counterparty's possession, with both recognized market values and no "firm specific" value, the right of collateral sales, upon motion, for other collateral without firm-specific value and upon court determination of the fair value of the collateral, and the right, upon motion, to access collateral of the categories just identified, still in the possession of the debtor

There are concerns that no such short stay, such as our proposal of three days, could possibly allow a debtor to "net out" the value of potentially thousands of related swaps. Whether or not true under the existing procedures—and we note that an even more aggressive abbreviated time-table exists for depository banks under the FDIC resolution procedure and in Title II of Dodd-Frank—it is also the case that recent requirements, including Dodd-Frank's insistence on "living wills" as well as its push to have swaps traded on exchanges—will go far to make "net out" valuations much more instantaneous, and thus potentially consistent in terms of quick valuation and evaluation with the brief stay we favor.

Operationally, this would be accomplished through the following changes, applicable to Chapter 14, of current bankruptcy provisions. The single most important "fix" would be to condition the application of §560 on the expiration of three days from the filing of a petition in bankruptcy by a financial institution.<sup>6</sup> Prior to the termination of that period, the derivative/swap counterparty (like a party to any other comparable executory contract) would not have the right to terminate the contract without going to court first. And the debtor would have, as it does with other comparable executory contracts, the right to decide to assume or reject the derivative contract (although a master agreement or the setoff right might make that exercise be an "all or nothing" affair).

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<sup>6</sup> Although not the current focus (which is on derivatives/swaps), §§555 & 556, which deal with securities contracts and forward contracts in an analogous manner to §560, should likewise be conditioned on the expiration of three days from the filing of a petition in bankruptcy by a financial institution.

This change (i.e., the limitation that would be written into §560) would mean that the counterparty could not offset, net out, or sell collateral unless and until **(a)** the debtor decides to reject the contract and it is (by that action) terminated or **(b)** the three-day time period for the debtor to decide whether to assume or reject expires. Upon termination (either by the counterparty, upon the expiration of the three-day time period, or by the debtor when it rejects the contract), the existing §362(b)(17) rights (which are opaquely worded and should be clarified) would remain—that is, a right to set-off one contract against another without first going to court and, ancillary to that, sell collateral in the possession of the counterparty without first going to court. With the understanding, that should be made the basis of statutory distinction, that most of that collateral will be financial instruments—or “cash-like” collateral (with recognized market values)—the ability of a counterparty to “self-help” by selling collateral (in its possession) or netting out need not be a major disruption to the ongoing operations of the debtor and would not need to be repealed.

The right of a counterparty, under a master agreement, to “cross link” derivatives/swaps so that the rejection of one by the debtor would permit the counterparty to treat all of the derivatives/swaps as terminated (thus precluding the debtor’s assumption of any of them), would remain in force.<sup>7</sup> Section 362 should also be amended, for Chapter 14 purposes, to give a right of relief upon petition by a counterparty seeking to sell collateral backing the derivatives/swaps (a) in the possession of the counterparty that, while not highly-marketable, has no “firm specific” value, upon the determination of its fair market value, (b) in the possession of the debtor to the extent that collateral consists of highly-marketable securities or other cash-like collateral (which can be easily valued and does not have “firm specific” value), and (c) in the possession of the debtor to the extent that the collateral consists of other non-firm-specific collateral, upon the determination of its fair market value.

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<sup>7</sup> This right, however, would be limited to cross-linking derivatives/swaps pursuant to a master agreement. The master agreement would not be enforceable to the extent it attempted to cross-link repos and derivatives/swaps. Since repos are automatically “terminated” upon the filing of a bankruptcy petition, cross-linking across these categories would allow a counterparty with one (small) repo to avoid the debtor’s ability to assume all derivatives/swaps under §365. The master agreement provisions in the Bankruptcy Code should be amended to make this clear.

c. *Repos, Derivatives/Swaps, and Trustee Avoiding Powers*

*Background*

Bankruptcy has several devices, usually lumped together under the rubric of “trustee avoiding powers” to protect dismemberment of the estate, either through actions of the debtor or through actions of creditors to seek to protect themselves, after making a loan or entering into a contract, from the consequences of an imminent bankruptcy proceeding. The most important of these “reach back” avoiding powers are **(a)** fraudulent transfers, §548, and **(b)** preferences, §547.

Under §548, the fraudulent transfer provision,<sup>8</sup> the trustee (or debtor-in-possession) may avoid two types of transfers as fraudulent. The first, in §548(a)(1)(A), are transfers made within two years of bankruptcy “with actual intent to hinder, delay, or defraud any entity”—this is known as the actual fraud provision. The second, in §548(a)(1)(B), known as the constructive fraud provision, reaches pre-bankruptcy transfers within two years of bankruptcy where the debtor “received less than a reasonably equivalent value” at a time when the debtor was insolvent, had unreasonably small capital, or believed that it would incur debts beyond its ability to pay.

Under §547, the preference section, the trustee may avoid a transfer “on account of an antecedent debt,” made within 90 days of bankruptcy<sup>9</sup> and while the debtor was insolvent,<sup>10</sup> that enables a creditor to receive more than it would have received, in bankruptcy, had the transfer not been made. Thus, transfers are not just payments, but would include things such as the posting of additional collateral on an existing contract (“on account of an antecedent debt”). There is an exception for transfers that are both intended, and are in fact, “a contemporaneous exchange for new value given to the debtor,” although it is essential to note that “new value” is defined as excluding “an obligation substituted for an existing obligation,” §547(a)(2). There is also, for security interests in inventory or receivables, what is known as a “two-point net improvement” test, which looks at whether “the aggregate of all such transfers caused a reduction,” on the commencement of bankruptcy, of the creditor’s claim 90 days before

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<sup>8</sup> The trustee also has access to state fraudulent transfer provisions pursuant to his §544 “lien creditor” powers, which oftentimes have a longer reach-back period than the two year period provided by §548.

<sup>9</sup> One year if the transfer is to or benefits an “insider” of the debtor.

<sup>10</sup> “Insolvent” is defined in §101(32) as having debts greater than assets, at fair valuation.



bankruptcy (or the date on which new value was first given), §547(c)(5). (Thus, the fact that the inventory went down in value and then went back up in value would be ignored, unless the inventory value on the date of bankruptcy was greater than the inventory value 90 days before bankruptcy.)

### *Current Law*

Under §546(e), (f), (g), and (j), the trustee's avoiding powers (with the exception of the actual fraud provision of §548) are not enforceable against the holder of qualified financial contracts. This started with what is now §546(e), exempting the transfers of margin and settlement payments by or to brokers (an exemption that makes some sense since these payments usually don't have the hallmarks of "opt out" activity on the eve of bankruptcy). From this narrow beginning, the Bankruptcy Code has been amended to provide similar protection for *all* qualified financial contracts, including repos, §546(f), and derivatives/swaps, §546(g).

### *Concerns*

QFC counterparties tend to be among the most sophisticated creditors of a financial institution. Providing a safe-harbor from preference law (and other trustee avoiding powers), when "regular" creditors are subject to such powers, seems perverse, in that it protects the parties most likely to "see" bankruptcy coming and take steps to protect themselves or, alternatively, take steps that lead to a bankruptcy case being commenced in a more timely fashion. While there are special features of various QFCs that do not fit comfortably into existing preference law, a blanket exemption seems overbroad.

### *Proposal*

With respect to repos and derivatives/swaps, and subject to an amendment to §547(c)(5) regarding an extension of a "two point net improvement" safe harbor that is discussed below, remove the current exemption from trustee avoiding powers by amending §546(f) and (g) (as

well as §546(j), which repeats the protection for transfers made pursuant to a master netting agreement) to provide that these provisions do not apply in a Chapter 14 proceeding.

It is important to understand what this does, and does not, do (here, focusing on the preference provisions of §547. Because of the nature of preference law—did a creditor improve his position at the expense of other creditors via a transfer within the preference period?—“improvements in position” by a creditor that are due to market increases in value of collateral are *not* subject to preference attack. Say a security, posted as collateral, is worth \$70,000 on 90 days before bankruptcy and is worth \$90,000 at the time of bankruptcy. The \$20,000 “improvement in position” is not a voidable preference because it involves no “transfer of property of the debtor” (and, conceptually, does not diminish the returns to the other creditors). Because of this feature, and the nature of repos, most repos will not be subject to attack under §547. With a typical repo, in which the debtor promises to buy back property that had been previously sold to a counterparty, fluctuations in the value of that property due to market forces between the sale and repurchase are not preferences under §547; recharacterizing the transaction as a secured loan does not change the underlying preference analysis. The case where preference law would matter would be cases in which, notwithstanding the sale/repurchase form, the property subject to the repo declines in value and the repurchaser (the failed financial institution) posts additional property. Treated as a secured loan, this is equivalent to the posting of collateral with an original value of \$70,000 that declines, within the preference period, to \$60,000, leading to a requirement that the debtor post an additional \$10,000 of collateral. Preference law would treat this additional posting as a voidable preference.

Preference law, however, looms larger for swaps and other derivatives, where collateral is in fact used to secure an underlying obligation. Here, however, it is still the case that increases in the value of collateral due to market forces are not themselves preferential. And there is a second, important, situation in which “new” collateral would not be preferential, which we will call “roll over” derivatives. To see this, consider the following reasoning. While the definition of “new value” in §547(a)(2) excludes “an obligation substituted for an existing obligation,” that definition would not exclude treating “rolled over” derivatives as constituting new value, as long as the “roll over” occurs upon the maturing of one derivative. That is to say, if derivative #1, with \$20,000 of collateral securing a \$15,000 obligation matures, is paid off (which involves no

preference, as the counterparty is fully secured), and is replaced by derivative #2, with \$40,000 of collateral securing a \$15,000 obligation, there is no preference issue, even if the collateral (in both cases) declines by 50% by the time a bankruptcy case is commenced. Thus, even if a predictable response to subjecting derivatives to preference law would be to shorten the maturity of derivatives, and rely on “roll over” derivatives, there is a world of difference between “opting out” of bankruptcy concerns with an *existing* transaction, and a series of shorter, but independent, transactions that run their ordinary course.

The preference concerns of a counterparty thus would focus on two other issues: (a) payment on the derivative within 90 days of bankruptcy when the payment exceeded the value of the collateral (that is, the counterparty was undersecured) and (b) transfers of new collateral to the counterparty within the 90 day preference period that increase (rather than through market forces) the value of the aggregate collateral securing the obligation to the counterparty. While (a) is a straight-out preference, (b) is more complicated.

To delve into that complication, it is useful to return to the analogy of the “two point net improvement test” for cases where the collateral is inventory or receivables. The original idea behind the “two point net improvement test” for inventory or receivables follows the image of a “pool” of collateral. One takes (for example) a security interest in “inventory,” and knows that the inventory will fluctuate in value, not because of a change of market valuation of each individual item in that inventory, but because the nature of inventory is that it fluctuates in size. Thus, in the completely ordinary course of business, a security interest in an inventory of widgets, with each widget always worth \$10, may fluctuate because the number of widgets in the inventory might be 8,000 on one day, 12,000 a week later, and 10,000 the following week. Viewing that this is unlikely to be the result of opt-out activity,<sup>11</sup> the Bankruptcy Code provides a safe-harbor for such fluctuations, except to the extent that the creditor’s overall position is better at the time of the commencement of the bankruptcy case than it was at a point 90 days earlier (or when credit was first extended within that 90 day period), §547(c)(5). Thus, if the debtor owes \$100,000 to the lender and the “pool” of widget inventory was worth \$80,000 90 days before bankruptcy, declined to \$60,000 30 days before bankruptcy, and then increased so

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<sup>11</sup> Which is not to say that it could not be, as where a creditor demands that its debtor “build up” its inventory within 90 days before bankruptcy.

that it was valued at \$90,000 on the date of bankruptcy—all because of fluctuations in the number of widgets in the inventory—the creditor would have a potential voidable preference of \$10,000, rather than \$30,000.<sup>12</sup>

Derivatives are rarely secured by inventory or receivables, and so are not able to claim the protection of §547(c)(5). But certain features of certain derivatives fit the underlying principle, in addition to being protected by the more general principle that changes in market values of underlying collateral are not themselves preferential, as discussed above.<sup>13</sup> For example, if a certain derivative transaction is secured by “all” of the debtor’s mortgage backed securities, and the quantity of those securities fluctuates, the analogy to inventory or receivables (which are protected by §547(c)(2)) is strong, and is deserving of comparable protection, which requires an amendment to §547(c)(5) to include classes of securities or other “pool-like” collateral that might be the subject of derivative transactions in a Chapter 14 proceeding.

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<sup>12</sup> The creditor may not even have a voidable preference in the amount of \$10,000, as the trustee must also show that reduction in the creditor’s unsecured claim was “to the prejudice of other creditors holding unsecured claims,” §547(c)(5), which may be difficult to show if all the debtor’s other assets are worth exactly as much as before.

<sup>13</sup> This would also protect the substitution of a new security as collateral when an old security matured, as long as the new security was not more valuable than the old.

## Summary of Proposed Revisions

### *I. Creation of a New Chapter 14*

- Add a definition of a financial institution to §101 to pick up institutions (including their subsidiaries) with assets more than \$100 billion that are substantially engaged in providing financial services or financial products.
- Create a new Chapter 14 for financial institutions and require that financial institutions use it.
- Amend §109 to provide that a financial institution must concurrently file for a Chapter 7 liquidation or a Chapter 11 reorganization at the time that it files for Chapter 14, and that all resulting proceedings will be conducted pursuant to Chapter 14.
- Create designated district court judges in the Second and DC Circuits to hear Chapter 14 cases, by adding a new provision to Title 28. Provide that these designated district court judges have exclusive jurisdiction over Chapter 14 cases notwithstanding the provisions of 28 U.S.C. §157, and prohibit them from delegating the case to bankruptcy judges, but permitting them to assign to a special master, from a designated panel of special masters, the case and its proceedings as if it were a designation to a bankruptcy judge under 28 U.S.C. §158.

### *II. Commencing a Chapter 14 Case*

- Revise §109 to eliminate the exclusion from bankruptcy of insurance companies when Chapter 14 applies.
- Revise §109 to eliminate the exclusion of stockbrokers and commodity brokers from Chapter 11 when Chapter 14 applies.
- Provide that the special subchapters in Chapter 7 for stockbrokers (§§741 et seq.) and commodity brokers (§§761 et seq.) don't apply when Chapter 14 applies.
- Adopt existing rules for the treatment of customer accounts currently in §763 & §766 to apply to proceedings (whether liquidations or reorganizations) under Chapter 14.

- Provide that SIPC (for stockbrokers) and CFTC (for commodity brokers) have a right to be parties in relevant Chapter 14 cases.
- Amend §303(b) and (h) to provide that the primary regulator may commence an involuntary case against a financial institution.
- Amend §303(h) to permit an involuntary case commenced by the primary regulator to go forward if the financial institution's assets are less than its liabilities, at fair valuation, or the financial institution has unreasonably small capital.

### *III. Role of the Primary Regulator in Chapter 14; DIP Funding*

- Provide that the regulators of the business of a covered financial institution, or any subsidiary thereof, would have standing with respect to the financial institution or the particular subsidiary, to be heard or to raise motions relevant to their regulation with the Chapter 14 court.
- Amend §363 to provide that the primary regulator has the power to file motions for the use, sale, or lease of property.
- Amend §1121 to provide that, in a Chapter 14 case, notwithstanding §1121(c), the primary regulator or a creditors' committee can file a plan of reorganization at any time after the order for relief.
- Amend §364(b), (c), and (d) to make clear that, in a Chapter 14 case, DIP financing is permitted, upon court approval after motion and hearing instigated by the debtor-in-possession, the trustee, or the primary regulator, for the purpose of providing partial or complete payouts to some or all creditors, with petitioners for such funding bearing the burden of proof on (a) the necessity (for liquidity or other systemic reasons) of such payout (including its amount and the identified parties), (b) that such payout is less than or equal to a conservative estimate of the amount the creditors would receive in the bankruptcy proceeding without such funding, (c) that any such prepayments were not likely to favor particular creditors or otherwise undermine the operation of bankruptcy's priority rules, and (d) it shall be a provision of any such funding that, should the payout exceed the amount that the creditors would have received in the bankruptcy proceeding in

the absence of such funding, either the creditors receiving such advanced payout agree to repay to the estate the amount by which their advanced payout exceeded that amount or the funder agrees to subordinate his claim to that of the other creditors to the extent necessary to allow them to receive what they would have received in bankruptcy in the absence of such funding. In addition, if the government is the source of the funds to make these prepayments, the petitioners for such funding will additionally be required to show that such funds are not available from a private party on reasonably equivalent terms.

#### *IV. Qualified Financial Contracts in Chapter 14*

- Automatic stay and repos: amend §362 to give the counterparty, in Chapter 14, the right to sell cash, or cash-like, collateral in its possession at any time, as well as the right to sell, upon petition, other financial (non-firm specific) collateral in its possession upon a determination of the reasonable value of such collateral.
- Automatic stay and repos: amend §362 to give, in Chapter 14, a right of relief from the automatic stay upon petition by a counterparty seeking to sell collateral in the possession of the debtor to the extent the collateral consists of highly-marketable securities or other cash-like collateral as well as, to the extent the collateral consists of other non-firm specific collateral, upon the court's determination of its fair market value.
- Automatic stay and swaps: limit the applicability of §560 (as well as §§555 & 556) in Chapter 14 cases to the expiration of three days from the filing of a bankruptcy petition. After the expiration of that period, the counterparty has the right to sell collateral in parallel to the provisions for collateral sales by repo counterparties in Chapter 14.
- Automatic stay and swaps: clarify §362(b)(17) so that a counterparty cannot offset, net out, or sell collateral until the debtor rejects the contract or the time period specified in §560 expires.
- Automatic stay and repos/swaps: make explicit that cross-termination and cross-collateralization provisions in master agreements remain effective notwithstanding

termination—but not from repos to swaps (or vice-versa) until both have been terminated.

- Trustee avoiding powers, repos and swaps: Provide that the provisions of §546(f), (g), and (j), do not apply in a Chapter 14 proceeding.
- Trustee avoiding powers, repos and swaps: Amend §547(c)(5) so that its “two point net improvement” test applies to swaps in a Chapter 14 proceeding when the collateral can be identified as a defined “pool.”



## **An Examination of Lehman Brothers' Derivatives Portfolio Post-Bankruptcy and Whether Dodd-Frank Would Have Made Any Difference**

*By Kimberly Summe*

### I. Introduction

In the two and a half years since 157 year-old Lehman Brothers made the largest bankruptcy filing in United States history, the regulatory and financial landscape has shifted in many ways. As expected after any market crash of such severity and duration, policymakers considered, among many issues, whether the U.S. Bankruptcy Code functioned effectively and concluded that it had not. Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System, testified to the House Committee on Financial Services on October 1, 2009 that:

In most cases, the federal bankruptcy laws provide an appropriate framework for the resolution of nonbank financial institutions. However, the bankruptcy code does not sufficiently protect the public's strong interest in ensuring the orderly resolution of a nonbank financial firm whose failure would pose substantial risks to the financial system and to the economy. Indeed, after Lehman Brothers' and AIG's experiences, there is little doubt that we need a third option between the choices of bankruptcy and bailout for such firms.<sup>1</sup>

Congress and the White House enshrined that third option into Title II of the Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), signed into law by President Obama on July 21, 2010. Title II of Dodd-Frank promulgated an entirely new insolvency regime for large,

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<sup>1</sup> Testimony of Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System, to the U.S. House of Representatives Committee on Financial Services, (October 1, 2009), 7.

interconnected financial companies whose possible failure would portend the sort of economic devastation that policymakers assumed the Lehman Brothers bankruptcy unleashed.

The purpose of this paper is to examine how Lehman Brothers' bankruptcy has unfolded to date with respect to its U.S. derivatives portfolio and how that would be different had Dodd-Frank been in effect in September 2008. The paper concludes that with respect to the derivatives portfolio of any failed "systemically important" company captured by the resolution procedures of Title II of Dodd-Frank, Congress' efforts neither resulted in a change to the way derivative trades are handled post-bankruptcy nor provided comfort that a government bail-out of a clearinghouse will be avoided.

## II. Lehman Brothers – How Has Its Derivatives Portfolio Fared Post-Bankruptcy?

Contemporary financial institutions, particularly those that are arguably most systemically important, operate globally. A mix of banks, broker-dealers, commodity brokers, futures commission merchants, corporations and insurance companies operate under the financial institution's umbrella and engage in business twenty-four hours a day, seven days a week, in dozens of jurisdictions. Upon insolvency, each entity becomes subject to its own insolvency regime, depending upon its jurisdictional location, its organizational form and its activities. Lehman Brothers' bankruptcy, in the broadest sense, involved five bodies of laws applicable to its various corporate entities: first, the Federal Deposit Insurance Act applied to its U.S. banks<sup>2</sup>; second, the Bankruptcy Code applied to its insolvent corporations, such as its Delaware corporations that traded derivatives, including Lehman Brothers Special Financing, Inc.; third, the Securities Investor Protection Act regime applied to the insolvent broker-dealer, Lehman Brothers Inc.; fourth, state insurance laws applied to its insurance subsidiaries; and lastly, over 80 jurisdictions' insolvency laws applied to the insolvent non-U.S. Lehman Brothers entities<sup>3</sup>.

As noted above, Lehman Brothers Special Financing, Inc. ("LBSF") was the primary, although not the exclusive, entity through which Lehman Brothers' U.S. derivatives business was done.

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<sup>2</sup> Note that Aurora Bank and Woodlands Commercial Bank just received approval from the Federal Deposit Insurance Corporation to sell their respective businesses. Those entities did not immediately file for bankruptcy, but recently, became unable to meet their capital requirements. [Update.]

<sup>3</sup> Lehman Brothers Holdings Inc. State of the Estate (September 22, 2010), 8. See also The Financial Crisis Inquiry Report, 340.

Outside of the United States, derivatives transactions were done through Lehman Brothers International (Europe) (“LBIE”).<sup>4</sup> When Lehman Brothers filed for bankruptcy, the U.S. estate reported that it was a counterparty to 930,000 derivatives transactions documented under 6,120 ISDA Master Agreements.<sup>5</sup> The vast majority of those derivatives transactions involved LBSF, a Delaware corporation, with documentation being executed pursuant to the industry standard ISDA Master Agreement.<sup>6</sup> While the exact size of LBSF’s derivatives portfolio pre-bankruptcy has not been published, Lehman Brothers’ global derivatives portfolio was estimated to be \$35 trillion in notional value, representing about five percent of derivatives transactions globally.<sup>7</sup>

Under the ISDA Master Agreement, upon a counterparty’s (or guarantor’s) default such as a voluntary or involuntary bankruptcy, the non-defaulting party has the right to designate a date on which the portfolio of derivatives will be valued and terminated, to terminate the transactions on such date and to liquidate and apply any collateral. Once Lehman Brothers Holdings Inc. filed for bankruptcy on September 15, 2008, its status as the guarantor for LBSF’s derivatives transactions meant that non-defaulting parties were able to elect to terminate their transactions, even though LBSF did not file for bankruptcy until October 3, 2008. Approximately 80 percent of the derivatives counterparties to LBSF terminated their derivatives transactions under the ISDA Master Agreement within five weeks of bankruptcy.<sup>8</sup> In those transactions where the non-defaulting party owed LBSF money, those amounts were paid. If LBSF, on the other hand, owed money to the non-defaulting party, such amounts were not paid.

The estate has been successful, almost immediately post-bankruptcy, in capturing these receivables. On September 14, 2008, the estate reported that LBSF had a then-current cash position of \$7 million. Within three and a half months, LBSF had a current cash position of

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<sup>4</sup> Note that this paper does not address how derivatives claims against LBIE are proceeding.

<sup>5</sup> Lehman Brothers Holdings Inc. First Creditors Section 341 Meeting, January 29, 2009, 19-20 ([www.lehmanbrotherssestate.com](http://www.lehmanbrotherssestate.com)). Note that the Lehman Brothers Holdings Inc. The State of the Estate (November 18, 2009), 28, reports a slightly different figure of 6,355 contracts.

<sup>6</sup> Note that other U.S. Lehman entities engaged in derivatives trading, but LBSF was by far the largest among the U.S. entities trading.

<sup>7</sup> Bank for International Settlement, “Semiannual Over-The-Counter (OTC) Derivatives Markets Statistics”, [www.bis.org/statistics](http://www.bis.org/statistics), June 2009.

<sup>8</sup> Debtors’ Motion for an Order pursuant to Sections 105 and 365 of the Bankruptcy Code to Establish Procedures for the Settlement or Assumption and Assignment of Prepetition Derivatives Contracts, Lehman Brothers Holdings Inc., *et al*, No. 08-13555 (U.S. Bankr. Ct., S.D.N.Y. November 13, 2008).

\$925 million.<sup>9</sup> By November 18, 2009, the Lehman estate reported that figure had grown dramatically to \$5.025 billion dollars in current cash and investments<sup>10</sup> for LBSF; adding in the other U.S. entities involved in trading derivatives, increased that figure to \$8 billion.<sup>11</sup> By June 30, 2010, LBSF had approximately \$7.355 billion in current cash and investments<sup>12</sup>, and \$11.467 billion when including the other Lehman entities<sup>13</sup>, reaching \$8.79 billion as by February 1, 2011<sup>14</sup>, and \$15 billion in aggregate being received to the credit of the estate.<sup>15</sup> LBSF represents nearly half of all cash and cash investment positions as compared to the aggregate of the other Lehman U.S. debtor entities.<sup>16</sup>

After two and a half years, challenges still remain with respect to winding down Lehman Brothers' U.S. derivatives portfolio. While the administrator has worked effectively to increase the assets of the estate, as noted above, and the ISDA Master Agreement offered a well-understood process and approach to calculating the value of terminated transactions, these factors have not lessened the sheer magnitude of effort involved in unwinding the most complex derivatives business in history. While the vast majority of counterparties quickly terminated their derivatives transactions with U.S. Lehman Brothers entities, including LBSF, that did not mean that the process was at an end. Rather, a multi-step process for reconciling, reviewing counterparty valuations of the terminated transactions and then moving to settlement is required. The last time Lehman Brothers published its resolution process figures in November 2009, 61 percent of derivatives claims had been reconciled and 50 percent had their valuation completed.<sup>17</sup> In that same report, the estate reported that LBSF had 3,222 claims against it, presumably all or mostly all derivatives claims. This figure represented at the time five percent

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<sup>9</sup> Lehman Brothers Holdings Inc. First Creditors Section 341 Meeting, January 29, 2009, 6 ([www.lehmanbrothersestate.com](http://www.lehmanbrothersestate.com)). (Reflects figures as of January 2, 2009).

<sup>10</sup> Lehman Brothers Holdings Inc. The State of the Estate (November 18, 2009), 9.

<sup>11</sup> *Ibid.*, 26.

<sup>12</sup> Lehman Brothers Holdings Inc. The State of the Estate (September 22, 2010), 10.

<sup>13</sup> *Ibid.*, 11.

<sup>14</sup> Monthly Operating Report (February 2011); Case No. 08-13555 (March 18, 2011).

<sup>15</sup> Lehman Brothers Holdings Inc. Plan Status Report (January 13, 2011), 16.

<sup>16</sup> Lehman Brothers Holdings Inc. The State of the Estate (September 22, 2010), 10.

<sup>17</sup> Lehman Brothers Holdings Inc. The State of the Estate (November 18, 2009), 28.

by volume and eleven percent by dollars, of the top five debtor entities claims in aggregate.<sup>18</sup> It is assumed that progress has continued since the intervening 16 months.

As the estate's work progressed, the administrator took the view that many counterparties were inflating their derivatives claims. Daniel Ehrmann, a managing director at Alvarez & Marsal and co-head of derivatives at Lehman Brothers Holdings Inc. stated that "...we discovered that out of all the claims against the Lehman estate, those in the derivatives subset were most inflated."<sup>19</sup> In fact, in April 2010, Lehman Brothers Holdings Inc. sued Nomura Holdings Inc., arguing that Nomura's \$720 million of derivatives claims relating to 2,464 transactions were the product of "egregious inflation" and reflected a desire to "secure a windfall" from Lehman's bankruptcy at the expense of creditors.<sup>20</sup> Indeed, the week prior to Lehman Brothers' bankruptcy, Nomura reported that it owed money to LBSF of over \$200 million.<sup>21</sup> At the time of this paper, the case had not settled and depositions were underway.

While the mechanics of the ISDA Master Agreement functioned effectively (and quickly post-bankruptcy) such that the vast majority of derivatives transactions were terminated, the legal obligations imposed on the administrator are such that a high standard of care is required before claims can be finalized for settlement. The statutory duties of the trustee in a Chapter 11 case are set forth in Section 1106 of the U.S. Bankruptcy Code<sup>22</sup>. In addition, case law imposes fiduciary obligations on a trustee, including treating all beneficiaries fairly and equally.<sup>23</sup> With thousands of derivatives claims, the administrator has a fiduciary duty to review and reconcile the process and conduct of how each non-defaulting party reached its early termination amount relating to each derivative trade – this for over 6,000 counterparties and around one million transactions. The goal of this painstaking but required process is to ensure that no creditor is preferred over another and to maximize the size of the estate for the benefit of all creditors. Practically, what

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<sup>18</sup> *Ibid.*, 32. Duplicate claims were often filed against LBSF and the parent company, but LBSF had a relatively small percentage of the claims made against the various U.S. Lehman Brothers entities as most were understandably against the parent company.

<sup>19</sup> Cameron, Matt, "LBHI Administrators Push for Settlement of Derivatives Claims," Risk (March 2, 2011).

<sup>20</sup> Adversary Complaint and Objection filed by Lehman Brothers Holdings Inc. in Bankr. Ct. S.D.N.Y. (April 23, 2010), 2.

<sup>21</sup> *Ibid.*, 3.

<sup>22</sup> 11 U.S.C. §1106.

<sup>23</sup> Restatement (Second) of Trusts §§ 170, 174 and 183.

this means is that the administrator conducts daily meetings with creditors to review the proposed settlement of each derivative claim – in essence, the early termination amount for each individual derivative transaction must be reviewed in accordance with the administrator’s fiduciary duty requirements to ensure that the estate’s beneficiaries are being treated fairly and equally. By the end of the third quarter 2010, two years after Lehman Brothers’ bankruptcy, the administrator reported that 45.6 percent of derivatives counterparties’ claims had been settled.<sup>24</sup>

The settlement of the derivatives portfolio should be considered in the context of the overall bankruptcy process to date. On March 15, 2010, Lehman Brothers Holdings Inc. and its twenty-two affiliated Chapter 11 debtors filed a joint Chapter 11 plan with the U.S. Bankruptcy Court for the Southern District of New York. The following month Lehman Brothers filed with the bankruptcy court its liquidation plan. The liquidation plan called for maintaining the corporate distinction of each Lehman entity that had filed for bankruptcy in 2008. This was a key point as it ensured that each affiliate would make payments to its creditors on the basis of its own asset base. However, creditors of the parent company, Lehman Brothers Holdings Inc., argued that parent company guarantees of affiliates such as LBSF meant that more debt resided at the parent level while assets were at the subsidiary level. For example, Lehman Brothers Holdings Inc. reported \$2 billion in cash and investments on June 30, 2010, whereas LBSF had \$7.35 billion in cash and investments.<sup>25</sup> Perhaps not surprisingly, a group of ten creditors, led by Paulson & Co., Canyon Partners LLC, the California Public Employees Retirement System and Pacific Investment Management Co. countered with their own liquidation plan on December 15, 2010, proposing to consolidate all affiliates’ assets into one Lehman entity – resulting in holders of parent company claims receiving more than if the corporate entity structure remained intact. This group of ten represents \$20 billion of Lehman Brothers Holdings Inc. claims, including \$16 billion of senior bonds in an \$80 million class.<sup>26</sup> In essence, the claims of derivatives creditors would be slightly reduced to the benefit of the bondholders under this creditor group’s proposal.

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<sup>24</sup> Liquidation plan filed with the Southern District of New York on January 25, 2011. [Need more precise cite].

<sup>25</sup> Lehman Brothers Holdings Inc. State of the Estate (September 22, 2010), 10.

<sup>26</sup> [Insert cite from their plan]. McLaughlin, David and Linda Sandler, “Lehman’s \$61B Plan Has Carrot, Stick for Paulson-Calpers,” Bloomberg (January 26, 2011).

In response, on January 25, 2011 Lehman Brothers filed an amended version of its liquidation plan seeking compromise with those creditors.<sup>27</sup> The new plan proposed to retain the corporate formalities of each debtor entity, but to re-distribute the payouts made to certain creditors. In essence, between 20 and 30 percent of payments owed to creditors of various operating companies, such as LBSF, would be forfeited and re-allocated to the parent company's creditors. For example, under Lehman Brothers' April 2010 plan, derivatives creditors of LBSF, such as Bank of America, Credit Suisse and Goldman, Sachs, would have received a 24.1 percent payout, while in the amended January 2011 liquidation plan, those derivatives creditors would receive a 22.3 percent payout, as creditors of the parent entity received slightly more than originally proposed. Goldman, Sachs has been reported to not be satisfied with either plan and as of the date of this paper is considering proposing its own. The investment bank has filed claims of \$2.5 billion against LBSF and filed a duplicate claim against Lehman Brothers Holdings Inc. based on the guarantees made by the parent to its affiliate.

As part of Lehman Brothers' January 2011 revised liquidation plan, a derivatives claims settlement framework was included. The framework offers a standardized methodology for valuing the remaining half of outstanding derivatives claims. The so called "big bank" derivatives counterparties represent 48 percent of all remaining derivatives claims in the U.S. bankruptcy process.<sup>28</sup> While roughly half of the derivatives claims have been settled post-bankruptcy, the estate notes that its derivatives claims framework was propelled by the fact that its big bank counterparties represent 85 percent of unresolved trades (and only five percent of contracts remaining).<sup>29</sup> That figure is not surprising as the vast majority of derivatives trading occurs between large financial institutions. [Ask Larry why they decided to tackle big bank claims "last" since presumably the bulk of the trades are rates.]

Citing the time and costs involved in settling the remaining derivatives claims, Lehman Brothers asserted in January 2011 that it would develop "consistent, transparent, derivative valuation rules".<sup>30</sup> Under the 1992 ISDA Master Agreement, the most common agreement between Lehman Brothers and its derivatives counterparties, the non-defaulting party can value the

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<sup>27</sup> See [www.lehmancreditors.com](http://www.lehmancreditors.com) for a copy of the liquidation plan.

<sup>28</sup> Lehman Brothers Holdings Inc. Plan Status Report (January 13, 2011), 16.

<sup>29</sup> *Ibid.*, 16.

<sup>30</sup> Lehman Brothers Holdings Inc. Plan Status Report (January 13, 2011), 17.

derivatives transactions by obtaining market quotations from dealers or it can reasonably determine in good faith its total losses and costs associated with the terminated derivatives transactions. Dealers historically favored the latter method, loss, as the selected mechanism, although note that these two elections were scrapped in the 2002 ISDA Master Agreement when a single method, close-out-amount, blended aspects of both. Under the 2002 agreement, the non-defaulting party could consider market quotations from dealers or other providers, but it could also utilize quotes and data for valuing like transactions from internal sources.

Although the details of the derivatives settlement framework have not yet been released publicly by the administrator, the principal challenge that the derivatives settlement framework proposal creates is that the contractual rights the parties bargained for at the outset of the trading relationship will be subjugated to whatever valuation mechanic the Lehman estate develops and the bankruptcy court approves. The Lehman Brothers' plan inserts itself as the (defaulting) sole party making the termination amount determination, arguing that it is well-placed to ensure that its methodology avoids exaggerated and self-serving claims made by non-defaulting parties. In essence, Lehman Brothers is arguing that its counterparties' variance in the interpretation of the contractual methodology for the value of the terminated transactions is adding to the time and costs involved in settling the derivatives portfolio, and that rather than continue to negotiate each derivatives portfolio with its counterparties, it should be able to substitute a new methodology, post-contract and post-bankruptcy, instead. As a general matter, courts are reluctant to interfere with the parties' contract unless certain circumstances such as mistake, duress or other factors are present.

The administrator has released a few general statements on the framework, including that the remaining derivatives contracts would be valued at mid-market at the end of a specified termination date, such as September 15, 2008. This approach will likely be contested by some derivatives counterparties who will argue that significant intra-day fluctuations occurred on the Monday the parent company filed for bankruptcy and that the ISDA Master Agreement explicitly permits the non-defaulting party to select an early termination date within 20 days after the termination notice has been received by the defaulting party. While details of the component transactions representing Lehman Brothers' derivatives portfolio are not public, based on data



that the Office of the Comptroller of the Currency (“OCC”) and the Bank for International Settlements (“BIS”) publish, one could reasonably assume that its derivatives portfolio resembled the portfolios of most other major derivatives players, with two-thirds or more of the portfolio being foreign exchange and interest rate derivatives and credit derivatives being ten percent or less of the portfolio. Lehman Brothers estimates that \$40 billion of derivatives claims remain, so on the basis of this writer’s assumption, \$26 billion of the remaining derivatives claims are likely foreign exchange and interest rate derivatives. This composition of Lehman Brothers’ derivatives portfolio may mean that if the bulk of the outstanding transactions are interest rate swaps, the most ubiquitous derivative, the selection of one point in time for the valuation of that transaction type may be problematic. Interest rate swaps, for example, are not typically closed out at the same time on the same day as trades may be booked in different jurisdictions and therefore time zones. For example, the BIS triennial survey reported that for all interest rate and foreign exchange derivatives, 70 percent of trading occurs with counterparties outside the United States.<sup>31</sup> This aspect of the market may make it more challenging for the administrator to argue that it is fair to select one point in time to value the terminated transactions. Conversely, it may be that the credit derivatives markets have a greater percentage of trading done within a jurisdiction, but no reliable figures can be cited for this statement.

In addition, the derivatives settlement framework proposes to reduce the number of maturity “buckets” used for aggregating and offsetting exposures and to have Lehman Brothers determine the bid-ask spread that is typically applied by the non-defaulting party. To date, when a derivatives portfolio is being terminated, the components of that portfolio are divided into buckets organized by maturity of the individual transaction type. The non-defaulting party can then net those exposures. A bid-offer adjustment is often made to the netted exposure amount – a cost to the defaulting party and one that represents uncollateralized risk. The challenge in closing out transactions in the volatile markets of September and October 2008 meant that more bid-offers were included in the non-defaulting parties’ close-out prices and fewer exposures were netted. The administrator’s post-contract reduction of the number of maturity buckets means that the bid-offer adjustment will be retroactively reduced, thereby significantly impacting the value

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<sup>31</sup> “The Foreign Exchange and Interest Rate Derivatives Markets: Turnover in the United States,” (April 2010), Federal Reserve Bank of New York, 9-10. Note that this survey is coordinated by the BIS with 53 central banks in April of every third year.

of the terminated transactions. Thus, while spreads on normally liquid transactions, such as interest rate swaps, increased in the aftermath of Lehman Brothers' bankruptcy, the administrator wants to impose a more narrow and uniform approach that will minimize the valuations produced by those volatile markets.

Lastly, an inconsistency in the approach the estate has taken to date to resolve half of its derivatives claims, arguably following the fiduciary requirements imposed on an administrator, will now see settlement of the other half of its derivatives claims follow an entirely different methodology and approach. Will the administrator be able to persuade the bankruptcy court that its execution of its fiduciary duty treated all derivatives counterparties fairly given the different approaches? Some of LBSF's largest derivatives counterparties, including Bank of America Merrill Lynch, which has \$4.8 billion in claims, BNP Paribas, Credit Suisse and J.P. Morgan Chase, have already been reported to oppose the proposed derivatives settlement framework.<sup>32</sup> Lehman Brothers has not submitted a motion to the bankruptcy court yet to approve the framework, as it attempts to negotiate these issues with its big bank derivatives counterparties.

### III. Would Dodd-Frank Have Changed the Settlement of Lehman Brothers' Derivatives Portfolio?

Ben Bernanke, Chairman of the Board of Governors of the Federal Reserve System, and Timothy Geithner, Secretary of the U.S. Treasury, perhaps more than most of their predecessors, were policy mavens well-suited in many respects for the roles economic history thrust upon them. After all, Chairman Bernanke was steeped in the arcane details of the Great Depression while Secretary Geithner spent 13 years at the U.S. Treasury in the 1980s and 1990s, followed by over five years at the Federal Reserve Bank of New York, tenures marked by currency crises and a large hedge fund failure, among other events.<sup>33</sup> These two gentlemen were instrumental in crafting proposals for how the financial regulatory framework should be modified, focusing, in part, on the "opaque" nature of derivatives and connecting derivatives to bankruptcy. For example, on April 20, 2010, U.S. Treasury Secretary Geithner testified that: "The market turmoil following Lehman's bankruptcy was in part attributable to uncertainty surrounding the exposure

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<sup>32</sup> Cameron, Matt, "LBHI Administrators Push for Settlement of Derivatives Claims," Risk (March 2, 2011).

<sup>33</sup> Skeel, David. The New Financial Deal [insert details].

of Lehman's derivatives counterparties."<sup>34</sup> Secretary Geithner added that "In this regard, Lehman's bankruptcy highlights another flaw in our financial infrastructure: the opacity and complexity of the OTC derivatives markets. These products grew exponentially in the run-up to the crisis. The notional amount of outstanding credit default swaps grew from about \$2 trillion in 2002 to over \$60 trillion at year-end 2007. Because these trades are conducted on a bilateral basis, the market has very little visibility into the magnitude of derivatives exposures between firms."<sup>35</sup>

Economists such as John Taylor have already pointed out that the market turmoil following Lehman Brothers' bankruptcy was more likely connected with Secretary Geithner's unveiling of the Troubled Assets Relief Program and the \$85 billion government bail-out of AIG rather than the failure of Lehman Brothers and uncertainty about derivatives counterparty exposure.<sup>36</sup> Moreover, policymakers likely conflated or failed to appreciate the distinctions in the principal causes of failure of AIG (unhedged, non-collateralized credit derivatives trading), Bear Stearns (failure to sustain liquidity as a result of its reliance on the overnight repo market) and Lehman Brothers (poor risk management of its real estate portfolio and over-reliance on overnight financing), thereby leading to policy conclusions that perhaps are unsupported by the complex reality of why those firms and others failed. Rather, policymakers focused on two objectives: first, preventing or mitigating systemic risk when a major derivatives participant fails and second, granting regulators new resolution authority to prevent the government from bailing out the failing or failed firm. Policymakers accomplished these two objectives by first crafting legislation in Title VII of Dodd-Frank that attempts to manage counterparty risk by mandatory clearing of certain derivatives through a central counterparty and the consequent imposition of more uniform derivatives collateralization, and second, by introducing resolution authority in Title II of Dodd-Frank to address failed systemically important entities with, among other businesses, a derivatives portfolio. Title VII is inextricably linked to Title II as the former aims to prevent or to mitigate failure in the first place as it relates to derivatives, in part by enhancing information available to regulators, while the latter has broad power available to regulators to

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<sup>34</sup> Testimony of U.S. Treasury Secretary Timothy Geithner, before the Committee on Financial Services, U.S. House of Representatives, April 20, 2010.

<sup>35</sup> *Ibid.*

<sup>36</sup> Taylor, John. [Include proper cite.]

take action to resolve a failed institution when such institution is deemed capable of introducing systemic risk.

*Title VII – Derivatives Reform Through Clearing and Collateralization*

Title VII of Dodd-Frank requires that all eligible derivatives be cleared on a central clearinghouse, known colloquially as a “central counterparty” or “CCP”. Currently, a bilateral over-the-counter or OTC derivatives contract is executed between two parties. The terms of that transaction and the amount of collateral posted in association with that trade are private. When a transaction is centrally cleared, however, this single transaction between a buyer and a seller is replaced with two transactions, each involving a third party, the central counterparty. In other words, the central counterparty is the buyer to every seller and the seller to every buyer, in essence, standing between the buyer and the seller.

Clearinghouses perform a valuable function in their mitigation of counterparty risk. In order to do this, the financial resources of a clearinghouse must understandably be robust. The Commodity Futures Trading Commission (“CFTC”) proposed on October 1, 2010 that a clearinghouse must maintain financial resources to meet its members’ obligations notwithstanding the default of one or possibly two of its members with the largest exposures.<sup>37</sup> The CFTC also proposed that quarterly stress tests should be conducted to determine the amount of resources required. Given that Bank of America, Citibank and J.P. Morgan are the three largest derivatives counterparties in the United States, the simultaneous collapse of two of those institutions could mean the termination of a \$146.81 trillion notional derivatives portfolio – representing 25 percent of global notional derivatives value as compared to Lehman Brothers’ estimated five percent.<sup>38</sup> The International Monetary Fund has published two papers that estimate that under-collateralization of derivatives relative to risks in the financial system may be \$2 trillion.<sup>39</sup> The TABB Group estimates that near-term collateral requirements of moving interest rate and credit derivative transactions to a clearinghouse model will require an additional

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<sup>37</sup> Commodity Futures and Trading Commission [insert cite to October 1, 2010 proposal].

<sup>38</sup> OCC’s Quarterly Report on Bank Trading and Derivatives Activities Fourth Quarter 2010, Table 2.

<sup>39</sup> [Insert Singh and Aitken papers from 2009 and 2010.]

\$240 billion in collateral.<sup>40</sup> Query whether the clearinghouses collectively will be able to address the magnitude of those figures through reserve funds and required collateral posting.

Policymakers were right to focus on collateralization as a risk mitigation technique, as it is critical to the risk management of derivatives, both cleared and uncleared. However, collateralization of derivatives transactions has existed for nearly twenty years, so the posting of collateral to mitigate exposure is not new. Over time, the amount of collateralized derivatives exposure has increased as derivatives trading volume has increased. In 2000, there were estimated to be 12,000 ISDA Credit Support Annexes, the principal document for derivatives collateralization, in place.<sup>41</sup> By the end of 2009, the International Swaps and Derivatives Association (“ISDA”) annual Margin Survey indicated that there were 171,879 collateral agreements in place, with 92 percent of those agreements being the ISDA Credit Support Annex.<sup>42</sup>

Before the economic crisis began, perhaps at the end of 2006, ISDA reported in its annual Margin Survey that the gross amount of collateral in use was \$1.335 trillion, with 59 percent of mark-to-market credit exposure covered by collateral.<sup>43</sup> Note that the largest firms, including the largest U.S. commercial banks, held 80 percent of all collateral.<sup>44</sup> By the end of the fourth quarter of 2010, the OCC reported that banks held collateral against 93 percent of their exposure to banks and securities firms, and 246 percent against their exposure to hedge funds.<sup>45</sup> The latter figure is high because it is market practice for banks to require the provision of upfront or initial margin from hedge funds in addition to securing any current credit exposure.

Collateralization by product area varies, but the overall amount of collateralization is very high (and has remained so for the last several years). For example, the fifteen largest reporting firms in ISDA’s annual Margin Survey in 2010 reported that an average of 97 percent of credit

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<sup>40</sup> Rowady, Jr., E. Paul, “The Global Risk Transfer Market: Developments in OTC and Exchange Traded Derivatives,” The TABB Group (November 2010), 6.

<sup>41</sup> ISDA’s 2000 Collateral Survey, 1.

<sup>42</sup> ISDA’s 2010 Margin Survey, 1.

<sup>43</sup> ISDA’s 2007 Margin Survey, 4. The ISDA Margin Survey covers U.S. and non-U.S. market participants. In 2007, for example, 25 percent of respondents were based in the United States, while 52 percent were based in Europe or South Africa. The OCC Quarterly Reports, by contrast, only cover U.S. national banking associations.

<sup>44</sup> *Ibid.*

<sup>45</sup> OCC’s Quarterly Report on Bank Trading and Derivatives Activities Fourth Quarter 2010, 8.

derivatives trades were collateralized, whereas among the total of 89 firms responding to the survey, that figure was 93 percent. Interest rate derivatives at the fifteen largest reporting firms are collateralized at 84 percent, whereas among the total of 90 firms reporting to the survey, that figure was 79 percent.<sup>46</sup>

The type of collateral is important as well. Cash has long been the preferred form of collateral. At the end of 2006, for example, nearly 80 percent of collateral was cash, with U.S. Dollars being 46 percent of the cash pool and the Euro representing 28.8 percent.<sup>47</sup> By the fourth quarter of 2010, the OCC reported that approximately 81 percent of the collateral held by U.S. banks was in the form of cash (50.5 percent in U.S. Dollars and 30.5 percent in other liquid currencies like the Euro), while the ISDA figures, covering the U.S., Europe and Asia, reported 82 percent of collateral globally was in the form of cash, with 42.1 percent being in U.S. Dollars and 31.5 percent being in Euro.<sup>48</sup> U.S. Treasuries as collateral represented 2.0 percent and equity securities represented 1.2 percent in the OCC's Report, while ISDA's annual Margin Survey in 2010 reported U.S. government securities as comprising 4.5 percent of the global collateral pool and European Union member-state government securities representing 5.7 percent.<sup>49</sup> While policymakers focused on the lack of collateralization of AIG Financial Products' derivatives trading, surely these figures show that that was an outlier based on its profile then as a subsidiary of a AAA-rated entity. In addition, there was so little collateral provided that was in the form of something other than cash or Treasury securities that it does not even make an appearance on either ISDA's or the OCC's surveys. In other words, the industry was collateralizing as part of its derivatives risk management program for close to two decades without needing Congress to tell it to do so.

What has shifted under Dodd-Frank is that the CCP's calculation of required collateral is substituted for the individual counterparty assessing its risks. As is done today, both initial and

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<sup>46</sup> *Ibid.*, 10.

<sup>47</sup> ISDA's 2007 Margin Survey, 6.

<sup>48</sup> OCC's Quarterly Report on Bank Trading and Derivatives Activities Fourth Quarter 2010, 8. ISDA Margin Survey 2010, 6. Note that the FDIC published an article in April 2011 entitled "The Orderly Liquidation of Lehman Brothers Holdings Inc. Under Dodd-Frank," in the FDIC Quarterly (volume 5, no. 2) wherein the authors state on page 6 that collateral, especially lightly traded collateral, can exacerbate losses when there is a counterparty default. However, as the OCC and ISDA reports show, the vast majority of collateral is in the form of cash.

<sup>49</sup> *Ibid.*

variation margin will be required. Counterparties to cleared swaps will be required to post initial collateral to the CCP based on the CCP's assessment of the risk profile of that transaction.<sup>50</sup> In addition, each day the CCP will set the variation margin associated with each transaction by recalculating the value of transaction and accordingly calling for or releasing collateral, ensuring that counterparties have neutral risk positions in relation to the value of the underlying asset. In other words, the goal is that every day the CCP receives margin payments from counterparties whose contracts moved against them to ensure that the CCP, or those that participate through the CCP, always have funds to satisfy their obligations under contracts.

The posting of collateral is tied to how the derivatives transactions of a clearinghouse member that has become insolvent are handled. For example, LCH.Clearnet Limited's draft contract states that upon the default of a clearing member, the clearinghouse may close out and terminate the cleared transactions and will not transfer such positions. [CME Clearing and ICE Trust, on the other hand, allow cleared transactions and associated collateral to be transferred to another clearinghouse member.] In addition, the treatment of a counterparty's collateral is important. The CFTC requested comments in November 2010 on various collateral protection models, such as the individual segregation of each customer's collateral at the futures commission merchant, derivatives clearing organization and custodian levels; the commingling of collateral of multiple customers, but in which the value of each customer's collateral is treated on an individual basis; the use of collateral of non-defaulting customers in the default of a clearing member; and the commingling of collateral of a futures commission merchant's customers.

Were Lehman Brothers to have been a clearing member of one of the U.S. clearinghouses, it is anticipated that upon its insolvency, its \$35 trillion notional derivatives portfolio (and associated collateral) would have been ported to other clearinghouse members. The concern in a marketplace where other major participants such as Bank of America, Citibank and Morgan Stanley, among others, were under attack means that portability of Lehman Brothers derivatives

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<sup>50</sup> As it relates to uncleared swaps, Dodd-Frank requires swap dealers and major swap participants to notify their uncleared swap counterparties of their right to segregate their initial margin with an independent third-party custodian. The CFTC's November 2010 proposal would require that the custodian be independent of both the counterparty and the swap dealer or major swap participant and that there be a written custody agreement between the counterparties and the custodian. ISDA's annual Margin Survey in 2010 reported at page 8 that only nine percent of collateral is segregated with a custodian.

portfolio may not have allayed counterparty risk to the non-defaulting party population because arguably an equally unstable counterparty was receiving those transactions or a stronger clearing member may have rejected the transactions being proposed for transfer without some sort of government backstop for the unknowable counterparty risk being assumed.

In addition, there are challenges associated with a clearinghouse's approach to collateral calculations. Currently, in the over-the-counter derivatives market, a counterparty's collateral requirements are assessed based on its aggregate exposure across all products. For example, a hedge fund that had exposure to a particular security through its prime brokerage account could have its collateral requirements offset through a derivatives transaction. Central clearing, however, will make this cross-margining more difficult. Positions associated with different products are unlikely to be assessed margin in this more holistic manner, thereby resulting in end users posting more collateral in aggregate than currently. It would be worth understanding whether those entities required to post more collateral than at present are the same entities that present the most systemic risk.

### *Titles I and II of Dodd-Frank and the Resolution of Systemically Significant Financial Companies*

A regulatory triumvirate chorused for greater powers to resolve failing or failed financial companies and non-bank financial companies in the wake of Lehman Brothers' bankruptcy. As Chairman Bernanke's statement in the Introduction makes clear, it was his view that the U.S. Bankruptcy Code in 2008 did not protect the public's strong interest in ensuring the orderly resolution of Lehman Brothers, and that that failure resulted in substantial consequences to the financial system and to the economy. Sheila Bair, Chairwoman of the Federal Deposit Insurance Corporation (the "FDIC"), testified that "Failing non-bank financial companies ...could only be resolved under the Bankruptcy Code, further exacerbating the financial crisis."<sup>51</sup> And the U.S. Treasury Department's website currently boasts that financial reform will "end 'too big to fail' and taxpayer-funded bailouts, so that average Americans will no longer have to pay the price for greed and irresponsibility on Wall Street."<sup>52</sup> While those statements may carry a certain

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<sup>51</sup> Testimony of Sheila C. Bair, Chairwoman of the Federal Deposit Insurance Corporation, to the Financial Crisis Inquiry Commission, (September 2, 2010), 1.

<sup>52</sup> See [www.treasury.gov/initiatives/wsr/Pages/wall-street-reform.aspx](http://www.treasury.gov/initiatives/wsr/Pages/wall-street-reform.aspx) (March 17, 2011).



political appeal, it is this author's view that Dodd-Frank does not significantly alter how a complex derivatives portfolio like Lehman Brothers' would be handled, even with the enhanced resolution authority granted to regulators, nor does the legislation provide comfort that the U.S. government would not bail out a clearinghouse were it to default.

To put the resolution authority of Dodd-Frank into context, it is helpful to understand the definitional corrals of its Titles I and II. Title I of Dodd-Frank established the Financial Stability Oversight Council (the "Council"). The Council, comprised of various financial markets regulators and chaired by the Secretary of the Treasury, has a dual mission: first, to identify risks and to respond to emerging threats to the financial stability of the United States and its financial system; and second, to promote market discipline by eliminating the concept of "too big to fail". The Council is thus tasked with designating "significant bank holding companies" and "significant nonbank financial companies" that will be subject to enhanced supervision by the Federal Reserve Board. "Significant bank holding companies" are proposed to be those entities with at least \$50 billion in total consolidated assets and are automatically considered systemically important. "Significant nonbank financial companies" are those designated as systemically important by the Council. Thus, it is possible that a "significant nonbank financial company" is not necessarily systemically important.<sup>53</sup>

Once systemic importance designations are made, entities that are failing or have failed are taken out of the usual insolvency laws that would have applied to its various corporate entities and instead, the Federal receivership or resolution authority of the FDIC comes into play through Title II of Dodd-Frank. Title II allows for the orderly liquidation of these "financial companies". Title II's definition of "financial company" captures four general categories of entities: bank holding companies, as defined in Section 2(a) of the Bank Holding Company Act of 1956<sup>54</sup>; nonbank financial companies (which includes, as noted above, nonbank financial companies that the Council has determined must be supervised by the Federal Reserve Board); subsidiaries of entities included within one of the first two categories; and brokers and dealers. The fact that an

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<sup>53</sup> The FDIC stated that some Lehman entities may not have been systemically important and thus would have been subject to the Bankruptcy Code. It would then be possible that one Lehman Brothers entity would be subject to Title II, while another would not. See "Orderly Liquidation of Lehman Brothers Holdings Inc. Under Dodd-Frank," FDIC Quarterly, volume 5, no. 2 (April 2011), 13.

<sup>54</sup> 12 U.S.C. § 1841(a). See also Section 102(a)(1) of Dodd-Frank.

entity is a financial company is not enough for the Federal receivership provisions of Title II to apply, however. To be eligible for the resolution authority to apply, the financial company must be a “covered financial company”. At the risk of further definitional contortions, a “covered financial company” is a financial company as to which a systemic risk determination has been made by the relevant set of regulators.<sup>55</sup> In other words, if Title I of Dodd-Frank allows an entity to be deemed systemically important, then if such entity is failing or has failed, the Federal receivership provisions of Title II will apply.

Procedurally, Title I requires the Secretary of the Treasury or the FDIC and the Board of Governors of the Federal Reserve System (or the SEC in the case of brokers or dealers or the Federal Insurance Office for insurance companies)<sup>56</sup> to present a written recommendation stating whether a particular covered financial company presents systemic risk. At least two-thirds of the then-serving members of the Board of Governors and the board of directors of the FDIC (or parallel agency) must approve the petition of systemic risk designation. The relevant regulators must prepare a written analysis of whether the covered financial company is in “default or danger of default”. “Default or danger of default” is intentionally broad in its definition, covering circumstances such as a bankruptcy case that has been or likely will be commenced; the financial company incurring losses that will or are likely to deplete all or substantially all of its capital; the assets of the financial company being less than, or likely to be less than, its obligations to creditors; or the financial company is, or is likely to be, unable to pay its obligations in the ordinary course of business.<sup>57</sup> The repetition of the phrase “likely to” gives the relevant regulator the ability to take action before a covered financial company actually files for bankruptcy. The written analysis must also set forth the effect that the bankruptcy of the covered financial company would have on the financial stability of the United States, evaluate whether any private sector alternatives to prevent the insolvency exist, assess whether or not a bankruptcy case is appropriate for the covered financial company and evaluate the effect of a Federal receivership on creditors, counterparties and shareholders of the covered financial company, as

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<sup>55</sup> The FDIC and the Board of Governors of the Federal Reserve System determine whether the Federal receivership provisions will apply to a financial company, and the SEC and the Board of Governors of the Federal Reserve System make such determination for covered brokers or dealers.

<sup>56</sup> Section 203(a)(2) of Dodd-Frank.

<sup>57</sup> Section 203(c)(4) of Dodd-Frank.

well as other market participants.<sup>58</sup> Once this analysis is submitted, the Secretary of the Treasury, in consultation with the President of the United States, must appoint the FDIC as the receiver for the covered financial company if the Secretary determines that in fact the covered financial company is in default or in danger of default, that its default would have a serious adverse effect on the financial stability of the United States, that no private sector alternative is available to prevent the insolvency, the effect of the Federal receivership on the claims of creditors, counterparties and shareholders is beneficial and lastly, that an orderly liquidation would avoid or mitigate adverse effects.<sup>59</sup>

In the case of Lehman Brothers, it seems almost obvious in hindsight that the Council would have deemed the investment bank to be systemically important as a nonbank financial company and therefore subject to enhanced supervision by the Federal Reserve Board and, possibly, the resolution authority provided for under Title II. The encyclopedic Examiner's Report, issued in March 2010, provides extensive details regarding the doubtful solvency of Lehman Brothers. Using Dodd-Frank's directive to regulators to consider whether the nonbank financial company was in default or in danger of default, the balance sheet assessment was one obvious avenue of inquiry, but perhaps of greater importance than capital to an investment bank was its access to liquidity. The "unreasonably small capital" test, relied upon by bankruptcy courts to avoid pre-petition transfers, is a helpful tool because the test takes a broader view of risks, like liquidity, that are not necessarily reflected through the more traditional balance sheet assessment.<sup>60</sup> As the Examiner's Report notes, the unreasonably small capital test had two components: first, was it reasonably foreseeable that Lehman Brothers was at risk of losing access to financing that it required to operate its business and to satisfy its obligations as they became due; and second, whether Lehman Brothers' liquidity stress tests were reasonably constructed.<sup>61</sup> The SEC and the Federal Reserve Bank of New York's performance as it related to the evaluation of the strength of Lehman Brothers following the failure of Bear Stearns in March 2008 would not be immediately reassuring. Given that Bear Stearns had collapsed in a matter of days when its liquidity sources dried up, Lehman Brothers met almost immediately with the two regulators to

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<sup>58</sup> Section 203(a)(2) of Dodd-Frank.

<sup>59</sup> Section 203(b) of Dodd-Frank.

<sup>60</sup> Report of Anton R. Valukas, Examiner, to the U.S. Bankr. Ct. (March 11, 2010), 1643.

<sup>61</sup> *Ibid.*, 1649.

discuss the results of its own liquidity stress tests, in essence examining scenarios for declining funding. In its May 28, 2008 stress test report, for example, Lehman Brothers reported to its regulators that it survived the stress tests by a margin of over \$10 billion.<sup>62</sup> It took the Federal Reserve Bank of New York over two months after Bear Stearns' failure to develop and conduct its own stress test and scenario analysis, which concluded that Lehman Brothers would fail in a "Bear Stearns" type run on the bank by \$84 billion.<sup>63</sup> Moreover, the SEC failed to recognize or enforce Lehman Brothers' requirement to be able to monetize its liquidity pool within 24 hours, as Lehman Brother relied instead on a five day test.<sup>64</sup> Lastly, the derivatives business conducted by LBSF indicated that at May 31, 2008 and August 31, 2008, it held 0.41 percent and 0.44 percent, respectively, in terms of its ratio of equity to assets, characterized as borderline solvent.<sup>65</sup> Under Dodd-Frank, perhaps these types of strands of analysis would have led the regulators to conclude that Lehman Brothers was in danger of collapsing.

While the enhanced supervision powers designated by Title I should provide regulators with greater information about the largest and most complex entities, if one of those entities actually begins to demonstrate weakness or fails, then the Secretary of the Treasury will likely be working diligently to conclude a private sector solution (which will be challenging, particularly during a volatile market like that experienced in the fall of 2008). Further, the Secretary of the Treasury will be obligated to assess whether the Bankruptcy Code provides an appropriate framework in which to resolve the failed non-bank entity. These requirements in Dodd-Frank result in virtually no change in the bodies of insolvency laws that would apply to the financial company, either because the failing financial company or key parts of it are absorbed by an acquiring company or the failed company's insolvency is handled, in part, under the U.S. Bankruptcy Code and/or the Federal Deposit Insurance Act. The application of the Bankruptcy Code and the Federal Deposit Insurance Act presumably means that no bail out of the failing company occurs, thereby inadvertently solving the "too big to fail" problem at least as it relates to bank holding companies, banks and certain non-bank financial companies.

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<sup>62</sup> *Ibid.*, 1679.

<sup>63</sup> *Ibid.*, 1680.

<sup>64</sup> *Ibid.*, 1507, 1508.

<sup>65</sup> *Ibid.*, 1618, 1621.

As it relates to derivatives specifically, many of today's largest counterparties execute their derivatives transactions through their U.S. commercial bank. Banks have historically been excluded from the U.S. Bankruptcy Code<sup>66</sup>, and instead bank insolvencies were addressed under the Federal Deposit Insurance Act. Despite the underlying policy rationale that derivatives were responsible, at least in part, for the economic crisis and the creation of systemic risk, the insolvency of a derivatives counterparty, which happens to be a bank, was largely un-addressed by Dodd-Frank.

Banks dominate as derivatives counterparties. The OCC's quarterly report on U.S. banks' derivatives activity noted in its most recent report that the five largest U.S. commercial banks represent 96 percent of the total banking industry notional amount of derivatives trading activity.<sup>67</sup> The concentration of a small number of financial institutions in the derivatives market has not shifted much in many years, including prior to Lehman Brothers' bankruptcy.<sup>68</sup> The vast majority of this derivatives trading activity is focused on interest rate swaps: in the OCC's First Quarter Report in 2008, that figure was 79 percent whereas in the OCC's Fourth Quarter Report in 2010, it was 84 percent. Interest rate swaps are perhaps the least complicated derivative instrument, particularly as compared to the challenges historically associated with credit derivatives in terms of credit event triggers and settlement, the complex calculations and dependencies of equity derivatives and the inherent volatility of commodity derivatives, so presumably there is less risk in trading interest rate swaps than other derivatives.<sup>69</sup> In addition, the OCC reports that 61 percent of the top five commercial banks' net current credit exposure is to other banks and securities firms, with corporates representing 33 percent, and hedge funds, the

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<sup>66</sup> 11 U.S.C. § 109(b)(2).

<sup>67</sup> OCC's Quarterly Report on Bank Trading and Derivatives Activities Fourth Quarter 2010, 1.

<sup>68</sup> In the OCC's Quarterly Report on Bank Trading and Derivatives Activities First Quarter of 2008, the five largest commercial banks represented 97 percent of the total banking industry notional amount of derivatives trading activity. In order by notional, those institutions were JP Morgan Chase Bank, Bank of America, Citibank, Wachovia Bank and HSBC Bank USA. In the OCC's Quarterly Report on Bank Trading and Derivatives Activities Fourth Quarter 2010, the five largest commercial banks in order by notional were JP Morgan Chase Bank, Citibank, Bank of America, Goldman Sachs Bank USA and Wells Fargo Bank. In addition, the number of insured U.S. commercial banks engaged in derivatives trading has remained relatively stable: at the end of the first quarter of 2008 there were 1,003 banks (at 7 of 2008 Report), whereas at the end of the fourth quarter of 2010, there were 1,070 (at 1 of 2010 Report).

<sup>69</sup> OCC's Quarterly Report on Bank Trading and Derivatives Activities Fourth Quarter 2010, 11. Credit derivatives represent 6.1 percent of the OTC notional amounts for U.S. commercial banks, while equity derivatives are 0.6 percent and commodity derivatives are 0.5 percent. Note that these figures shift slightly when considering the data collected by the Bank for International Settlements as greater numbers of institutions are covered.

most overly collateralized group as noted above, being a mere one percent of net credit exposure.<sup>70</sup>

Thus, our financial landscape is dominated by the world's largest banks, who in turn are among the world's largest derivatives counterparties, and yet while these banks will be more closely regulated under Title I of Dodd-Frank, the way in which their insolvency under Title II would be handled would likely differ very little from the pre-Dodd-Frank environment. If the resolution authority granted under Title II does not apply, then the Federal Deposit Insurance Act applies to the largest bank derivatives counterparties. If the resolution authority granted under Title II does apply, then its effect is largely a mirror of the existing Federal Deposit Insurance Act provisions – provisions that commercial banks are already subject to in the event of insolvency.

Nonbank financial companies, just as with banks, are also captured by the definition of “covered financial companies” under Dodd-Frank. Nonbank financial companies are defined as those “predominantly engaged in financial activities”.<sup>71</sup> This phrase was already embedded in Section 4(k) of the Bank Holding Company Act of 1956 and Regulation Y.<sup>72</sup> The Federal Reserve Board issued a proposal to refine this phrase on February 8, 2011, stating that “predominantly engaged in financial activities” should be measured either by a revenue or an asset test. Specifically, it was proposed that “predominantly engaged in financial activities” means the entity either has consolidated annual gross financial revenues in either of its two most recently completed fiscal years of 85 percent or more of the company’s consolidated annual gross revenues or its consolidated total financial assets as of the end of either of its two most recently completed fiscal years is 85 percent or more of the company’s consolidated total assets. Financial revenue or financial assets are those derived from or related to activities that are “financial in nature” or the ownership, control or activities of an insured depository institution or any subsidiary of such institution. “Financial in nature” ties back to Section 4(k) of the Bank Holding Company Act and includes activities such as securities underwriting, dealing and market-making and engaging in financial and investment advisory activities. The definition would not include activities that are incidental or complementary to financial activities, such as

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<sup>70</sup> *Ibid.*, 8.

<sup>71</sup> Section 102(a)(4)(A)(ii) of Dodd-Frank.

<sup>72</sup> [Insert reference.]

trading in physical commodities. In other words, companies that are not predominantly engaged in “financial activities” cannot be designated as systemically important. Under Dodd-Frank, LBSF and Lehman Brothers, each as nonbank financial companies, likely would be captured as covered financial companies subject to Title I’s heightened regulatory scrutiny.

As it relates to Title II being applied to a nonbank financial company such as LBSF, the treatment of derivatives would remain largely unchanged from the application of the Bankruptcy Code pre-Dodd-Frank. Non-defaulting counterparties under Section 210(c)(8) of Dodd-Frank remain able to terminate, close-out and liquidate their derivatives contracts upon the insolvency of a nonbank financial company such as LBSF (or its parent) with the application of a one day stay<sup>73</sup> – the same approach already applicable to banks under the Federal Deposit Insurance Act. There are a handful of differences, though, such as the Bankruptcy Code’s accommodation of a rapid sale of the failing business (such as with the sale of Lehman Brothers’ broker-dealer business to Barclays coincident with Lehman Brothers’ bankruptcy), as compared to the FDIC’s ability under Dodd-Frank to establish a “bridge financial company” to succeed to selected assets and liabilities of the covered financial company (or covered broker or dealer). This would give the failing company time to negotiate its sale to another company or to seek other types of resolution of its failing status.

The largest failures of entities due to mis-management of derivatives to date have not involved any U.S. banks but rather entities that are non-banks. Some of the more spectacular derivatives-related failures include the municipality of Orange County in 1994, which lost 1.7 billion of the county’s \$7.4 billion investment portfolio, the hedge fund Long-Term Capital Management’s loss of \$4.6 billion in 1998 and AIG Financial Products, a dealer and subsidiary of AIG that operated with a \$2 trillion derivatives portfolio, which is continuing to be unwound. Orange County would not have been captured by Title II given the unique legal treatment of municipalities. Perhaps Long-Term Capital Management would not have attracted regulators’ attention in a 2011 landscape of thousands of hedge funds, as compared to 1998, and thus not deemed worthy of being liquidated under Title II of Dodd-Frank. AIG Financial Products would have been most obvious to have been deemed systemically important and therefore subject to

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<sup>73</sup> Section 210(c)(10)(B)(i)(l) of Dodd-Frank.

Title I's enhanced regulatory supervision. If AIG had been allowed to file for bankruptcy, the winding up of its derivatives portfolio in AIG Financial Products would have proceeded under the U.S. Bankruptcy Code much as it currently has. If AIG Financial Products had been subject to Federal receivership under Title II of Dodd-Frank, then the derivatives portfolio would have been unwound in much the same fashion.

While it is possible that the resolution authority of Title II will in practice be of little to no effect for unwinding the derivatives portfolios of covered financial companies, the clearinghouses present an entirely different risk profile. The legislative mandate of Dodd-Frank to clear certain yet-to-be specified derivative transactions has guaranteed that the largest global financial behemoths will concentrate risk at the central clearinghouses they each trade and clear through, and as noted above, collateral may be set too low to prevent a systemic effect if one or two clearing members or significant customers default. In fact, the Basel Committee on Banking Supervision proposed in December 2010 that the largest global banks hold additional capital against the risk that a clearinghouse defaults.<sup>74</sup> At the time of this paper, many of the regulations relating to the risk management and operational aspects of the clearinghouses and swap execution facilities have yet to be released by the regulators, and the clearinghouses continue to refine their collateral calculations and documentation with the clearing members.

Currently, the largest commercial banks are the clearing members of the leading clearinghouses, partly as a result of the significant financial resource requirements specified by each exchange. For example, ICE Trust U.S., owned by Intercontinental Exchange Inc., is a limited purpose trust company that serves as a central clearing facility for credit default swaps. Ice Trust U.S. requires that its 14 clearing members, including four of the five largest U.S. commercial bank derivatives participants, have \$5 billion in capital.<sup>75</sup> The CME Group, which clears credit derivatives and interest rate swaps, has 10 and 12 clearing members for those respective products – again, with the largest U.S. commercial banks being clearing members.<sup>76</sup>

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<sup>74</sup> Bank for International Settlements, [insert cite].

<sup>75</sup> Rules of ICE Trust U.S. LLC, Section 201(b)(ii).

<sup>76</sup> The CFTC proposed in February 2011 that clearinghouses open membership to companies with at least \$50 million in capital. While a vibrant and competitive market is critical in virtually all cases, the potential catastrophe that could befall clearing members if one member were to default would be staggering. Smaller firms would simply



Section 804 of Dodd-Frank provides the Council with the authority to designate a financial market utility such as a clearinghouse as systemically important. As the Notice of Proposed Rulemaking in February 2011 stated, clearinghouses' interconnectedness concentrates a significant amount of risk in the market, and their payment and settlement processes are highly interdependent.<sup>77</sup> If the Council designated a particular clearinghouse as systemically important, then that clearinghouse would be subject to the liquidation provisions of Title VII. The Notice on Proposed Rulemaking attracted only twelve comment letters, ranging from a law firm to a trade association to Visa, but the comments were largely common to one another. In essence, these groups felt that in order to be systemically important, the type of market served by the clearinghouse, the nature and size of its counterparties and the complexity and liquidity of the products should be considered in making the determination. In addition, the level of interdependence, whether the clearinghouse had the potential to create significant liquidity disruptions or dislocations in the event of failure or whether the clearinghouse had the potential to create large credit or liquidity exposures relative to participants' financial capacity were also common themes.

The Council issued its response in February 2011, incorporating many of the recommendations included in the comment letters. The Council determined that there are four statutory considerations for the systemically important designation as it relates to financial market utilities ("utilities") such as clearinghouses.<sup>78</sup> First, the number and value of transactions processed, cleared or settled by the utility would be assessed. Second, the aggregate credit and liquidity exposures to counterparties would be considered. For example, the mean daily and historical peak aggregate intraday credit provided to participants, as well as the value of the margin held would be assessed. In addition, an evaluation of the estimated peak liquidity required in the case of the default of the largest single participant. Third, the interdependencies and other interactions with other utilities or payment, clearing or settlement activities would be examined. Lastly, the Council would consider the effect that the failure of or disruption to the utility would have on

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not be able to contribute, as required under current clearinghouse rules, to the guarantee and default pools of reserves in the same way that the larger financial institutions can.

<sup>77</sup> 12 C.F.R. Part 1320.

<sup>78</sup> *Ibid.*

critical markets, financial institutions or the broader system. Under these criteria, the CME Group, ICE Trust U.S. LLC (“ICE Trust”) and LCH.Clearnet would be included, but it remains to be seen whether there will be other clearinghouses or other utilities that can be added to this list.

As noted above, the clearinghouses have yet to finalize their collateral formulations and their documentation for clients of clearing members. However, the rules of the leading clearinghouses have been published. In many respects, the Rules resemble those of the well-understood ISDA standards, in fact with ISDA membership being required.<sup>79</sup> The key difference of course is that unlike a privately negotiated derivative contract, cleared derivatives will have documentation that is truly standardized and therefore not capable of being modified by clients of clearing members.

There has been much industry thought given to how the default of a clearing member (or even the default of a client of a clearing member) will be handled, and waterfalls or priorities of payments are being finalized for the various clearinghouses. Sections 605 and Section 611 of ICE Trust’s Rules provide that when a clearing member defaults, meaning that it or its guarantor has failed to meet its obligations or it has failed to transfer requested collateral, the clearinghouse is permitted to terminate, liquidate accelerate and close-out the client’s “open positions”. Section 805 of ICE Trust’s Rules codify that bankruptcy and the failure to pay or deliver with respect to open positions or the guaranty fund are the only defaults applicable to ICE Trust.

Upon the default of a clearing member, ICE Trust’s Rules provide that it shall determine the loss incurred and the amount of collateral that can be liquidated. Once the “Closing-out Process” has commenced, ICE Trust has three business days to decide whether it will replace all or part of the transactions of the defaulting clearing member by porting or transferring those transactions to other clearing members that will agree to accept their transfer. The client of the clearing member can decide (prior to default) to designate certain clearing members are acceptable parties to whom their cleared trades can be transferred in the event of a default.<sup>80</sup>

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<sup>79</sup> Rules of ICE Trust U.S. LLC, Section 201(b)(viii).

<sup>80</sup> *Ibid.*, Section 20A-02.

Thus, if ICE Trust or another clearinghouse were designated as systemically important and thus subject to Title II's resolution authority, the termination of the defaulting party's derivatives transactions would in essence be transferred to another clearing member, with ICE Trust effecting such transfer within three business days. Collateral would be transferred along with the open derivatives position. If ICE Trust or another clearinghouse were not considered systemically important, then the bankruptcy of such clearinghouse would depend upon the entity's organizational form and location.

#### *The Automatic Stay under Dodd-Frank*

Under the U.S. Bankruptcy Code and the Federal Deposit Insurance Act, counterparties to certain derivatives are generally permitted to enforce default and termination provisions in those contracts upon the insolvency of their counterparty. While the Bankruptcy Code does not impose a timeframe for exercising those rights, the Federal Deposit Insurance Act allows such rights to be enforced after a one day stay. In addition to those rights, the debtor's counterparties may also liquidate collateral that has been posted by the debtor. Any shortfall resulting thereafter will constitute unsecured claims against the bankruptcy estate, entitling creditors to share in any distribution.

Within weeks of Lehman Brothers' bankruptcy filing, Harvey Miller, the bankruptcy doyen tasked with the filing, testified that a "massive destruction of value" could have been averted if an automatic stay had been in place for derivatives contracts.<sup>81</sup> Derivatives counterparties' exemption from application of the automatic stay, which has been embedded in the U.S. Bankruptcy Code since 1978 for an expanding class of products, was actually designed to achieve the opposite of what Mr. Miller asserted – the mitigation of systemic risk arising from cascading bankruptcies of other entities. By providing a safe harbor from the stay for these contracts, the delays assumed to be inherent in the bankruptcy process would be avoided and counterparties could reduce the losses that would otherwise result from the degradation of

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<sup>81</sup> Testimony of Harvey Miller, before the Committee on the Judiciary, Subcommittee on Commercial and Administrative Law, U.S. House of Representatives, October 22, 2009, 3.

collateral pledged by the debtor.<sup>82</sup> Dodd-Frank did not alter this accommodation to derivatives. Rather, it continued with the thirty-two year statutory approach of allowing derivative contracts to be exempt from the automatic stay of action that applies to all other creditors. Dodd-Frank thus followed the Federal Deposit Insurance Act in settling on a one business day stay.<sup>83</sup>

The arguments for and against the safe harbor for derivatives from the application of the stay have been sufficiently covered in academic literature. Once more in the legislative litany, Dodd-Frank re-affirmed the special treatment afforded to derivatives contracts. To this author, the most salient factor in the debate has always been whether the safe harbor for derivatives manages to mitigate systemic risk. While derivatives certainly lived up to their famous moniker as weapons of mass destruction in the view of the media and many policymakers, the fact remains that derivative transactions were terminated quickly and efficiently, although obviously settlement of claims and the ensuing fiduciary requirements of administration certainly slow the process, no major counterparties slid into bankruptcy, parties were eventually able to re-hedge their positions and quality collateral was fairly ubiquitous both before and after the meltdown in 2008. While the period of the stay was debated in the negotiations that led to Dodd-Frank, it is this author's view that the imposition of a one business day stay is likely ineffective in terms of stabilizing the financial system, and barely provides the FDIC with enough time to identify an appropriate entity or entities to which the failed entity's derivatives portfolio could be transferred. What would be effective in mitigating systemic risk, however, is ensuring an expanse of time pre-default for a failing financial company to novate transactions or to establish a bridge bank for those transactions. In the post-Dodd-Frank world, the regulators on the Council cannot claim that inadequate powers will stymie their risk management efforts. The enhancements achieved in Title I of Dodd-Frank should ensure that Title II never comes into operation, and the application of a stay under resolution authority is thus superfluous.

### Conclusion

For all the hullabaloo about derivatives, their treatment in bankruptcy hardly changed under Dodd-Frank. Moreover, the experience of Lehman Brothers from a derivatives perspective

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<sup>82</sup> The President's Working Group on Financial Markets, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," April 1999, 20.

<sup>83</sup> Section \_\_\_ of Dodd-Frank.

demonstrates how quickly and effectively transactions can be terminated and how well a defaulting party post-bankruptcy can manage and significantly increase the size of its estate. Certainly the way in which these products will trade has been significantly altered under Dodd-Frank and these legislative refinements should lessen some of the risks presented by these products, most notably counterparty risk.

The practical reality, however, is that the greater the inter-dependence of our financial systems and the participants within those systems, the more likely that periods of instability will result. The challenge market participants and regulators will always face is minimizing the systemic effects of bouts of instability and preventing disruption in an overnetworked environment.<sup>84</sup> Dodd-Frank, while having little practical effect on how the largest derivatives counterparties will be treated in bankruptcy, hopefully achieves its potential through more effective and well-timed regulatory oversight. As Professor L.C.B. Gower once commented, the regulation and supervision of financial companies should not seek to achieve the impossible task of protecting fools from their own folly, but should be no greater than is necessary to protect reasonable people from being made fools of.<sup>85</sup>

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<sup>84</sup> See Overconnected: The Promise and Threat of the Internet by Dr. William H. Davidow (2011). With his background in electrical engineering and his decades of experience as a Silicon Valley executive and successful venture capitalist, Dr. Davidow offers an engaging read on the perils of being over-connected and how to minimize systemic disruptions.

<sup>85</sup> [Insert cite.]

## DODD-FRANK: RESOLUTION OR EXPROPRIATION?

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Much of the impetus for the financial reform legislation came from the view, correct or not, that when Lehman Brothers failed and had to go into bankruptcy, disaster ensued because it could not be taken over like a failed bank. Therefore, the Dodd-Frank Act in Title II created a new procedure (“Orderly Liquidation Authority”) to seize even nonbank financial companies whose default would, in the view of the Secretary of the Treasury, have serious adverse effects on financial stability. This procedure gives unprecedented power and discretion to an administrative official, going far beyond banking law to the point of posing serious Constitutional problems.

The Fifth Amendment provides that “No person shall...be deprived of life, liberty or property without due process of law...”, a clause that is central to the rule of law of which this country is justly proud. The meaning of “due process” in different contexts is something that English and American courts have developed over time to a reasonable degree of clarity. Usually administrative action to take someone’s property must be preceded by notice and opportunity for a hearing<sup>1</sup>. If a court finds that summary action can be warranted by urgent circumstances, as the Supreme Court has held in the case of a regulator appointing a receiver or conservator for banks<sup>2</sup>, it has been premised on the availability of a prompt post-seizure hearing. Thus if the Comptroller of the Currency appoints a receiver or conservator to take over a national

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<sup>1</sup> The factors to be considered are discussed in *Mathews v. Eldridge*, 424 U.S. 319 (1976): the impact on the private party affected, the risk of administrative error, the governmental interest involved, and the value of additional procedural safeguards.

<sup>2</sup> See *Fahey v. Mallonee*, 332 U.S. 245 (1947).

bank, the bank may go to district court for a full and open hearing “on the merits” of the asserted grounds.<sup>3</sup>

The Dodd-Frank Act squeezes due process down to the vanishing point. Consider how its resolution procedure is supposed to work. Companies “predominantly engaged” in financial activities are to be regulated and supervised by the Fed if they are systemically important. If the Treasury Secretary (upon recommendation by the Fed, and FDIC or SEC) makes a determination that (among other things) a financial company is in danger of default which would have serious adverse effects on financial stability, he informs the company that he intends to appoint the FDIC as receiver. If the company does not consent, he petitions the district court of the District of Columbia (regardless of the location of the company’s headquarters) for an order of authorization—and now the squeeze is on.

Under Section 202 of the Act, the district court judge is given 24 hours from the moment of filing to (1) notify the company and hold a closed hearing, (2) review the hearing evidence and determine whether the Secretary’s action was “arbitrary and capricious”, and (3) if so, provide a written statement of each reason supporting its opinion. If the judge can’t accomplish all that in 24 hours, then the petition is deemed “granted by operation of law” and the receiver is to immediately begin liquidating the company (reorganization is prohibited). The decision and liquidation is not subject to any stay or injunction during any appeals to the DC Circuit Court of Appeals or Supreme Court, whose scope of review is limited to whether the Secretary’s determination was arbitrary and capricious.

How would this work in practice? A financial company covered by the Act is by definition a large and complex institution, probably with hundreds of billions of dollars in assets. A large portion of those assets would consist of corporate or hedge fund loans, derivatives contracts, complex securities and other financial contracts—much of them illiquid and thinly traded at best. That makes their valuation difficult and judgmental, as the argument over collateral<sup>4</sup> between AIG and Goldman Sachs in January 2008 vividly illustrated. The key determination by the Secretary is that the financial company is in danger of default. If a company has assets less than its obligations, or is unable to pay its obligations in the normal

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<sup>3</sup> 12 U.S.C. §§ 191(b), 203(b).

<sup>4</sup>See <http://www2.goldmansachs.com/our-firm/on-the-issues/valuation-pricing-doc.pdf>

course of business, or is likely to incur losses that will deplete substantially all of its capital, then it meets the definition of “default”.<sup>5</sup> Asset valuations are likely to be at the heart of any dispute, and they will not be clear cut.

Judicial review of administrative actions is a central safeguard against error and abuse of discretion. Here the judicial hearing before the seizure is designedly just about meaningless. Suppose the Secretary takes his action at the close of a business day, as has become customary in banking. He files with the petition an extensive set of documents prepared by the Fed and FDIC for their recommendations and by Treasury staff for his determinations. By the next morning the company has to have received and analyzed them, and prepared its own counter valuations of thousands of securities, to present at the hearing. That afternoon the judge can review it all, make findings and write an opinion in a couple of hours, or give up and rule that with so much paper work no action can be arbitrary, or just let the clock run out at 5 o’clock instead of serving as a rubber stamp.

What about post-seizure judicial review, as some emergency circumstances can justify? The reviewing courts are limited to the same one-sided record and a dilemma as to any real relief. Though they can take more time, they are prohibited from issuing any stays, and liquidation is meanwhile intended to be proceeding apace. And even if somehow a final ruling were in the company’s favor, irreparable damage would already have occurred. Nor could the company sue the United States for monetary compensation—it would claim sovereign immunity.<sup>6</sup>

Note that none of these problems would arise if the company were simply put into judicial bankruptcy proceedings, as in fact was Lehman Brothers. And it is hard to find actual disasters occasioned by the Lehman process itself—as opposed to the shock to the markets that the Government wasn’t rescuing it as it had Bear Stearns.<sup>7</sup> There are desirable adjustments to

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<sup>5</sup> §202(c)(4).

<sup>6</sup> See *U.S. v. Gaubert*, 499 U.S. 319 (1991). The Federal Tort Claims Act contains an exception for “discretionary functions”, even if the discretion is abused. 28 U.S.C. §2680(a).

<sup>7</sup> See, e.g., K. Summe, “Lessons Learned from the Lehman Bankruptcy”, in K. Scott, G. Shultz & J. Taylor, eds., *Ending Government Bailouts* (2010).



the Bankruptcy Code that could somewhat reduce spillover effects in such cases. But if the Dodd-Frank procedure meets Constitutional requirements, there isn't much left of the Due Process Clause for financial companies.