

Restructuring Failed Financial Firms in Bankruptcy: Selling Lehman's Derivatives Portfolio

Mark J. Roe & Stephen D. Adams†

Lehman Brothers' failure and bankruptcy deepened the 2008 financial crisis whose negative effect on the United States' economy lasted for several years. Yet, while Congress reformed financial regulation in hopes of avoiding another crisis, bankruptcy rules such as those that governed Lehman's failure, have persisted unchanged. When Lehman failed, it lost considerable further value when its contracting counterparties terminated their financial contracts with Lehman. These broad terminations degraded Lehman's overall value to its creditors beyond the immediate losses that caused its downfall. Lehman's financial portfolio was thought to be running a paper profit of over \$20 billion when it filed, and is said to have lost up to \$75 billion as a result of the post-filing liquidation by Lehman's counterparties of their deals with Lehman. How such a vast value loss can occur and how bankruptcy can ameliorate the problem are the subjects of this Article.

For bankruptcy to handle a systemically important financial institution successfully, it must be able to market those parts of the failed institution's financial contracts portfolio that are saleable at their fundamental value, i.e., other than at fire sale prices. Current law prevents this marketing, however. It allows only two polar choices: sell the entire portfolio, intact, or allow for the liquidation of each contract, one-by-one. The latter is what happened for Lehman, disrupting markets worldwide. The former—sale intact—cannot be accomplished as a business matter for a very large financial contracts portfolio (and the most serious are embedded in the world's biggest financial institutions) and would be economically undesirable even if possible. Bankruptcy needs authority, first, to preserve the failed firm's overall portfolio value, and, second, to break up and sell a very large portfolio that is too large to sell intact.

Congress and the regulators have said that bankruptcy is the favored means for financial resolution. Yet, while regulatory initiatives have sought to make failure less likely and resolution more viable than it proved during the crisis, U.S. bankruptcy law has neither been fixed nor even updated since the financial crisis. If a major financial institution were to fail today, the same bankruptcy problems that arose during the past crisis and vexed Lehman could again disrupt the country's and the world's financial systems. We here outline one critically needed fix: authorizing bankruptcy to break up a large derivatives portfolio by selling its constituent product lines, one-by-one, instead

of limiting bankruptcy to its current constraints of either a sale of the entire portfolio or a Lehman-style close-out of each contract, one-by-one.

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Introduction

When Lehman Brothers filed for bankruptcy in September 2008, its financial portfolio was said to be worth over \$20 billion; but as the portfolio unwound in its bankruptcy, the portfolio’s value turned deeply negative, declining by as much as \$75 billion. In this Article, we examine conceptually

how portfolio value can contract so sharply, the central role bankruptcy rules played in facilitating portfolio value destruction, how bankruptcy rules can be designed better, and why the Dodd-Frank Act's 2010 handling of the problem is (1) better than bankruptcy's today, yet (2) still inadequate to reposition a major firm's financial portfolio.

The problem is not just backward-looking, but foundational for financial safety regulation going forward. Policymakers need effective bankruptcy tools to resolve a failed financial firm. The newer post-crisis nonbankruptcy tools have not yet been tested and may not work. Just as engineers need redundancy and resiliency in a complex engineering system, financial regulators need multiple means to handle major problems, like that of a major financial failure. Moreover, public authorities who invoke new and unusual remedies in a crisis—such as Dodd-Frank's Title II resolution regime—may damage systemic confidence, because they would be vividly announcing, as the Dodd-Frank governing legislation requires, that a financial firm's failure threatens the entire economy. Indeed, Congress, recognizing some of these problems, is considering whether to amend the relevant bankruptcy rules.¹ This Article analyzes how the current proposals fall short.

To reduce the chance of a future failure again disrupting financial markets, the rules for resolving failed firms—including bankruptcy rules—must be able to stabilize a large financial firm's financial contracts effectively. Current bankruptcy law does not allow it to do so, as we see in Part III; the debtor firm's counterparties can terminate their contracts in ways that can destroy the debtor's portfolio value and disrupt the economy. To stabilize a financial contract portfolio, bankruptcy law must have authority to hold the failed firm's entire portfolio together for sale and then to sell the portfolio along its natural internal divisions, i.e. its product lines. Large portfolios of systemically important institutions are too large to sell intact readily, safely, and without government financial assistance. Under current bankruptcy law, the portfolio cannot be held together at all, much less sold along natural product lines.

The main alternative to bankruptcy here—Dodd-Frank's Title II regulatory resolution—lacks the power to sell a firm's portfolio along product lines. It does authorize regulatory authorities to sell the portfolio intact, which

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1. See, e.g., *The Financial Institution Bankruptcy Act of 2014: Hearing Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary*, 113th Cong. (2014); *The Bankruptcy Code and Financial Institution Insolvencies: Hearing Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary*, 113th Cong. (2013).

improves on bankruptcy. Yet, for a large failed financial firm—the kind we worry about causing systemic economic problems—the portfolio is unlikely to be saleable intact in a stable way. First, the overall portfolio may have negative value; the firm, after all, has failed. Worse and second, systemically important firms' portfolios are huge and are unlikely to be safely bought by any single firm.

Derivatives portfolios are concentrated in five major financial firms in the United States—Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, and Morgan Stanley.² If any buyer of such an intact mega-portfolio emerged, it would be another mega-firm. Although this kind of mega-transaction was necessary in the recent financial crisis—examples include Bank of America's purchase of Merrill Lynch and JPMorgan Chase's purchase of Bear Stearns—concentrating finance yet further would be unwise. But because the breakup of a bankrupt firm's financial portfolio is not permitted under current law, further dangerous hyper-concentration is a very real threat in a future financial crisis.

Bankruptcy rules as they now stand neither allow the bankruptcy court to hold the portfolio together for sale intact nor allow it to sell that portfolio along product lines. The Dodd-Frank Act's upgrade to regulatory resolution allows the intact transfer of the entire portfolio but does not allow a product line sale either. Yet, to promote financial stability, the United States must have a procedure by which a mega-firm's financial portfolio can be broken up coherently; the firm would have failed, a business restructuring would be needed, and the best systemic result would often be to break up a mega-portfolio of financial contracts along product market lines. This break-up and sale would likely be the best way to maximize the overall value of the portfolio. Standard bankruptcy practice allows the bankruptcy authorities to break up the nonfinancial assets if that is the best way to maximize overall value. Hence, the result we urge would align the rules for a debtor's financial assets with baseline bankruptcy practice. Only a few decades ago, bankruptcy was unable to reorganize a large, failed public industrial firm; it can do so now and regularly does. The same can be achieved for failed financial firms.

Baseline bankruptcy rules bar creditors from seizing and selling collateral as soon as the debtor files for bankruptcy, thereby giving the debtor time to organize and restructure without a destructive fire-sale—a bankruptcy filing creates an automatic injunction against creditor collection from the debtor, forcing all creditors to use the bankruptcy channel to be paid, while the court and the parties ascertain whether the firm is best kept together as a going concern. The rationale is that without this bar to immediate collection, the debtor's creditors would rip apart the firm, even if it were worth more if kept intact. Furthermore, baseline bankruptcy rules allow the debtor to repackage its assets and sell off the repackaged operations to multiple buyers. Bankruptcy

2. OFFICE OF THE COMPTROLLER OF THE CURRENCY, OCC'S QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITIES FOURTH QUARTER 2014, at 27 (2014).

thereby seeks to make the whole greater than the sum of individualized contractual parts.

A large class of financial contracts, however, is exempt from this core bankruptcy policy of holding the bankrupt's operations together; these exemptions played a large role in the Lehman bankruptcy. In that case, exempt creditors were able to immediately close out their deals with the debtor and repay themselves out of the collateral that the debtor had given them. The justifying theory is that those holding these contracts need quick liquidity, and that affording them that liquidity is inconsistent with a long bankruptcy proceeding and an equally long freeze on creditor actions and collections. Evidence indicates that these exemptions from bankruptcy—the so-called safe harbors—exacerbated Lehman's portfolio value destruction. The value of Lehman's derivatives and related investment portfolio declined by tens of billions of dollars in the first weeks of its bankruptcy.³ In our view, even if the justifications are correct—that these financial contracts should not bear the risk of being frozen in a long bankruptcy—bankruptcy policy need not jump from a nearly unlimited waiting period to no waiting period. A short waiting period in which the financial portfolio is repackaged and sold makes more bankruptcy sense than what we saw during the financial crisis.

When these financial contracts make up a major part of the firm's value, as they did in Lehman, and particularly if the contracts are put together to form a coherent, interacting portfolio, then the safe harbors degrade the debtor's ability to maintain the portfolio's going concern value, which creditors as a group will find, and did find, costly. Current bankruptcy rules cannot maintain the going concern value of the debtor's financial portfolio, because they allow the creditors to pursue their individual remedies, terminating and liquidating their piece of the bankrupt firm, contract-by-contract.

Bankruptcy should instead hold together and sell the portfolio intact or, particularly if a mega-firm fails with a mega-portfolio, sell off viable subparts of the portfolio separately. The special exemptions for these financial contracts thereby destroy the shared value of the overall portfolio because they allow the debtor's creditors to rip it apart, as we shall analyze in depth below in Part III. Yet, as we shall also see in Part III, although the baseline rules would have allowed the debtor and the bankruptcy court to maintain portfolio value if they governed, the debtor's incentives and its considerable discretion under baseline rules would not lead it to maintain the full economic value of the portfolio. Hence, we do not recommend returning to the baseline rules. Instead, we examine the adjustments from the baseline that are needed to build out the most viable system for all and, in particular, for economic stability.

3. See Jeffrey McCracken, *Lehman's Chaotic Bankruptcy Filing Destroyed Billions in Value*, WALL ST. J., Dec. 29, 2008, at A10 ("As much as \$75 billion of Lehman Brothers Holdings Inc. value was destroyed by the unplanned and chaotic form of the firm's bankruptcy filing in September."). Below we conceptually disaggregate this decline: a portion moved value to Lehman's counterparties while another portion was a loss to the economy. Both declines hurt the overall economy.

Some observers, policymakers, and academics consider the preservation of the firm and its going concern value a sufficiently worthy goal that they would impose costs of preserving the firm on the firm's suppliers and creditors. We have nothing to say here of the worthiness of that goal. Rather, we examine whether the total economic value of the portfolio can be maintained under current bankruptcy rules, even when the overall costs of maintaining the portfolio in coherent form are less than the benefits of doing so. We conclude that it cannot.

Lastly, we emphasize that more is at stake than preserving an individual firm's portfolio value. The major motivation for the safe harbor exemptions from the baseline rules was to contain financial panic—the systemic risk of financial disruption and a chain of illiquid failures. The safe harbors did not accomplish that goal during the 2008–2009 financial crisis. Indeed, the safe harbors exacerbated panic and financial disruption, at the cost of the country's economic well-being.

The economic stakes implicated here are not small: Federal Reserve researchers estimate that the financial crisis overall has cost the country \$1 trillion in annual lost capacity in the half-dozen years since the financial crisis began.⁴ The Bank for International Settlements estimates that although the odds of the derivatives market inducing a financial crisis are low each year, the costs to the world's economy would again be devastating if one occurs.⁵ Under such estimates, even costly reforms become worthwhile. In this Article, we propose a low-cost but efficacious reform to stabilize derivatives portfolios and reduce the chance that they would exacerbate a financial crisis.

A road map for the Article follows. In Part I, we show why a bankruptcy path to resolution is critical to strengthening the financial economy. We want an effective process to obtain best value for the participants overall, of course. We want a bankruptcy process for the derivatives market that will facilitate a nationwide economic recovery instead of deepening a financial and economic crisis.

In Part II, we examine how a portfolio's value can exceed the value of its parts. The primary mechanism that facilitates this value creation has two related channels: the well-known value-building character of diversification and the less well-known but cumulatively very large transaction cost of trading,

4. See David Reifschneider et al., *Aggregate Supply in the United States: Recent Developments and Implications for the Conduct of Monetary Policy* 8 (Fed. Reserve Bd. Fin. & Econ. Discussion Series, Working Paper No. 2013-77, 2013) (estimating the U.S. gross domestic product would be nearly 7% below pre-crisis trajectory by the fourth quarter of 2013), <http://www.federalreserve.gov/pubs/feds/2013/201377/201377pap.pdf>.

5. Macroeconomic Assessment Grp. on Derivatives, *Macroeconomic Impact Assessment of OTC Derivatives Regulatory Reforms*, BANK FOR INT'L SETTLEMENTS 2, 12-14 (Aug. 2013), <http://www.bis.org/publ/othp20.pdf> (finding derivative reforms have economic benefits worth 0.16 percent of GDP per year and economic costs of 0.04 percent of GDP per year). A caveat on the study: An unstable financial market may not *cause* a financial crisis. One might emerge elsewhere, with maladapted financial institutions exacerbating the economic destruction.

canceling, and replacing these contracts when bankruptcy has them cancelled and then (usually) replaced.

In Part III, we show how these portfolio concepts interact with the Bankruptcy Code. The bankruptcy safe harbors allow a bankrupt debtor's counterparties to close out the contracts they find profitable to terminate, as soon as bankruptcy begins. Other creditors typically cannot do so because the Bankruptcy Code gives the court and stakeholders in the firm time to see if the firm is worth more intact or sold in units instead of being ripped apart. We go on to show, however, that bankruptcy's baseline rules without the safe harbors *also* incentivize the debtor toward value destruction. Hence, we do not recommend returning to the baseline rules.

In Part IV, we examine the chaotic closeouts in the Lehman bankruptcy and show how these largely fit the theory developed in Parts II and III. Ironically, Lehman's broker-dealer could be sold intact within a few days of Lehman's filing, in the way that we recommend bankruptcy be changed to facilitate for financial contracts. And, equally telling, a fraction of Lehman's financial contracts were held by a single counterparty with more authority than the bankruptcy court. That party rapidly sold its contracts with Lehman *and*—consistent with our thesis—sold them along product market lines, just as we propose for bankruptcy.

In Part V, we examine mechanisms that preserve portfolio value, and their limits. We show that bankruptcy's well-known section 363 sale has the capacity to preserve portfolio value. The section 363 sale has revolutionized the reorganization of industrial firms. However, bankruptcy safe harbors prevent the use of section 363 for financial firms because a bankrupt debtor's counterparties can use bankruptcy safe harbor exemptions to close out their positions and liquidate a debtor's posted collateral well before the bankruptcy court or the financial players can engineer a section 363 sale. The best resolution is to allow a short stay on counterparty closeout, but not the unlimited one that baseline bankruptcy rules provide. During that period, the debtor's portfolio could be sold, either intact or by product lines, e.g., interest rate swaps to one buyer, foreign exchange dealings to another, and credit default swaps to a third.

A sale along product lines is the natural way to sell the business. U.S. finance needs a way to break up the portfolio of a large derivatives dealer that fails and the best way will be in bankruptcy. The derivatives market is concentrated, with much of it embedded in a handful of the largest financial firms in the United States, including Citigroup and Bank of America, which too often make it onto regulator watch lists as needing to be strengthened. There is no obvious buyer for either firm's huge derivatives book. A breakup along product lines could well make the portfolio more saleable and the financial system safer.

Moreover, the debtors' inability to reposition a huge derivatives portfolio incentivizes counterparties to the five major dealers to conclude that the United

States is unlikely to allow a mass close-out of the kind that proved to be chaotic in Lehman's failure. Instead, financial markets may well come to believe that if the current resolution mechanisms (which are structured to preserve the derivatives subsidiaries intact) fail, the government will again prop up the entire systemically important financial institution's derivatives book. This belief could lead to further concentration within the U.S. financial system, making it more fragile. This concentration would occur because only the largest firms benefit from that expectation of government support, so even more trading could migrate to the largest, systemically most vital firms. But if a debtor's portfolio could be repositioned with several product lines sold intact, then regulatory authorities could conclude in a crisis that one or two product lines, for which no buyer appears, could be closed out contract-by-contract without systemic impact. The marketplace, anticipating break-up instead of bail-out, with partial failure and partial abandonment, would be less susceptible to moral hazard and its resultant financial concentration and fragility. They should come to believe that while the government will not let a whole portfolio of a systemically important firm fail and liquidate, it could allow one product line or another to be closed out and not be supported.

In Part VI, we examine "moving target" issues. Finance and financial regulation are changing, making some of the Lehman-era problems smaller and others larger. A bankruptcy mechanism is needed because not enough has changed and some of what has changed makes bankruptcy resolution more important. First, we again turn to the Dodd-Frank Act's approach to the portfolio problem. Dodd-Frank allows the resolution authorities to take the entire portfolio of a large institution and put it in a separately-managed entity, which bankruptcy bars. This improves on current bankruptcy rules. However, Dodd-Frank would not permit the portfolio to be sold and repositioned along product lines. The portfolio consequently would need to be sold to another systemically important financial firm or managed on a standalone basis by government authorities. Both are poor solutions: the first would further concentrate finance and the second would invite preferential and supportive financing. Some analysts fear that a stealth bailout, if anticipated by financial markets, would exacerbate ongoing too-big-to-fail problems.

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Financial regulators want to allow failing financial firms to be resolved in bankruptcy. Congress, via Dodd-Frank, sought the same. At the same time, regulators believe that bankruptcy now destroys value, such that, if the subject firm is systemically important, a bankruptcy proceeding could damage the nation's economy, as was the case with Lehman. A good fraction of this value loss comes from safe-harbor-induced portfolio value destruction. Bankruptcy is not now ready to handle the problem; were a Lehman-sized bankruptcy to occur in 2015, it would fare no better than Lehman did in 2008. Therefore, the

regulatory and congressional hope that basic bankruptcy be the first line of defense in a financial firm failure remains illusory.

I. Rationale for Bankruptcy Resolution

Current bankruptcy rules prevent both the sale of a financial portfolio intact and the breakup of an unwieldy failed firm's concentrated financial portfolio into its natural units. Congress passed the Dodd-Frank Act in 2010, which contemplated regulatory resolution outside of bankruptcy and regulators have sought resolution structures that would avoid bankruptcy's steep impediments. Why is that not enough? Indeed, why is the Dodd-Frank result not superior in all important dimensions to any possible bankruptcy result?⁶ We address these issues in this Part.

Three categories of consideration are relevant here: (1) limits to Dodd-Frank, (2) advantages of bankruptcy, and (3) regulatory advantages of hybridization.

Dodd-Frank, whose resolution mechanisms have been hotly contested, is imperfect. Critics fear that Dodd-Frank has no good mechanism to break up a large failed bank,⁷ that it institutionalizes stealth bailouts,⁸ and that, because it is untried and complex, one should not be confident that it would work in a crisis⁹ because, for example, its decision-making procedure may be too slow, too politicized, and otherwise flawed.¹⁰ We have no strong view on the probabilities here other than to be wary of a complex, untried system.

Backup plans are appropriate. It is better to upgrade current bankruptcy rules for resolving a firm's financial stress and have it available alongside

6. These considerations are discussed in *The Bankruptcy Code and Financial Institution Insolvencies, Hearing before the Subcomm. on Regulatory Reform, Commercial and Antitrust L. of the H. Comm. on the Judiciary*, 113th Cong. (2013) (testimony of Mark J. Roe, David Berg Professor of Law, Harvard Law School), http://judiciary.house.gov/_files/hearings/113th/12032013_2/Roe%20Testimony.pdf.

7. See, e.g., Paul H. Kupiec, *The Way is Clear for Three Easy Dodd-Frank Fixes*, WALL ST. J., Nov. 6, 2014, at A17 (arguing that the Dodd-Frank resolution mechanism will make big banks bigger).

8. See Adam Levitin, *Single-Point-of-Entry: No Bank Left Behind*, CREDITSLIPS (Aug. 31, 2014, 6:42 PM), <http://www.creditslips.org/creditslips/2014/08/single-point-of-entry-no-bank-left-behind.html>.

9. Howell E. Jackson & Stephanie Massman, *Options for Resolving Distressed Financial Conglomerates* (Harvard Law School working paper, May 3, 2015); Kwon-Yong Jin, Note, *How to Eat an Elephant: Corporate Group Structure of Systemically Important Financial Institutions, Orderly Liquidation Authority, and Single Point of Entry Resolution*, 124 YALE L.J. 1746, 1765-77 (2015); Roe, *supra* note 6; see also *The Dodd-Frank Act: Too Big Not To Fail*, ECONOMIST (Feb. 18, 2012), <http://www.economist.com/node/21547784> (criticizing Dodd-Frank's complexity).

10. See DAVID A. SKEEL, JR., THE NEW FINANCIAL DEAL 137-42 (2011); see also Timothy F. Geithner, *The Paradox of Financial Crises*, WALL ST. J., May 13, 2014 ("Americans don't give their presidents much in the way of emergency authority to fight [financial crises] That . . . makes governments, even when they do have the authority, too slow to act."); Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979) (describing deficiencies in rational judgment in high risk situations involving probability and uncertainty).

Dodd-Frank. For example, regulators might not invoke Dodd-Frank because in order to resolve a firm under Title II of Dodd-Frank, multiple regulatory approvals are needed¹¹ and regulators may disagree whether resolution is wise. In the run-up to Lehman, the Secretary of Treasury's concern with the moral hazard costs of bailing out Lehman impeded a government-led Lehman rescue.¹² Congressional pressure or public revulsion against unpopular bailouts may stymie future regulators from acting even if they conclude Dodd-Frank resolution is economically needed.

Even if the regulators act, they often do not act quickly enough. Moreover, Dodd-Frank formally requires that bankruptcy be the primary line of defense against financial failure. As of now, however, it cannot function and will not be used.

Worse yet, a regulatory invocation of Dodd-Frank's Title II could hurt the real economy. When regulators announce that a firm's failure will damage the economy—as Dodd-Frank requires as a prerequisite to invoke Title II—the announcement itself would be systemically damaging, because it would publicly signal that regulators think the country's economic well-being is at risk. The announcement could trigger panic in the economy. While bankruptcy might trigger a similar reaction, we would judge that any fallout should be smaller, especially if bankruptcy becomes as routinized for finance as it has become for airlines and large industrial firms.

Regulators ought to have a credible threat that they will do nothing vis-à-vis a failing financial firm. As of now, they do not have that threat. They must either accept a chaotic Lehman-like result or invoke Dodd-Frank's Title II. Critics of Title II have sought to have the structure available in bankruptcy—i.e., an intact transfer or sale of a failed firm's derivatives portfolio.¹³ We favor a viable Title II and a viable bankruptcy analog. Our contribution here is to show that if Title II or the currently proposed bankruptcy analogue to Title II were to fail or to be viable only with a bailout, there is now no credible bankruptcy alternative other than a Lehman-style chaotic liquidation. A credible bankruptcy alternative opens up more wholesome regulatory possibilities. Here we show what those would be and how to get there through the Bankruptcy Code.

Furthermore, bankruptcy can be regularized and made part of the background of economic reorganization and restructuring. It has evolved well from the 1970s when there was widespread belief that a major industrial firm

11. See SKEEL, *supra* note 10.

12. See Joshua Zumbrun, *Paulson's Line in the Sand*, FORBES (Sept. 15, 2008), http://www.forbes.com/2008/09/15/lehman-bernanke-paulson-biz-beltway-cx_jz_0915paulson.html.

13. See H.R. 5421, 113th Cong. (2014) (proposing a bankruptcy version of Title II); S. 1861, 113th Cong. (2014) (proposing to repeal Title II and substitute a bankruptcy parallel); see also ENDING GOVERNMENT BAILOUTS AS WE KNOW THEM (Kenneth Scott, George Shultz & John Taylor, eds., 2010) (laying out the original bankruptcy proposal entitled "chapter 14" as an alternative to Dodd-Frank resolution).

that entered Chapter 11 could not exit bankruptcy.¹⁴ Nowadays, bankruptcy regularly reorganizes complex industrial firms.

Lastly, engineers know that complex systems demand redundancy. As of now, we have only one useful system for resolving systemically important financial institutions—Title II of Dodd-Frank, which is untried and may not be invoked when needed. Like engineers building resiliency into a complex system, we should want more than one way to handle a major financial problem. Improving current bankruptcy rules will help create a more resilient financial system infused with hybrid vigor. Regulators could allow a failing financial firm to enter bankruptcy with the expectation that even if the firm will not exit intact, its portfolio and business will. If bankruptcy fails to work, the regulators could then pull the firm out from bankruptcy and into Dodd-Frank's Title II. They lack that option now because, as shall be seen, current bankruptcy law would facilitate the tearing apart of the failed firm's derivatives portfolio. The eggs cannot thereafter be unscrambled.

Perhaps most importantly, we have a concentrated financial market in financial derivatives, and we should have a mechanism to break up a failed firm's derivatives portfolio. Dodd-Frank's Title II does not allow such a break-up. Bankruptcy can and should be fixed to be able to do so.

II. Portfolio Value and Its Destruction in Bankruptcy

In this Part, we outline basic portfolio construction to see first, how construction economies arise and second, how they are lost when courts are powerless to protect portfolios' integrity.

A portfolio's investments interact, usually via diversification, to add value to the overall portfolio. That portfolio value can be slashed if the investments are pulled apart, one-by-one. This loss of value from disaggregation is a fundamental business problem that bankruptcy handles with rules that normally enjoin creditors from quickly pulling the debtor firm apart. But bankruptcy drops these hold-together rules for derivatives.¹⁵ Dodd-Frank's solution to the hold-together problem yields an all-or-nothing alternative: either the *entire* portfolio must be repositioned intact or the portfolio can be pulled apart

14. For example, Lee Iacocca, chairman of Chrysler during its late-1970s weakened state testified to Congress that the difficulties that a large industrial firm would face in chapter 11 were so severe that: "I would bet my life on the fact that if we go to bankruptcy, . . . the cash flow will go to zero and we will go into liquidation immediately." Chrysler Corporation Loan Guarantee Act of 1979, H.R. Rep. 690, 96th Cong., 1st Sess. 14 (1979); 1979 U.S.C.A.N. 2787, 2795 (1979)

15. Bankruptcy's injunction on creditor collection is quite costly to derivatives counterparties, whose contracts can suffer volatile price movements, particularly during a long bankruptcy. While accommodation is needed, the current total exemption from bankruptcy is not the only alternative.

contract-by-contract.¹⁶ No middle ground is provided—and that missing middle ground is what bankruptcy and the financial system need.

A. Portfolio Value

1. *The portfolio's parts.* A risky asset worth, say, nothing or \$2 million with equal likelihood is not worth its average expected value of \$1 million if the downside of nothing is particularly costly to its owner, or if the \$2 million upside is not twice as valuable in life amenities as the \$1 million expected cash value. Due to the diminishing marginal utility of money, most people, if unable to diversify, would trade the nothing or \$2 million bet for something less than its \$1 million expected value.¹⁷ For a financial firm financed with debt obligations, the costs of the downside risks are analogous: the firm suffers further losses from financial stress when it sells assets in “fire sales” to raise cash, or misses opportunities because management is stabilizing the firm. Asset values will decline if they cannot be inexpensively embedded in an appropriately diversified portfolio.

2. *The sum of the portfolio's parts.* If the portfolio can be constructed with offsetting risks, its value rises.¹⁸ One security might yield \$2 million when the other is worth nothing and vice versa. If the portfolio assembler could buy this second security from a risk-averse holder for \$900,000, the portfolio assembler would have created value by turning two \$900,000 securities into a \$2 million portfolio.¹⁹

3. *Portfolio value and financial derivatives.* Risk management in derivatives markets parallels the earlier discussion on portfolio value creation. A volatile undiversified cash flow is less valuable than a stable cash flow, even if the two are equal in expected value. Expenses for the cash-flow holder can be lumpy and time-sensitive, making it costly to miss a payment or to lack the cash needed to operate the business smoothly. Although the firm with the volatile cash flow can hold cash reserves, and some do, holding low-earning cash reserves is costly. Risk management, by smoothing cash flows with derivatives and by comparing the cost of cash versus the cost of derivatives that cover a cash need, creates value.²⁰

Financial institutions are often heavily leveraged and vulnerable.²¹ A financial institution that trades in derivatives often seeks to have much of its portfolio in an offsetting book, in which it sits in the middle of opposite trades,

16. 12 U.S.C. § 5390(c)(11) (2012) (“the Corporation shall either . . . disaffirm . . . all qualified contracts [between the debtor and any creditor or its affiliate] . . . or disaffirm . . . none”).

17. See N. GREGORY MANKIW, PRINCIPLES OF ECONOMICS 437 (3d ed. 2004).

18. If it is costless to embed the asset in a diversified portfolio, the asset will command its diversified price. This is the basic lesson of the capital asset pricing model.

19. See RENÉ M. STULZ, RISK MANAGEMENT AND DERIVATIVES 30–36 (2003).

20. *Id.* at 36–46.

21. See Leverage in Financial System Higher Now Than Pre-Financial Crisis: BIS, MIDASLETTER (Sept. 16, 2013), <http://www.midasletter.com/2013/09/leverage/>.

analogous to the two \$900,000 investments in the prior paragraphs.²² Disruptions in the value of either side of these trades can destroy portfolio value and destabilize the financial institution. If the financial disruptions are wide enough, they damage the economy. Modern financial institutions often run not a single, centrally controlled portfolio, but dozens of portfolios from different trading desks, targeting different customers, and selling different products, with each desk maintaining its own hedges. These sub-portfolios, where many day-to-day management decisions are made, can also be called product lines.

B. Value Destruction Due to Portfolio Disassembly

The Bankruptcy Code's safe harbors will stymie a court that wants to preserve an otherwise valuable portfolio, because the debtor's counterparties can terminate and sell off their positions with the debtor as soon as it files for bankruptcy, and indeed can and will start terminating even before it files for bankruptcy.²³ The social cost of individually replacing a large number of the debtor's derivatives contracts, one-by-one, can be very high, as it was in Lehman's case. If the portfolio could be repositioned wholesale, the total transaction costs can be much lower.

1. *Diversification.* If the portfolio owner loses ownership of part of the portfolio, its value could decline by more than the market value of the lost piece. Take the diversification example of the two risky opposites, zero or \$2 million. These bets are worth \$900,000 each standing alone but worth \$2 million together, because of the offsetting outcomes. If one piece is extracted from the portfolio, even at a fair, proportionate value—\$1 million, in this running example—the remaining piece declines in value from \$1 million to \$900,000 to the owning firm, until it can appropriately diversify the embedded risk.

2. *Transaction costs due to the bid-ask spread.* Perfectly efficient markets that transact costlessly would not tolerate this value loss. A financial contract would be worth its expected value, without regard to the risk of that particular contract, if anyone could costlessly construct a diversified portfolio.²⁴ However, swaps markets have costs for transacting and, when these contracting costs cumulate, they lead to large losses. Worse yet, these contracting costs rise when a major swap dealer fails. They rise for both the failed dealer and for other financial firms that deal in the same market.

22. See DON M. CHANCE & ROBERT BROOKS, AN INTRODUCTION TO DERIVATIVES AND RISK MANAGEMENT 565 (8th ed. 2010) ("The dealer usually hedges its risk and earns a profit from the difference in the prices it bids and offers.").

23. We discuss the mechanics of the bankruptcy safe harbors in detail in Part III and how Dodd-Frank Act alters and does not alter these safe harbors in Part VI.

24. The text's sentence captures and simplifies the basics of modern portfolio theory.

The largest trading transaction cost comes from the bid-ask spread—the difference between the price for which a dealer will buy and the price for which it will sell.²⁵ Replacing terminated financial contracts is costly, as the debtor needs to search for a good deal and bargain for it. The gist of the debtor's problem is that its counterparty can terminate and clear out the safe harbored transaction with the bankrupt debtor, inducing the debtor and the counterparty to replace and re-contract, wastefully duplicating the search, bargain, and contracting arrangement that one or the other, or both, have already done.

A dealer will, for example, buy the right to a future payment of \$100 million worth of euros for \$99 million in cash today. The dealer could then sell that amount in future euros to a third party for \$101 million, with the difference between the obligation and the price being its gross profit.²⁶ But such a portfolio does not happen by chance. The dealer must find the right parties, sell them the swap, and manage the portfolio to keep it risk-neutral. To cover its costs, and to make a profit, the dealer charges each party, buying at a price slightly below market, or selling at slightly above market. This difference is the bid-ask spread.

However, if the dealer or one customer terminates its contract, the debtor's work in creating the social value of the balanced transactions has already been spent and the value of the assembled transactions is then lost to the dealer and the economy. One party or the other could reestablish the lost transaction, but to do so, it must find a willing counterparty, spending resources to find the party (or pay a dealer to do the work). This duplication of the costs of rebuilding the portfolio is social waste.

In a bankruptcy, these costs are typically charged under the derivatives contract to the debtor, but our main point here is not where the costs fall, but that the search and replacement contracting costs are wasteful if they can be readily avoided. Bankruptcy, through its safe harbors, exacerbates these costs.

On a single transaction, this loss may not be much. But when aggregated over many contracts, the loss can amount to a high fraction of both the portfolio's and the leveraged firm's overall equity value. The financial firm—and the financial system—could then degrade further and, if the failing firm is systemically important, its interconnections with the rest of the financial system may pull down other financial institutions and financing channels.²⁷

25. See generally Solomon J. Noh, *Lesson from Lehman Brothers for Hedge Fund Managers: The Effect of a Bankruptcy Filing on the Value of the Debtor's Derivatives Book*, 5 HEDGE FUND L. REP. 1 (2012) (describing how the bid-ask spread induced Lehman's derivative losses).

26. The dealer and its counterparty will not actually exchange a check for \$100 million worth of euros for \$99 million in dollars, but will only exchange the net difference, here \$1 million. The \$100 million in euros is thus the notional basis and the \$1 million is the net amount.

27. See generally Hal Scott, *Interconnectedness and Contagion*, COMMITTEE ON CAP. MKTS. REG. (Nov. 20, 2012), http://capmktreg.org/app/uploads/2014/11/2012.11.20_Interconnectedness_and_Contagion.pdf.

* * *

Below, we consider both how the safe harbors facilitate this inefficient result and how that portfolio degradation can damage the overall economy. Termination problems are local losses, worthy of concern and fixing. But they are not just local losses—they can affect the entire economy.

True, a failed firm's portfolio may occasionally be more valuable when disassembled, contract-by-contract. After all, the firm may have failed because management put together the portfolio's pieces poorly. And, while Lehman's closeouts proved to be chaotic, not all such efforts need be as chaotic. Trying to save value for all concerned by repositioning the portfolio along product lines could for some failed firms be a waste of time. But even in these circumstances, the Bankruptcy Code changes we propose are appropriate. Rather than bankruptcy requiring that the portfolio be liquidated, which bankruptcy without Dodd-Frank now demands, bankruptcy should reposition the portfolio coherently into private hands. The new owners could then decide whether to liquidate the portfolio or hold it together intact.

III. How Bankruptcy's Safe Harbors Destroy Portfolio Value

In this Part, we examine how the current bankruptcy safe harbors, as well as the baseline rules, incentivize parties to terminate and thereby destroy value in the debtor's portfolio.

A. The Safe Harbors

Baseline bankruptcy rules bar the bankrupt debtor's creditors from suing and collecting from the debtor except through a plan of reorganization or with the court's permission. Bankruptcy's grant of relief soon after the debtor files for bankruptcy automatically enjoins parties from trying to collect on their pre-bankruptcy debts.²⁸

The concept behind the automatic stay is that the whole firm can be worth more than the sum of its parts. If the financier of a steel mill could pull the smelter out of the steel company and leave the other steel-rolling equipment inside, an otherwise viable steel mill might be destroyed. Its suppliers and customers would be forced to run for replacements and its employees would be forced to look for other jobs. The bankruptcy bar against creditors collecting from the bankrupt is not permanent; the creditor is paid eventually. The bar is designed to help test whether the firm has going concern value, to allow the firm to realize that going concern value, and then to distribute fair value to the widest possible group of creditors.

28. 11 U.S.C. § 362 (2012).

Other bankruptcy rules support the capacity to test whether the firm has ongoing value if kept intact, in whole or in part: The debtor's counterparties that grabbed value from the debtor via pre-bankruptcy collections must return these grabs to the bankrupt's estate if the transfers cannot pass muster under the Bankruptcy Code's preference rules.²⁹ Fraudulent conveyances of the debtor's assets before bankruptcy for inadequate value can be pulled back into the bankrupt business³⁰ and ipso facto clauses that make the filing of the bankruptcy an event of default are generally unenforceable.³¹ These baseline rules help to keep the debtor's business intact, at least for a time. Additionally, the sales rules in the Code, most famously section 363, allow the debtor's operations to be sold intact or in coherent subparts to third parties to preserve value.³²

Because bankruptcy safe harbors suspend normal bankruptcy rules for financial contracts, they facilitate counterparties' disassembling of the debtor's portfolio.

1. Relief from the automatic stay. The most important safe harbor for derivatives counterparties is relief from the automatic stay, which bars creditors from collecting against the defaulting debtor once the debtor has filed for bankruptcy. Ordinary creditors must wait for the court to grant "relief from the automatic stay," allowing them to sue and collect.

But counterparties with derivatives contracts need not wait.³³ Upon the debtor's filing for bankruptcy, they can demand payment, sue, and if they have security for any damages, can seize and sell that security.³⁴ The volatile nature of derivatives risks justifies deviating from the standard, potentially long automatic stay for them. That is, derivatives protect counterparties from price changes in the contracted financial feature—interest rates, foreign exchange rates, and commodity prices. The automatic stay would typically subject derivatives counterparties to greater risk than ordinary counterparties bear.³⁵ Hence, some accommodation for derivatives away from an extended automatic stay was warranted. The actual accommodation though created other severe

29. *Id.* § 547.

30. *Id.* §§ 544, 548.

31. *Id.* §§ 365(e), 1124(2).

32. *Id.* § 363.

33. *Id.* § 362(b)(17). In financial circles, the term "qualified financial contract" is often used here. This is not a bankruptcy term, but one from financial regulation. Roughly speaking, it covers derivatives and repurchase agreements, the financial instruments that are safe harbored under the Bankruptcy Code. The term is used in the Dodd-Frank Act and codified for financial regulation in 12 U.S.C. § 5390(c)(8)(D)(i) (2012).

34. 11 U.S.C. § 362(a) (the automatic stay bars creditors from pursuing any judicial process, enforcing a judgment, acting to obtain possession of property, or setting off mutual debts).

35. See COLLIER ON BANKRUPTCY 5-560 (16th ed. 2010) (quoting the floor statement of Representative Fish, May 15, 1990: "The stability of the swap market depends on the ability of a non-defaulting participant to terminate outstanding transactions quickly; rapid changes in currency values and interest rates can make delay very costly.").

problems, such as those financial markets experienced when Lehman failed. Better accommodation is possible.³⁶

2. *Revitalizing ipso facto clauses.* For the contract creditor to act against the debtor, the debtor must have breached the contract. Without a breach, the creditor has no complaint and must wait for the debtor's performance, which may or may not come.

Creditors have long anticipated this problem by putting ipso facto clauses into their contracts that make the debtor's bankruptcy filing in and of itself a default under the contract, thereby allowing the creditor to sue. But bankruptcy law, anticipating the threat to its ability to reorganize otherwise viable firms, has long made such ipso facto clauses unenforceable in bankruptcy.³⁷

For derivatives contracts, however, the safe-harbored creditor can enforce the ipso facto clause,³⁸ allowing a safe-harbored creditor to pull its piece of the debtor's portfolio out.

3. *Safe harbors from preference law and fraudulent conveyances.* Creditors anticipate that a debtor will file for bankruptcy when business deteriorates. Creditors prefer to be repaid before bankruptcy to avoid the inconvenience and possibility of not being fully paid in bankruptcy. Accordingly, creditors have the incentive to demand repayment, or more collateral if their contract so requires, before a bankruptcy transpires. If enough creditors rush to be repaid or drain the debtor's value by insisting on large collateral postings, reorganization could become impossible. The run on the debtor can leave the firm crippled.³⁹

To reduce the lender's incentives to rush for repayment or security posting, bankruptcy makes a wide array of eve of bankruptcy repayments preferential. If a pre-bankruptcy payment was preferential, the debtor can recover it for the benefit of all of its creditors. In general, if the near-bankruptcy payment or collateral posting allows the preferred creditor to obtain

36. 11 U.S.C. § 362. The original derivatives-oriented safe harbor was added to the 1978 Bankruptcy Code at the suggestion of the Commodity Futures Trading Commission to ameliorate the risk to a clearinghouse if a clearing member failed through clearing payments being treated like voidable preferences. Few foresaw the rise of a trillion dollar industry relying on extensions of this safe harbor, extensions whose congressional history did not vet the full range of systemic risk issues deeply and was as much about fast growth and exciting possibilities of these new markets, should Congress include them in the safe harbors. See Steven Schwarcz & Ori Sharon, *The Bankruptcy-Law Safe Harbor for Derivatives: A Path-Dependence Analysis* 71 WASH. & LEE L. REV. 1715, 1737–39 (2014); Frederick L. White, *The Commodity-Related Provisions of the Bankruptcy Act of 1978*, 34 REC. ASS'N B. CITY N.Y. 262, 269 (1979). The text provides the public policy rationale for some form of safe harbor; the possibility also exists that the safe-harbored entities—often the country's largest financial institutions—were powerful enough to induce Congress to give them what they wanted, when a modest accommodation would have handled their legitimate needs.

37. 11 U.S.C. § 365(e).

38. *Id.* §§ 559–60.

39. For argumentation and data that the general, economy-wide run on repo worsened the crisis, see Gary B. Gorton & Andrew Metrick, *Securitized Banking and the Run on Repo*, 104 J. FIN. ECON. 425 (2012); Arvind Krishnamurthy, Stefan Nagel & Dmitry Orlov, *Sizing Up Repo* 20 (NBER Working Paper No. 17768, Jan. 2012), <http://www.nber.org/papers/w17768>.

disproportionate recovery and was not made in the ordinary course of business, and if it satisfies some other requirements, the recovery is considered preferential and the debtor may recover it.⁴⁰

Here too, bankruptcy law protects the creditor who receives otherwise preferential payments as a derivatives counterparty, because the debtor cannot recover such a preferential payment.⁴¹ Hence, if the debtor posts more collateral with the derivatives creditor on the eve of bankruptcy, then, even if that posting is preferential, the derivatives creditor can, after the bankruptcy commences, declare the debtor to have defaulted under the contract (because the ipso facto ban does not apply) and keep that preferential collateral to cover the debtor's debts. These rules facilitate portfolio value destruction.

B. Separating Value Transferred from Value Lost

1. *The zero-sum aspect.* Admittedly, a portion of the loss from portfolio deconstruction, such as that which Lehman suffered in its September 2008 bankruptcy, comes from closeouts at prices beneficial to the failed institution's counterparties.⁴² These closeouts transfer value as well as destroy value, meaning that the full loss to Lehman was not entirely a loss to the economy. Lehman lost a lot; its counterparties gained back some of what Lehman lost.

One might be tempted to conclude that Lehman's losses were primarily zero-sum transfers—that is, Lehman's losses equaled its counterparties' gains. While some of the losses must have been zero-sum, there is strong reason to believe they were not the bulk of Lehman's losses. First, key parts of Lehman's book presumably were hedged, as is common practice, so price changes would wash out. Secondly, where Lehman was not hedged and was speculating, prices were moving in Lehman's favor or were not volatile.⁴³ Lehman was reportedly betting that interest rates would go down, and interest rates in fact did decline. Since overall Lehman was largely hedged or had winning bets, Lehman's portfolio losses are best explained by the remaining alternative of a powerful cumulative effect of being closed out and forced to bear the transaction costs of counterparties replacing their deals with Lehman, one-by-one, at Lehman's expense. If the process could have been handled wholesale at low transaction

40. 11 U.S.C. § 547. On the anti-run, preservation of collective value explanation for preference law, see THOMAS JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 122–50 (1986).

41. 11 U.S.C. § 546(g) (safe harbor for derivatives and repo from preference law and most fraudulent conveyance law).

42. Cf. Michael Fleming & Asani Sarkar, *The Failure Resolution of Lehman Brothers*, 20 FRBNY ECON. POL'Y REV. 175, 186 (2014).

43. Attorneys involved in the bankruptcy report that Lehman's large fixed-rate receiver position in interest rate swaps increased in value as interest rates fell over the two years before its petition, and would have increased even more after its bankruptcy, as further interest rate cuts were expected. Cf. Martin Z. Braun, *Lehman Reaches Beyond the Grave Seeking Millions from Nonprofits*, BLOOMBERG (May 14, 2013, 11:20 AM), <http://www.bloomberg.com/news/2013-05-14/lehman-reaches-beyond-grave-to-grab-millions-from-nonprofits.html>; Fleming & Sarkar, *supra* note 42, at 185 n.22.

costs, which, as we argue below, it can be, then bankruptcy could have better limited the value loss and consequential financial disruption.

Even for the losses that were “mere” value transfers, serious economic costs were embedded. Transferring value from Lehman to a counterparty burns up economic value: the transaction cost of the closeout, the transaction cost of the counterparty finding an investment that covered the closed out investment, which is typically then charged to the debtor, the professional fees involved, and the litigation costs of the bankruptcy, which were substantial. Four years of litigation, with upwards of \$2 billion in litigation cost is an expensive way to effectuate a simple transfer of value from Lehman to the counterparties.⁴⁴ Much of the Lehman litigation cost was, we understand, driven by closeout disputes. If the breakup and transfer mechanisms we propose here were in place and effective, much of these costs could have been avoided.

2. *A Coasean analytic.* The Coase Theorem on transaction costs can be used to conceptualize both the criticism (“it’s just a value transfer”) and the correct analysis (that the cumulative impact of transaction costs across many transactions due to widespread re-contracting can be, and has been, exceedingly expensive in financial bankruptcy to the failed firm and the overall economy).

That is, critics of the portfolio destruction analysis could point to the Coase Theorem which shows how a rule’s potential inefficiencies between contracting parties can be avoided by the parties re-contracting.⁴⁵ Someone must pay, but the final contract will, if re-contracting is smooth and costless, be efficient. In the standard Coasean move, all that is lost by a poor but clear rule among contracting parties is the cost of their contracting again. For portfolio value destruction, the potential (but erroneous) Coasean critique is that the debtor, even if facing portfolio value destruction, can avoid that destruction by reacquiring the missing security.

The transactional benefit for the debtor of reacquiring the offsetting hedging position is clear, but the conceptual critique would go awry here because the very cost of portfolio value destruction is the transaction cost of reacquiring, or covering, a defaulted contract at a wrong spot in the bid-ask spread. These costs are large when aggregated over a large portfolio, particularly when the re-contracting is done during a financial crisis with disrupted financial markets.

* * *

44. See James O’Toole, *Five Years Later, Lehman Bankruptcy Fees Hit \$2.2 Billion*, CNNMONEY (Sept. 13, 2013), <http://money.cnn.com/2013/09/13/news/companies/lehman-bankruptcy-fees/>. Counterparties bore costs directly as well.

45. See generally Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960) (analyzing how parties work around inefficient rules by contracting).

Importantly, the knock-on effects of the Lehman bankruptcy—reflected in the widespread view that the bankruptcy and concomitant closeouts, along with the AIG closeouts, exacerbated the financial crisis—must be added into the policy balance. So, in coming up with an economic bottom line, one should deduct from the estimated \$75 billion lost by Lehman the portion that was recovered by Lehman’s counterparties (the simple transfers, which we analyzed above as likely to be a small portion of the \$75 billion). But to that lowered net amount, one must *add* (1) the counterparties’ own additional transaction costs, (2) the large transaction costs of the Lehman bankruptcy itself, and (3) the larger costs to the American economy as financial markets froze and economic activity declined. There is good reason to think that, particularly with the last cost, the net resulting cost to the American economy is more than \$75 billion, not less.

C. The Safe Harbors in Action

Portfolio destruction under the safe harbors is, with the prior sections’ analytics in mind, easy to understand. The safe harbors lead both to costs from the debtor’s loss of diversification, as well as to transaction costs from the termination and replacement of the derivatives contracts.

If the debtor firm with a balanced book files for bankruptcy, the safe harbors will encourage its counterparties to rip their contracts out from the debtor’s portfolio in ways that baseline bankruptcy rules would bar. Non-safe-harbored creditors need to apply to the court before they can seize and liquidate their collateral and cannot use the bankruptcy itself to declare the debtor to be in default. Not so for safe harbored creditors, who also, unlike regular creditors, can keep collateral and repayments received just prior to bankruptcy. The Code thereby facilitates counterparty destruction of the debtor’s portfolio. An excellent example of the effects of the safe harbors in action was the Lehman bankruptcy, which we discuss in more depth in Part IV.

D. How Bankruptcy’s Baseline Rules Would Also Destroy Portfolio Value

Thus, bankruptcy’s safe harbors allow counterparties to destroy the debtor’s portfolio’s value by transferring value to themselves and reducing the overall value of the portfolio to the debtor and its creditors. One might then think that bankruptcy’s baseline rules do not facilitate portfolio value destruction.⁴⁶ However, these baseline rules would *also* destroy value. Although the debtor would be better off without the safe harbors and the debtor *could* maximize the value of the portfolio for all concerned, it would lack the incentives to fully do so.

46. Perhaps for this reason, even provocatively entitled criticisms of the safe harbors retain substantial accommodation. See Stephen Lubben, *Repeal the Safe Harbors*, 18 AM. BANKR. INST. L. REV. 319, 323 (2010).

One might mistakenly think that if the debtor maximizes its own portfolio's value, it is maximizing its overall value to its creditor counterparties. But this is not so for basic bankruptcy reasons. The intuitive reason is that baseline bankruptcy rules allow the debtor to handle its portfolio so that it *shifts* value from some, perhaps many, creditors to itself. These shifts in value are not always zero-sum, one-for-one shifts: a dollar lost to the creditor increases the debtor's value but sometimes by less than a dollar.

1. *The automatic stay.* In the absence of the safe harbors, the automatic stay would bar counterparties from terminating their contracts and claiming their collateral. The automatic stay also prevents the counterparty from withholding performance on their contracts with the debtor, even if the debtor was not performing on its contracts.⁴⁷ The stay has no formal time limit.

The stay would allow the debtor to preserve its portfolio value. The debtor could, for example, seek to assign its balanced book to a third-party, with the portfolio assembly intact.⁴⁸ But the debtor would lack the incentives to do so. It would have incentives to break up its portfolio along self-interested lines, keeping the winners and rejecting the losers. It could delay its decisions, waiting for volatile markets to create more winners and losers, with the debtor then picking up the winners and rejecting the losers.

2. *The debtor's right to reject or assume.* Bankruptcy gives the bankrupt debtor the right to choose which incomplete contracts to keep and which to reject.⁴⁹ Contracts that the bankrupt debtor rejects yield the rejected counterparty a pre-petition claim, which, to the extent not secured or otherwise prioritized, is paid proportionately with other unsecured creditors.⁵⁰ The debtor is obligated to pay in full contracts that it assumes.⁵¹

In short, the debtor who rejects a contract does not pay the full level of damages. Instead, the debtor pays the amount paid to unsecured creditors, typically a proportion of its debts to its assets.⁵² Posit that the dealer rejects a

47. David Skeel and Thomas Jackson argue, however, that non-safe-harbored swaps would be treated like leases, which the debtor is required to perform while waiting to reject or assume. David A. Skeel, Jr. & Thomas H. Jackson, *Transaction Consistency and the New Finance in Bankruptcy*, 112 COLUM. L. REV. 152, 171 (2012).

48. See 11 U.S.C. § 365(f)(1) (2012) (allowing debtor to assign executory contracts, notwithstanding anti-assignment clauses).

49. *Id.* § 365. See also Jesse Fried, *Executory Contracts and Performance Decisions in Bankruptcy*, 46 DUKE L.J. 517, 517 (1996); Jay Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227 (1989); Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 439 (1972).

50. 11 U.S.C. §§ 365, 502(g).

51. *Id.* §§ 507, 1129(a)(9).

52. This is true for unsecured creditors. Secured creditors are guaranteed the value of their claim up to the value of their security. *Id.* § 506. Claims exceeding the value of the creditor's security are treated as secured up to that value and unsecured beyond it. Undersecured claims would thus be subject to pro rata damages to the extent they were unsecured. Derivatives contracts are often undercollateralized, as many counterparties of Lehman discovered. The general practice is for the security postings to be done at the middle of the bid-ask spread, leaving counterparties less than fully

contract and the counterparty's damages are \$100,000. A solvent dealer must pay that \$100,000. But a bankrupt dealer would pay proportionately to what it is paying other unsecured creditors. If unsecured creditors are being paid ten cents on the dollar, a common bankruptcy assumption (because only 10 cents of value is available for every dollar of debt),⁵³ then the debtor would only pay \$10,000 on \$100,000 of damages. Jesse Fried and George Triantis have separately shown in another context how debtors are motivated to reject contracts that it would perform outside of bankruptcy because it pays damages in cheaper "bankruptcy dollars". This result is often inefficient, with the debtor rejecting too many executory contracts.⁵⁴

3. *Portfolio consequences.* Even if two offsetting derivatives contracts together are economically more valuable if kept intact instead of being severed, the debtor will decrease its liabilities by rejecting the loser and keeping the winner. The debtor would be incentivized to go through its contract book of paired deals and reject each losing deal, paying off the counterparty in cheap "bankruptcy dollars." Then the debtor would assume the other side of the pair and be paid in full value dollars. The debtor would maximize the value of the package to itself, not to all of the parties.

For example, assume that the debtor has a contract to buy foreign currency from dealer A and to sell the same to dealer B. Because the contracts fully offset, the debtor is neutral on the contracts and profits from the fees it charges. Suppose that on the contract with dealer A, the debtor is running a \$100,000 profit. With dealer B the debtor is running a \$100,000 loss. (Assume that the obligation is unsecured.⁵⁵) Although the portfolio is best kept together to maximize the joint welfare of all three parties, the debtor will assume the contract with dealer A and reject that with dealer B. It will receive the \$100,000 profit from dealer A and suffer a bankruptcy claim of \$100,000 (payable at 10 cents on the dollar in our running assumption) from dealer B, which will cost it only \$10,000 out-of-pocket.

4. *Debtor's incentive to delay.* The debtor's ability to delay decisions to reject or assume under baseline bankruptcy rules allows it to destroy value in a major way, for its own benefit, because the Code does not directly constrain the debtor's timing in invoking its section 365 right to reject or assume.⁵⁶ Worse

secured. And, in rapidly moving markets the security shortfall could be greater, particularly if the debtor games the timing, waiting for winners and losers to develop in its contract book.

53. See, e.g., DOUGLAS G. BAIRD, *THE ELEMENTS OF BANKRUPTCY* 69, 85-86 (1993).

54. See Fried, *supra* note 49, at 517-18; George G. Triantis, *The Effects of Insolvency and Bankruptcy on Contract Performance and Adjustment*, 43 U. TORONTO L.J. 679 (1993). If the bankruptcy process compensated debtors, or their trustees, differently—say, based on total portfolio value—the result might be different.

55. Again, this is an important assumption, in that if the \$100,000 obligation is fully secured, then the debtor's inside-bankruptcy incentives approach that of its outside-of-bankruptcy incentives. See *supra* note 52.

56. While the Code allows the counterparty to request that the judge order the debtor to decide, 11 U.S.C. § 105(d)(2), we understand that this is not an overly common practice.

yet for the derivatives counterparties, the obligations underlying many derivatives—fast-moving commodities prices, interest rates or foreign exchange rates—are volatile. This volatility gives the debtor considerable power to profit via strategic timing and delay.

The debtor's power to assume or reject can also destabilize its counterparties and their portfolios because the counterparties would face uncertainty over their exposure, leading them to want to hedge further against downside risk. The counterparties' portfolio value would diminish as a result. Hence, returning to baseline bankruptcy rules that give the debtor a largely unconstrained right to assume or reject on a contract-by-contract basis would be unwise.

* * *

Overall, the baseline rules are too generous to the debtor, because overall portfolio value preservation should be a central policy goal for financial firm bankruptcies.

IV. Lehman Brothers' Bankruptcy

Lehman Brothers, a huge investment bank with \$640 billion of assets, filed for bankruptcy on September 15, 2008. It was the largest bankruptcy in U.S. history.⁵⁷

Lehman's failure exacerbated the financial crisis, especially after AIG's near-collapse in the days afterwards prompted counterparties to close out positions, sell collateral, and thereby depress and freeze markets.⁵⁸ Many financial players stopped trading for fear that their counterparty would be the next Lehman or that their counterparty had large unseen exposures to Lehman that would make the counterparty itself fail.⁵⁹ Such was the case with the Reserve Primary Fund, a money market fund that held too many defaulting obligations of Lehman.⁶⁰ That reaction led to further financial panic, a threat of

57. See Exhibit "A" to Voluntary Bankruptcy Petition at 17, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (JMP) (Bankr. S.D.N.Y. Sep. 15, 2008) (No. 1); see also Report of Anton R. Valukas, Examiner at 2, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (JMP) (Bankr. S.D.N.Y. March 11, 2010).

58. See, e.g., Porter Stansberry, *How AIG's Collapse Began a Global Run on the Banks*, DAILYWEALTH (Oct. 4, 2008), <http://www.dailywealth.com/506/aig-collapse-global-bank-run>.

59. See Elizabeth Stanton & Lynn Thomasson, *U.S. Stocks Plunge as Lending Freezes Up Following AIG Takeover*, BLOOMBERG (Sept. 17, 2008), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=amrQtoxTGmgU>.

60. See Press Release, *The Reserve, A Statement Regarding the Primary Fund* (Sept. 16, 2008), http://www.reservefunds.com/pdfs/Press%20Release%202008_0916.pdf; see also Jeffrey N. Gordon & Christopher Muller, *Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund*, 28 YALE J. REG. 151, 164, 181 n.80 (2011); Marcin Kacperczyk & Philipp Schnabl, *When Safe Proved Risky: Commercial Paper During the Financial Crisis of 2007-2009*, 24 J. ECON. PERSP. 29, 40-41 (2010).

a run on money market funds, and a government guarantee of all money market funds to stem the ongoing financial degradation throughout the economy.⁶¹

A. Lehman's Bankruptcy

Derivative dealing was a large, though not dominant, source of Lehman's profits before its bankruptcy filing.⁶² Two weeks before its bankruptcy, Lehman's internal estimates showed that the firm's derivatives portfolio had a net value of \$22.2 billion with derivative assets worth \$46.3 billion and derivative liabilities worth \$24.2 billion.⁶³ As of August 2008, Lehman had more than 900,000 derivative trades worldwide.⁶⁴ Within two weeks of the bankruptcy filing, Lehman's derivative counterparties terminated 99 percent of their trades.⁶⁵

Both Lehman's counsel and its restructuring advisor identified the bankruptcy safe harbors as value destroying. Harvey Miller, Lehman's lead counsel said, "had Lehman had the benefit of the 'breathing space' that is typically available at the initial stages of any chapter 11 case, the massive amount of value that was destroyed in the months after September 15, 2008 may have been saved."⁶⁶ Alvarez & Marsal, Lehman's restructuring advisor, estimated that the disorderly closeouts of Lehman's derivatives portfolio caused the Lehman estate to lose at least \$50 billion in portfolio value, possibly more. What started as a \$22 billion asset for Lehman turned into a multi-billion dollar loss.⁶⁷

B. Disrupted Financial Markets and the Disintegration of Lehman's Portfolio

How and why did Lehman lose so much value? Applying the framework we have thus far developed in this Article points us to three causes.

61. See Press Release, U.S. Dep't of the Treasury, Treasury Announces Guaranty Program for Money Market Funds (Sept. 19, 2008), <http://www.treasury.gov/press-center/press-releases/Pages/hp1147.aspx>; see also Kacperczyk & Schnabl, *supra* note 60, at 40–41.

62. Over-the-counter derivatives amounted to about \$3 billion of Lehman's \$15 billion in revenue for the second quarter of 2007. Lehman Bros. Holdings, Inc., Quarterly Report (Form 10-Q) 4, 32 (June 30, 2008).

63. Valukas, *supra* note 57, at 571–72.

64. *Id.* at 569.

65. McCracken, *supra* note 3. Some nonterminated contracts were, however, large in value.

66. *Too Big To Fail: The Role for Bankruptcy and Antitrust Law in Financial Regulation Reform: Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 111th Cong. 9 (Oct. 22, 2009) (testimony of Harvey Miller, Partner, Weil Gotshal & Manges LLP).

67. Estimates of the size of the loss range up to \$75 billion. McCracken, *supra* note 3. See also Miller, *supra* note 66, at 72 (describing the chaotic closeouts of derivatives as causing a "massive destruction of value"); Kimberly Summe, *Misconceptions About Lehman Brothers' Bankruptcy and the Role Derivatives Played*, 64 STAN. L. REV. ONLINE 16, 16 (2011), <http://www.stanfordlawreview.org/online/misconceptions-about-lehman-brothers-bankruptcy> [hereinafter Summe, *Misconceptions*].

1. *Transaction cost destruction of Lehman's portfolio value.* Lehman lost much value because it suffered its counterparties' closeouts at the wrong end of the bid-ask spread.⁶⁸ Again, while some loss here was only a value transfer from Lehman to its counterparties or to those dealers from whom those counterparties bought replacement contracts, much was a loss of value to the economy, as it costs real assets to rebuild a balanced portfolio, and there are real costs when rapid closeouts disrupt financial markets and degrade economic activity overall.

Derivatives contracts are typically not short-term deals that naturally end after a few days; they are longer-term efforts to transfer and contain risk.⁶⁹ As such, if the contracts reliably stayed in place, the disruption to worldwide financial markets should have been smaller. The immediate closeout of Lehman's large contract book put enormous transactional pressure on a financial market that does not normally need to do as much contracting construction and reconstruction in such a short time.

2. *Lehman-induced market disruption.* Market conditions determine the bid-ask spread for replacement contracts.⁷⁰ Lehman's collapse greatly increased the demand for replacement positions, making it harder and more costly for its counterparties to hedge and cover their positions. Lehman's collapse also exacerbated its own financial problems. The firm had large positions in credit default swaps and interest rate swaps. While interest rate swaps are typically standardized and liquid, shortly after Lehman failed, that market became deeply stressed: odd patterns of negative values appeared, presumably from purchase and sale pressure coming from Lehman counterparties hurriedly seeking to rebalance their disrupted portfolios.⁷¹

68. See *supra* Part II.B.2-3; Masahiko Egami et al., *An Analysis of CDS Market Liquidity by the Hawkes Process* (Kyoto Univ. Graduate Sch. of Economics Research. Project Ctr. Discussion Paper No. E-13-001 2013) (showing bid-ask spreads for credit default swaps widened by 300 percent and liquidity evaporated), <http://www.econ.kyoto-u.ac.jp/projectcenter/Paper/e-13-001.pdf>; Noh, *supra* note 25; *CDS Liquidity Drying Up as Bid-Ask Spreads Widen*, CREDITLIME BLOG (May 26, 2010), <http://blog.creditlime.com/2010/05/26/bid-ask-spreads>. See generally SYLVIE A. DURHAM, *TERMINATING DERIVATIVE TRANSACTIONS: RISK MITIGATION AND CLOSEOUT NETTING* § 5:4 (2010) (describing how Lehman's terminated derivatives contracts were valued).

69. Bloomberg, for example, lists swaps with a duration no shorter than one year, with the durations extending out to fifteen years.

70. See Lei Meng & Owain ap Gwilym, *The Determinants of CDS Bid-Ask Spreads*, 16 J. DERIVATIVES 70 (2008).

71. See Michael McKenzie, *Negative 30-Year Rate Swap Spread Linger*, FIN. TIMES, Sept. 9, 2009 (attributing downward pressure on swap spread to Lehman counterparties terminating and rehedging); Carrick Mollenkamp et al., *Lehman's Demise Triggered Cash Crunch Around Globe*, WALL ST. J., Sept. 29, 2008 ("[A]ctual trading in the CDS market declined to a trickle as players tried to assess how much of their money was tied up in Lehman."), <http://online.wsj.com/news/articles/SB122266132599384845>; Ivy Wang, *Public Lecture on the Impact of Lehman's Collapse*, RISK MGMT. INST. NEWSLETTER (May 2010), <http://www.rmi.nus.edu.sg/aboutus/enewslettermi/issue3/FeatureArticle.html>. See also Nicolas Dumontaux & Adrian Pop, *Contagion Effects in the Aftermath of Lehman's Collapse: Measuring the Collateral Damage* (Banque de France Working Paper No. 427, 2012), http://hal.archives-ouvertes.fr/docs/00/69/57/21/PDF/LEMNA_WP_201227.pdf, (describing "significant abnormal jumps in CDS spreads after Lehman's failure").

Finally, the unusually high transaction costs arising from Lehman also deterred value-creating transactions when Lehman's counterparties could not or did not replace their positions immediately after they terminated them.⁷²

3. *Disintegration of Lehman's balanced portfolio and consequential value loss.* Derivatives are interdependent financial instruments. They are valuable when held with other derivatives and with non-derivative assets, with which investors and firms pair them to even out cash flow or to mitigate unwanted risk.⁷³ However, in Lehman's bankruptcy many of these carefully cultivated connections snapped.

For example, four days after Lehman's bankruptcy, the Chicago Mercantile Exchange liquidated Lehman's proprietary positions on that exchange at a loss of \$1.2 billion. Lehman took on these positions primarily to hedge its over-the-counter swaps. When Lehman went bankrupt, its OTC swap contracts were cancelled, thus "stranding" its positions at the clearinghouse. Without corresponding positions, Lehman's remaining positions sold at significant discounts. "[Lehman's] inability to [sell] both legs of the hedged positions meant that [it] could not liquidate the outright positions on favorable terms, because counterparties would require substantial additional collateral and margins."⁷⁴

* * *

It is important to state what we do not argue here. The destruction of Lehman's derivatives portfolio was not the cause of the firm's demise. The firm failed because of too many illiquid hard-to-sell investments, particularly in the mortgage market. It ran out of cash, could not negotiate a merger without government backing, and went bankrupt.⁷⁵ Our analytic point here is that, once Lehman failed, bankruptcy's inability to reposition Lehman's derivatives portfolio well further destroyed value in Lehman and its counterparties and further disrupted financial markets and the real economy.⁷⁶

The Lehman bankruptcy shocked financial markets. Less than two years later, Congress passed the Dodd-Frank Act in response. Yet, even with Dodd-

72. Much Lehman litigation arose because during the week following Lehman's bankruptcy filing, financial markets had become so illiquid that counterparties could not find the three quotes they needed for clean closeouts under their safe harbored contracts. Many could not replace their positions. See Fleming & Sarkar, *supra* note 43, at 45. This result makes it contestable as to whether the safe harbors dampen financial disruption or increase it. Some disruption persisted for more than a year after Lehman filed. See Michael McKenzie, *Negative 30-Year Swap Spreads Linger*, FIN. TIMES, Sept. 9, 2009,

73. See Stulz, *supra* note 19, at 52-74.

74. See Fleming & Sarkar, *supra* note 42, at 44.

75. The merger failure could have several explanations beyond the usual reasons for a failed deal: Lehman's senior management could have expected government backing, or it might not have realized the depth of its problems early enough.

76. See Valukas, *supra* note 57, at 2-5 (attributing demise of Lehman to overleverage and overinvestment in illiquid assets); see also Summe, *Misconceptions*, *supra* note 67, at 16.

Frank's Title II framework for resolution of failed financial firms, the means to coherently break apart and reposition a failed financial firm's derivatives portfolio eludes the financial system. Dodd-Frank can keep the entire portfolio intact, but if we fall back to bankruptcy, the safe harbored counterparties would liquidate the portfolio piecemeal. Neither Dodd-Frank nor the Code allows the product-line sales that should be a part of financial resolution arsenal. We will further discuss Dodd-Frank's inadequate response below,⁷⁷ but first we propose a solution to this fundamental problem.

V. Preserving Portfolio Value in a Financial Meltdown: Product-Line Sales

In this Part, we show how to best preserve portfolio value. We also identify the conceptual limits to effective reform.

Section 363 of the Bankruptcy Code allows for the sale of the bankrupt's portfolio and is best adapted to preserve portfolio value. The primary reform would make the section 363 sale available for a derivatives portfolio in bankruptcy, giving bankruptcy the power to sell the mega-failed-firm's portfolio along product lines: interest rate swaps to one party, foreign currency swaps to another, commodities derivatives to a third. We explain next.

A. Adapting the Section 363 Sale to the Derivatives Portfolio

Section 363 authorizes courts to sell the bankrupt firm, or its constituent parts. It provides substantial flexibility to maintain the debtor's portfolio value and restructure the portfolio in an economically stable way. The debtor with the offsetting currency swaps described in Part II.A could package the two swaps together and sell them intact to a third party. When a third party buys the portfolio intact, no one is made to bear undiversified currency risk or incur the costs of hedging an uncovered risk, and the debtor's value to all (its own lenders and its counterparties, in the aggregate) is maximized.

Two major economic problems, however, cripple whole-portfolio sales. First, the money-losing portfolio cannot be sold intact, without a subsidy. Second, the mega-portfolio cannot readily be sold other than to another mega-firm, which would further concentrate the financial system, in ways that would not be sound in the longer-run.

B. Roadblocks: The Out-of-the-Money Portfolio and the Oversized Portfolio

1. The out-of-the-money portfolio. Selling a whole portfolio for cash is not viable if it is "out-of-the-money," i.e., if the portfolio's losing positions exceed its profitable ones. When the portfolio is losing money, no one will buy it. Instead, the portfolio must be transferred with cash, not for cash. The out-of-

77. See *infra* Part VI.

the-money portfolio is a liability, not an asset. But how the portfolio is dismantled determines whether more value is destroyed, whether it becomes a bigger liability, whether markets are further disrupted, and whether the end result further concentrates financial contracts into a systemically unsafe core.

If the portfolio could be sold along product lines—foreign exchange swaps to one buyer, interest rate swaps to another, credit default swaps to a third—then in-the-money segments could be saved and sold. As a result, markets would be less disrupted or not disrupted at all and a systemically important firm's failure could lead to a controlled breakup instead of either to a bail out or to further consolidation of the financial sector.⁷⁸

Orderly closeouts over a period of weeks to prevent multiplying losses have been the standard way of closing out massively out-of-the-money portfolios before, such as in the case of Long-Term Capital Management and the Orange County disaster.⁷⁹ However, these orderly break-ups were conducted outside of the Bankruptcy Code.

* * *

If the restructuring authorities conclude that the intact portfolio is more valuable than the parts, then they will have reason to sell the portfolio intact. The power to do so will still require bankruptcy amendments, as the current Code disallows such a sale,⁸⁰ although Dodd-Frank allows one.⁸¹ A sale in the entirety will be more appropriate for a mid-sized derivatives operation than a very large one. A converse advantage of selling a mega-portfolio along product market lines is that the separate lines should call forth more bidders than a large whole-portfolio sale, because the mega-portfolio may be indigestible to more

78. Paul Kupiec, former director of the Center for Financial Research at the FDIC, points out that Dodd-Frank's living wills need to focus on ways to break up the banks and sell the pieces, not transfer them whole. Our proposal, as a break-up proposal, fits this need. See Kupiec, *supra* note 7; see also Paul H. Kupiec & Peter Wallison, *Can the "Single Point of Entry" Strategy Be Used to Recapitalize a Failing Bank?*, AM. ENTERPRISE INST. 33 (Nov. 2014), <https://www.aei.org/wp-content/uploads/2014/11/SPOE-Working-paper-Nov-5.pdf> (describing reliance on selling distressed financial institutions to larger ones in current policy environment).

79. After Long-Term Capital Management lost 92% of its value within a few months, the Federal Reserve Bank of New York organized LTCM's major counterparties to stabilize LTCM and supplied \$3.6 billion in rescue equity. Thus recapitalized, LTCM could liquidate its portfolio over months, eventually eaning a small profit. See Philippe Jorion, *Risk Management Lessons from Long Term Capital Management*, 6 EUR. FIN. MGMT. 277, 283–84 (2000). Warren Buffett was interested in buying LTCM's whole portfolio for \$250 million at the last minute, promising to put in \$3.75 billion to stabilize the portfolio for liquidation, but his bid failed for technical reasons. The fact that he bid suggests, however, that private sales are viable. See ROGER LOWENSTEIN, *WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT* 202–05 (2000). Our proposal will, if implemented, make that possibility more likely.

80. See H.R. 5421, *supra* note 13. The decision to sell intact or by product-line is one that we would prefer to be made outside the bankruptcy litigation and judicial process. But this difficulty may be unavoidable.

81. See 12 U.S.C. § 5390(c)(10)(B)(i)(I) (2012) (describing stay on qualified financial contract closeouts for two days unless the counterparty receives notice of intent to transfer).

than one or two firms. More bidders ordinarily lead to better pricing overall for the counterparties.⁸²

2. *The systemically important, oversized portfolio.* The concentrated quality of derivatives portfolios in the American economy demands to be factored into the policy structure. A large fraction of derivatives portfolios is held by five large financial institutions,⁸³ two of which—Citigroup and Bank of America—have been weak. It could be that no buyer would have the resources to do so, thereby inviting bailout pressure. Even if a buyer could be found, the acquirer would presumably be one of the other five major derivatives dealers. The further concentration of that market would worsen financial safety. While we devote only a paragraph here to this concentration consideration, it is a major reason to reconstruct the derivatives safe harbors. The financial system should have a mechanism for an orderly break-up of one of the two or three large derivatives portfolios if the bank in which one is embedded fails. Right now, we lack an orderly break-up mechanism.

C. Doing Better

Who would buy the segments of a derivatives portfolio? Presumably those with a derivatives business, those looking to enter the derivatives business, or hedge funds and other investors looking for a bargain or a toehold in the derivatives market. The opportunity to buy product line segments of a major derivative dealer might be attractive to dealers who want to scale up their business. A sale is better for the American economy than the multi-year litigation problem that Lehman became. The mechanisms were in place for Lehman to sell its broker-dealer operation—Barclays bought the broker-dealer within a week with financing from the Federal Reserve Bank of New York.⁸⁴ However, there is still no mechanism for derivatives product line sales.

For the sale to happen, the debtor would need time to package, present, and allow for buyers' due diligence. However, the bankruptcy safe harbor that the derivatives counterparties enjoy would make an intact sale impossible. One might expect that the financial authorities would, before the bankruptcy filing, push the sinking firm to package and pre-position its portfolio for buyers, if such a product line sale were authorized in bankruptcy. Under Title I of the Dodd-Frank Act—the so-called “living wills” provision—regulators have authority to make this happen, but *not* on a product line basis.⁸⁵ With that authority, the regulators can have much of the business legwork done by the

82. See Andrei Schleifer & Robert W. Vishny, *Fire Sales in Finance and Macroeconomics*, 25 J. ECON. PERSPS. 29 (2011) (describing problem of fire sales caused by too few buyers).

83. See OFFICE OF THE COMPTROLLER OF THE CURRENCY, *supra* note 2.

84. Valukas, *supra* note 57, at 2165.

85. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 165(d)(1), 124 Stat. 1376, 1426 (2010) (codified at 12 U.S.C. § 5365(d)(1) (2012)); 12 C.F.R. pt. 243 (2012); 12 C.F.R. pt. 381 (2012).

time of filing. Experienced bankruptcy players would recognize this process for financial firm bankruptcies as resembling the commonly-used pre-packaged bankruptcy for industrial firms, where most of the business structures and plans are lined up before the bankruptcy filing.

However, there is no reason today for the regulatory authorities to prepare for such pre-positioning, as the bankruptcy rules would neither allow the failed firm's derivatives portfolio to be sold intact or along product lines. To make the Title I authority meaningful, Congress must reshape bankruptcy's safe harbors to permit a sale and a buffer of enough time for the court to review the pre-packaged terms (and for the parties to finalize them).

Astute players in the derivatives industry understand this part of the value destruction problem and have raised the general issue at derivatives industry meetings as to whether the contractual documentation should be altered to preclude immediate closeout and sale in bankruptcy:

Derivatives users should . . . amend[] one of their most-treasured legal rights to help in the fight to end too-big-to-fail, attendees at the International Swaps and Derivatives Association Annual General Meeting . . . heard Wilson Ervin—vice-chairman . . . at Credit Suisse and a leading architect of the so-called debt bail-in framework—argued in a keynote speech to ISDA delegates that modifying legal documentation that currently allows swaps to leapfrog other creditors of bankrupt firms was 'essential'.

To highlight the severity of the issue Ervin cited the US\$40bn in costs the Lehman Brothers administration had to swallow in order to comply with early termination requests from its swaps counterparties, hugely exacerbating the extent of the losses racked up by the bankrupt estate.⁸⁶

After the world's four major financial regulators called on the derivatives industry to rewrite their contracts along similar lines, the industry trade association updated its standard form contract.⁸⁷ The new form facilitates a delay on closeouts of a derivative player affiliated with a failed bank.⁸⁸ The entire resolution plan, called "single point of entry" by the bankers and their

86. Christopher Whittall, *Amending Swap Rights "Essential" for Resolution Regimes*, INT'L FINANCING REV., Apr. 25, 2013, at 1-2.

87. Joint Letter of Bank of England, Bundesanstalt für Finanzdienstleistungsaufsicht, FDIC, and Swiss Financial Market Supervisory Authority to ISDA (2013), <https://www.fdic.gov/news/news/press/2013/pr13099a.pdf>; see also Ben Moshinsky, *BOE Seeks Derivative Pact To Prevent a Repeat of Lehman Cascade*, BLOOMBERG (May 4, 2014, 7:00 PM), <http://www.bloomberg.com/news/2014-03-04/boe-seeks-derivatives-pact-to-prevent-a-repeat-of-lehman-cascade.html>.

88. Specifically, ISDA, the derivatives industry association, added a short stay to their standard derivatives deal papers, which would stop counterparties of an affiliate of a failed firm from invoking their cross-default clauses. See Press Release, Int'l Swaps & Derivatives Ass'n, ISDA Publishes 2014 Resolution Stay Protocol (Nov. 12, 2014), <http://www2.isda.org/news/isda-publishes-2014-resolution-stay-protocol>; see also *New ISDA Protocol Will Limit Buy-Side Remedies in a Financial Institution Failure*, ROPES & GRAY LLP (Nov. 24, 2014), <http://www.ropesgray.com/news-and-insights/Insights/2014/November/New-ISDA-Protocol-Will-Limit-Buy-Side-Remedies.aspx>.

regulators,⁸⁹ would allow for a whole-portfolio repositioning. While these efforts push in the right direction, they are incomplete. First, this “single point of entry”⁹⁰ mechanism is untested and may not work, as it faces multiple technical and political barriers.⁹¹ Second, the 24- to 48-hour delay in the contractual closeout, if it is called into play, is insufficient to engineer an effective section 363 sale along product-market lines. Third, the updated contracting arrangements, although beneficial, do not stop terminations and closeouts for a derivative unit that goes bankrupt (just cross-defaults where another unit in the financial institution fails). Lastly and most importantly, there is no means for a product-line sale. Still, we do not wish to belittle the changes even if they fail to accomplish the core policy goals we push forward in this Article. They are useful but, without facilitating a product-line restructuring of a failed firm’s derivatives portfolio, incomplete.

D. Making a Section 363 Portfolio Sale Viable

Below, we outline how to make such a bankruptcy sale viable.

1. *The ten-day stay.* Bankruptcy repositioning of a failed mega-firm’s derivatives portfolio needs a shortened form of the bankruptcy stay, such as a ten-day stay, so that the portfolio can be marketed intact or via its constituent product lines. This could be done via a stay that is long enough to rapidly market the portfolio, but no longer than that. Presumably that would be denominated in days or weeks, but no longer.

The appendix to this Article sets out statutory language for a ten-day stay, with a judicial option to extend it for another ten days if a sale seems imminent, and a judicial option to terminate the stay earlier than ten days if no sale seems possible or the relevant regulatory authority indicates to the court that no systemic purpose would be served by waiting out the stay.

2. *Regulatory pre-packaging.* If the sales process were to begin from scratch upon the firm’s filing, ten days could be too short for a court to effectively structure and review a sale. Instead, if the pre-filing processes from Title I of Dodd-Frank were used to pre-package such a portfolio sale, ten days could readily be enough for the court’s review. Today, there is no reason for the regulatory authorities to institutionalize that kind of bankruptcy planning for a

89. Randall D. Guynn, *Framing the TBTF Problem — The Path to a Solution, in ACROSS THE DIVIDE: NEW PERSPECTIVES ON THE FINANCIAL CRISIS* 281 (Martin N. Baily & John B. Taylor, eds. 2014); Kupiec & Wallison, *supra* note 78; David Skeel, *Single Point of Entry and the Bankruptcy Alternative* (SSRN working paper, 2014), www.ssrn.com/abstract=2408544.

90. “Single point of entry” is a banking industry and regulatory strategy for financial reorganization whereby a corporate complex is restructured at the top owning company (the “single point”), by bringing that parent company into bankruptcy, and not bankrupting all of the subsidiaries as well. The top entity, the “single point,” would be obligated to make the subsidiaries viable, even if they were insolvent.

91. Jackson & Massman, *supra* note 9; Jin, *supra* note 9, at 1765–77.

failing financial firm,⁹² because there is no bankruptcy sale mechanism available. For the regulators to make the bankruptcy planning thrust of Title I work better, they need to obtain an amended Code from Congress, along the lines we suggest here.

* * *

A policy judgment needs to be made. Here, policymakers must balance the counterparties' desire for certainty and resolution, on the one hand, and the economy's need to avoid panicked closeouts and further concentration of the derivatives market. In our view, the balance of systemic stability and private market goals tilts toward a short stay to allow the derivatives portfolio to be marketed.

But there is an even stronger basis for such a short stay. The policy choice is *not* between smooth, one-by-one closeouts that allow counterparties to realize their full value, versus systemic stability on the other. The current system, as Lehman's chaotic closeouts revealed, is already quite costly to counterparties, the debtor, and the derivatives markets overall. It is not enough to argue, as we have heard derivatives safe harbors' backers argue, that the counterparties need to move on smoothly or that volatility in derivatives markets requires that counterparties have immediate closeout capacity. The rapid disintegration of a major dealer's portfolio hurts the failed dealer's counterparties directly and severely. With national and worldwide financial markets disrupted, they *cannot* close out smoothly and cover their transactions.

That is, if one counterparty closed out with one dealer, the safe harbors could provide contractual and deal certainty. But when many counterparties close out simultaneously across the economy, the safe harbors *undermine* contractual and deal certainty. A major dealer's failure and consequential rapid closeouts lead to illiquid markets that *stymie* counterparties from rebalancing their own portfolios. Mass termination can make the counterparties of a failed major dealer all worse off, even though any single counterparty would like to use the safe harbors to close out and be free of the debtor. But they all cannot do so simultaneously without inflicting costs on one another.⁹³

The ipso facto clause safe harbors should be cut back as well. And the debtor's right to assume or reject a product line (but without cherry picking

92. See Sylvia A. Mayer & Sunny Singh, *Resolution Lemonade: Finding the Positives in Recovery and Resolution Planning*, 2013 BANKING L.J. 114, 114; *The Orderly Liquidation of Lehman Brothers Holdings, Inc. Under the Dodd-Frank Act*, 5 FDIC Q., no. 2, 2011, at 10–11 (emphasizing FDIC advance planning and on-site presence in advance of any resolution).

93. Moreover, recall that these derivatives obligations do not ordinarily become due in the few days after a bankruptcy filing; they are typically longer term deals. The obligations become immediately due because counterparties call defaults and, due to their exemption from ipso facto rules, can do so for safe-harbored contracts. That is, for most of the derivatives counterparties, a short stay and repositioning put their contracts back where they were before the dealer failed.

contract by contract inside that product line) should be permitted if done *both* during those ten days *and* at the bankruptcy filing values. The freezing of value at the time of the bankruptcy filing should prevent the debtor from treating reject or assume authority as an option that, given market volatility, could be quite valuable to the debtor. Time-value compensation to the counterparty for delay could be incorporated. And the limited duration of the proposed stay reduces or eliminates the debtor's ability to use time and delay to magnify the Code's reject or assume optionality for the debtor.⁹⁴

3. *Portfolio sale segmentation.* Counterparties could be allowed to net in bankruptcy along product lines. This product segmentation would allow for easier repositioning of the portfolio.

The debtor would not be permitted to assume or reject individual contracts, for the reasons already discussed. Instead the debtor would be required to market the portfolio intact or by product line. The latter option would be needed for two reasons: First, the overall portfolio might not be in the money. If the portfolio is unprofitable, then it cannot be sold without a bailout or an internal subsidy. Instead, the debtor would have to be able to sell off product lines separately. The unprofitable product lines can be closed down.

The extant safe harbors allow the debtor's counterparties full cross-product netting, such that dealer A's currency trades with the debtor have winners and losers, with the net amount being the amount due.⁹⁵ While the debtor cannot "cherry pick" among the different trades in different markets,⁹⁶ the safe harbors allow the debtor's counterparty to net trades in unrelated businesses. This protects the counterparty, but at the cost of the debtor having a complex, difficult to disentangle portfolio.

Second, recall that derivatives portfolios are highly concentrated in a handful of ultra-large banks in the United States and the collapse of any one of those institutions could mean the termination of anywhere between a \$44 and \$78 trillion notional derivatives portfolio—roughly six to ten percent of global notional derivatives value.⁹⁷ It is not obvious who could buy Citigroup's

94. We do not address whether the debtor should be required to perform on the underlying contracts if market-wide values shift during the ten-day stay period. Similarly, we do not address whether counterparties should be relieved from performing during that period for changes in the underlying value and could thus wait until the sale. Such a requirement on the debtor, or relief for the counterparty, would each be compatible with the sale proposal.

95. 11 U.S.C. § 561 (2012).

96. *Id.* § 553; cf. Skeel & Jackson, *supra* note 47, at 156 (doubting whether the Code would allow cherry-picking even in absence of the safe harbors).

97. OFFICE OF THE COMPTROLLER OF THE CURRENCY, QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITIES SECOND QUARTER 2014 (2014); *OTC Derivatives Activity in the First Half of 2014*, BANK FOR INT'L SETTLEMENTS (Nov. 6, 2014), http://www.bis.org/publ/otc_hy1411.htm?m=6%7C32%7C71 ("notional amount of outstanding contracts totaled \$691 trillion"); see also Kimberly Summe, *An Evaluation of the U.S. Regulatory Response to Systemic Risk and Failure Posed by Derivatives*, 4 HARV. BUS. L. REV. ONLINE 76, 77 (2014), <http://www.hblr.org/2014/04/evaluation-of-the-u-s-regulatory-response-to-systemic-riskand-failure-posed-by-derivatives/> [hereinafter Summe, *U.S. Regulatory Response*].

derivatives portfolio, even if it is in the money. Bankruptcy needs a mechanism to break up the portfolio and the natural way to do so is along product lines.

The safe harbors need major amending and a plausible policy solution is for bankruptcy to override cross-product netting. There are analogous bankruptcy provisions that override contract when the reorganization cost of respecting them seems too high. We have seen one already: the usual bar to enforcing ipso facto clause and immediate collection. Even closer, the Code bars anti-assignment clauses even if they would be enforced outside of bankruptcy.⁹⁸ A revised Code that allowed for product-line sales is a type of bar on anti-assignment clauses.⁹⁹

4. *Cross-product netting as concentration-promoting tying.* There is yet another reason to facilitate product-line marketing. Although cross-product netting has efficiency qualities, it has negative effects as well. Financial firms that have offsetting obligations with one another in different markets can deploy less capital because of the offsets. This is profitable, and it also frees capital to be used elsewhere in the economy. This efficiency result is good.

But cross-product netting is not purely beneficial. The derivatives industry is highly concentrated: Five banks dominate the derivatives market, holding 95% of the contracts outstanding.¹⁰⁰ One advantage these large banks wield is cross-product netting, which presumably allows them to out-compete stand-alone derivatives firms.¹⁰¹ If a smaller firm operates in only one derivative market segment, it will require counterparties to post collateral accordingly, based on its exposure in that market. It cannot net its counterparties' offsetting exposures in, say, interest rate swaps with foreign exchange. So, the smaller dealer is not as enticing a counterparty for a customer who trades in both markets. The mega-dealers trade in both markets and can offer better cross-product netting. At one level this effect of cross-product netting is efficient by economizing on capital; at another level it supports and cements concentration in the derivatives. Without it, new firms and fringe firms could more readily compete with the five core firms, taking market share away, decentralizing the

98. See Andrea Coles-Bjerre, *Ipsa Facto: The Pattern of Assumable Contracts in Bankruptcy*, 40 N.M. L. REV. 77, 91 (2010) (“[B]y protecting the debtor’s power to assign, the section furthers the purpose of enabling the debtor to reorganize.”).

99. A halfway improvement to the Code would give counterparties an adequate protection claim for any lost value if the full portfolio was broken down to be sold along product lines. For reasons set forth in the next subsection, we do not favor that result. But that would nevertheless still be a major step forward in facilitating mega-portfolio repositioning even if it did not facilitate deconcentration as the next subsection outlines.

Current deals should be grandfathered to the extent possible, with the easiest transition being to announce the new rules, but to have them applicable only for dealer failures after a future date. Some contracts would extend past that date, but new contracts could be entered with the impending rule change in mind.

100. Katy Burne, *Big U.S. Banks Make Swaps a Foreign Affair*, WALL ST. J., Apr. 27, 2014, <http://on.wsj.com/S0f7tQ>.

101. Cf. Robert R. Bliss & George G. Kaufman, *Derivatives and Systemic Risk: Netting Collateral and Closeout*, 2 J. FIN. STABILITY 55 (2006); Schwarz & Sharon, *supra* note 36, at 1743.

industry, and thereby facilitating financial safety. Regulatory requirements that the trades move to a clearinghouse also reduce this big-firm advantage.

E. Will a Short Stay Destroy Systemic Liquidity?

Proponents of today's robust safe harbors would reply with their original justification: Even a short stay will destabilize the financial system and would lead to runs against otherwise stable institutions. This answer is, however, incorrect for several reasons, some previously stated and some expanded on next.

1. *The term structure of the derivatives market.* It is the safe harbors that create much of the liquidity pressure when a large financial institution fails. Derivatives are typically not short-term contracts that are repeatedly rolled over, in the way that their safe-harbored cousin, the repurchase agreement contract, rolls over daily. Rather, it is the mass terminations of derivatives contracts in a short time period, such as the mass terminations in Lehman's bankruptcy, that force up liquidity pressures across financial markets, as counterparties terminate and scramble to fill contractual holes. If a short stay allowed a failed firm's financial contracts to be repositioned and transferred, these liquidity pressures would be much diminished.

2. *Nirvana fallacies.* Proponents of robust and extensive safe harbors here may suffer from a nirvana fallacy of comparing a short ten-day stay to a perfectly smooth closeout of one counterparty with a medium-sized contract on a failed firm: for the latter, markets are not disrupted, no systemic spillover occurs, and the counterparty covers its position smoothly without bid-ask spreads widening. By comparison, a ten-day stay causes the single, stand-alone counterparty to fret and suffer. That though is not the relevant comparison. The alternative to a ten-day stay for the nation's core derivatives dealers is mass termination, worldwide financial market disruption, systemic spillovers, and four years of intense closeout litigation, or a bailout. A short stay seems less costly to the system and possibly even to the individual counterparty.

3. *Lehman's lesson.* Put in another, perhaps aggressive, way, proponents of broad and nearly unlimited safe harbors had their chance with Lehman and they failed. Mass terminations destroyed value not just in Lehman but in the economy overall. The derivatives market was quite plausibly bigger than it otherwise would have been because of the safe harbors and more disrupted than it had to have been because of them. Lehman's counterparties were deeply at risk *with the safe harbors in place*. Many survived only because the Federal Reserve backed up the financial markets, including safe-harbored markets. Once a mechanism fails, it is time to learn and adjust, as we propose here, and not to repeat the same mistakes.

F. Public Choice Explanations of Why We Destroy Portfolio Value: Winners and Losers

Although our purpose is to show (1) how portfolio value is destroyed, (2) how both the safe harbors and the baseline rules destroy portfolio value, and (3) how the situation can be ameliorated, we should note that the problems of exiting the current difficulties are not just technical issues that, once understood, will inexorably lead to congressional, regulatory, and contractual solutions. The current rules create powerful winners—namely, those who benefit from the safe harbors—and less powerful losers—dispersed voters and taxpayers who bear the costs of a financial crisis and the associated bailouts.

1. *Who captures saved portfolio value?* The interests that could most effectively push for rules that would not destroy portfolio value have reasons not to do so. Although the rule changes should successfully conserve value, those most able to effectuate legislative and contractual change are unlikely to be unable to capture that value for themselves.

The major derivatives dealers are organized in coherent lobbying organizations—say ISDA, or the American Bankers' Association, or SIFMA.¹⁰² Other creditors and stakeholders in debtors' estates are less well-organized, and the biggest costs from portfolio value destruction will drag down the whole economy if a financial panic is exacerbated by a portfolio meltdown, thereby imposing costs on average voters, taxpayers, and workers. Unlike for banking or securities issues, there is no bankruptcy regulator to provide information and argumentation to the relevant congressional committees. Hence, one would predict that the current state of value-destroying rules has political economy staying power.

One way of looking at the political economy of the value destruction bankruptcy lawmaking process is that the derivatives industry successfully shifted much of the loss from portfolio value destruction to unsecured creditors and the broader economy. The derivatives industry may not have done this deliberately, but that was the effect and now that the rules allow that shift in value, it is hard to reverse those rules, because the winners are concentrated, organized, and powerful,¹⁰³ while the losers are diffuse and spread throughout the economy, with voters unresponsive to anything other than a populist animus against concentrated finance. Reforms to the current rules depend on responsible regulators making a concerted effort to lobby Congress and the

102. ISDA is the International Swaps and Derivatives Association which began as the major derivatives banks' trade association. SIFMA is the Securities Industry and Financial Markets Association.

103. As noted, a large fraction of the derivatives market is lodged in five banking complexes—Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, and Morgan Stanley.

regulators could readily have other issues on their agenda that they think take priority.¹⁰⁴

The reform we recommend here has multiple configurations of winners and losers. Take mass termination as the baseline and compare it to a ten-day stay and sale along product lines. For counterparties whose contract crosses multiple product lines, the recommendations here could make them worse off. If they are in the money when they net across product lines, dividing the sale across product market lines will hurt them. However, more product-by-product counterparties should be in-the-money if the proposal leads to less market disruption, but one could not predict which effect would dominate. Clear rules and sufficient lead time would allow at-risk creditors to adjust their portfolio structures.

If the baseline for comparison were the sale of the entire portfolio, the recommendation here would create more losers among the counterparties. A sale of the portfolio intact, as Dodd-Frank contemplates, would leave all of the counterparties fully compensated. If the portfolio is out of the money, a sale could not be done without concessionary financing from government authorities or a cross-subsidy from other debt of an affiliate of the financial institution, as the single-point-of-entry mechanism contemplates.¹⁰⁵ If the transfer cannot be done, the possibility of a bailout with government funding (and, hence, taxpayer losses) becomes real.¹⁰⁶ If bailout is less likely with product-line sales, then the government and taxpayers, and perhaps the overall economy, are the winners.

2. *The interests of the regulators.* Consider the likelihood that the most important regulators that could weigh in on these value-destroying safe harbors are the bank regulators. They are the regulators who are most likely to grapple with the issue and who are most likely to receive congressional lawmakers' deference.

But if bank regulators consider other bank safety issues better places to use up their congressional capital or are persuaded by banker lobbying that the current state of affairs for derivatives safe harbors is best or see initiatives like the single-point-of-entry as complete solutions to safety problems, then the most relevant regulators would conclude that no change in bankruptcy is warranted.

3. *Regulatory silos.* The approach we recommend here is a hybrid one: allow bankruptcy to reposition the derivatives portfolio by facilitating portfolio sales along product lines and thereby avoid the rapid closeout, liquidation, and

104. The current state of the safe harbors may be the result of an incompletely vetted, path dependent sequence, not a carefully thought out policy initiative. See Schwarcz & Sharon, *supra* note 36.

105. See *supra* note 89 and accompanying text.

106. See Republican Staff of House Comm. on Fin. Servs., *Failing to End "Too Big To Fail": An Assessment of the Dodd-Frank Act Four Years Later*, U.S. HOUSE OF REPRESENTATIVES (2014), http://financialservices.house.gov/uploadedfiles/071814_tbt_f_report_final.pdf.

financial turmoil from the failure of a major derivatives institution. If the bankruptcy process fails, moves too slowly for the regulators' liking, or leads to dysfunctional derivatives market overall, then regulators could oust the bankruptcy institutions and use Dodd-Frank's liquidation mechanisms. Or, hybridization from a different perspective is that the regulators may not agree on what to do, or may be stymied by Congress from acting; bankruptcy is the fallback.

This hybrid approach has not been pursued and there may be several reasons for this. First, regulators may not trust even amended bankruptcy laws to work. Congress and Dodd-Frank may make regulators publicly state that bankruptcy is the first line of defense, but maybe their heart really is not in that view. Second, in order for the amendments to pass Congress, regulators would need to overcome industry objections. Regulators have different priorities and mindsets and bankruptcy goes through the judiciary committees, not the banking committees with which banking regulators regularly deal. Third, turf protection is not unheard of and an alternative resolution mechanism in the bankruptcy courts may be unwelcome to some regulators.

VI. The Regulatory Moving Target: Dodd-Frank's Incomplete Effort

In response to the financial crisis, and with the degradation of Lehman Brothers portfolio in mind, Congress enacted new mechanisms for resolving important financial institutions with the Dodd-Frank Act. That statute does better than bankruptcy, but it is inferior to a hybrid system with bankruptcy made operational.

A. Repositioning the Portfolio Under Dodd-Frank: Reintroducing the Stay and a Section 363-Style Sale

Dodd-Frank adds back one critical, sine qua non piece of baseline bankruptcy: a stay on contract termination. The Dodd-Frank stay is not much—it is a one business day stay on counterparties closing out their derivatives contracts with the bankrupt debtor. During that day, the debtor (or its regulatory avatar) can sell the derivatives portfolio and can do so in ways that preserve portfolio value.¹⁰⁷

The one-day stay with a view to a sale is a step toward preserving portfolio value. Under one resolution mechanism, the stay would allow the portfolio to be transferred to a government-held bridge facility, which would presumably assume all of the derivatives contracts and run the portfolio. The portfolio could be later sold intact to a third party or run on a standalone basis, perhaps with government support.

107. This one-day stay appeared in the 2005 financial amendments, but was limited to the derivatives portfolio of the core bank and did not extend to all important financial firms. See 12 U.S.C. § 1821(e)(10)(B) (2012).

An alternative resolution channel is the emerging single-point-of-entry resolution structure, which is designed to make the portfolio-owning subsidiary solvent. Doing so may require the financial institution's parent company to send cash or other value down into the derivatives trading subsidiary to make it solvent and viable.¹⁰⁸

There is a regular refrain from Congress and regulators that bankruptcy is the preferred solution.¹⁰⁹ But these portfolio-positioning advantages of Dodd-Frank over extant bankruptcy are so large and show clearly why bankruptcy today is an impossible solution: there is no stay in bankruptcy. Dodd-Frank is not similarly shackled. Regulators should seek to make bankruptcy a real line of defense.

* * *

While Dodd-Frank improves on current bankruptcy law, the full Dodd-Frank rules still shackle the debtor's capacity to maintain portfolio value. First off, the stay is only a single business day¹¹⁰ and Dodd-Frank does not permit product-line sales.

Second, as we discussed earlier, the Dodd-Frank process may fail. It may fail for technical reasons or political reasons, or because regulators may wait too long.¹¹¹

Third, regulatory authorities ought to seek a credible threat that they would do nothing. A viable bankruptcy alternative would go far in making make regulatory forbearance credible.¹¹²

A short bankruptcy stay would allow the firm's derivative portfolios to remain intact briefly after a bankruptcy filing, while managers seek a sale and regulators decide whether to intervene or to let the bankruptcy play out, a more natural division of responsibility. Under the Code as it now exists, bankruptcy is instead ratchet-like: the debtor files for bankruptcy and its portfolio will be

108. See Notice and Request for Comments, Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76614 (Dec. 18, 2013); John F. Bovenzi et al., *Too Big to Fail: The Path to a Solution*, BIPARTISAN POLICY CTR. (2013), <http://bipartisanpolicy.org/wp-content/uploads/sites/default/files/TooBigToFail.pdf>; sources cited *supra* note 89.

109. See, e.g., Thomas M. Hoenig, Vice Chairman, Fed. Deposit Ins. Corp., Presentation to the Boston Economic Club (May 7, 2014) (stating that bankruptcy is the preferred resolution option); James R. Wigand, Dir., Office of Complex Fin. Insts., Fed. Deposit Ins. Corp., Statement to S. Subcomm. on Nat'l Sec. and Int'l Trade and Fin.: Improving Cross Border Resolution to Better Protect Taxpayers and the Economy (May 15, 2013), http://www.fdic.gov/news/news/speeches/spmay1513_2.html ("While bankruptcy remains the preferred option, Title II provides a back-up authority.").

110. See 12 U.S.C. § 5390(b)(10)(B)(i) (2012). One business day could stretch over a weekend, as is common in FDIC-initiated bank shut-downs.

111. See *supra* text accompanying notes 9–13.

112. Again, bankruptcy changes currently being seriously considered, *supra* note 1, would support a full portfolio transfer, but would not support a portfolio break up and product line sale.

ripped apart by safe-harbored closeouts; the financial regulators cannot then put it back together. The filing threat of a systemically important financial institution would put the regulators to a stark choice: take it over or let it go bankrupt. But if they let the institution go bankrupt, they cannot go back to the status quo ante to repair the firm that they then conclude is hurting the economy. The institution will already have been shredded.¹¹³

B. Dodd-Frank's Inability to Reposition Product Lines

Dodd-Frank requires that the debtor assign its entire book with a counterparty, thereby severely limiting the debtor's capacity to sell the mega-portfolio along product lines.¹¹⁴ The debtor must assume and sell the currency derivatives, interest rate swaps, commodity contracts, and credit-default package of the counterparty intact, making it difficult or impossible to package or sell product lines.

Consider the following scenario: a systemically important institution has three major product lines: \$1 trillion of foreign currency swaps, \$1 trillion of interest rate swaps, and \$1 trillion of credit default swaps. The institution's counterparties are the world's other major systemically important financial institutions with which it has extensive trades in all three product lines. Dodd-Frank, accordingly, bars the debtor from selling the product lines separately in a Dodd-Frank resolution. Further assume the following scenario for failure. The foreign currency swaps are overall in the money by \$100 billion, as are the interest rate swaps. The credit default swaps, however, are \$250 billion out of the money. Hence, under Dodd-Frank, the portfolio cannot be transferred intact to a third party without an influx of at least \$50 billion.

The derivatives operation needs \$50 billion to flow in from elsewhere, perhaps from the regulatory authorities if the parent company does not or cannot make good on the \$50 billion shortfall. But if the authorities will not back the failing firm with \$50 billion, because the authorities cannot agree to invoke the processes as a technical matter, or because political constraints limit the regulatory authorities from acting and bailing out the failed financial firm, then the firm will fail and will need to be reorganized in bankruptcy.

Today, a systemically important financial institution cannot be effectively reorganized in bankruptcy.

113. See Stephen D. Adams, *Swap Safe Harbors in Bankruptcy and Dodd-Frank: A Structural Analysis*, 20 STAN. J.L. BUS. & FIN. 91 (2014) (discussing potential negative effects of this dynamic).

114. 12 U.S.C. § 5390(c)(11) (requiring that any assignment or rejection by the debtor be of a counterparty's entire book with the debtor).

C. Clearinghouse Portfolio Repositioning

There is another moving target: clearinghouses are becoming more important for derivatives than they were when Lehman failed.¹¹⁵ Lehman's cleared, exchange-traded positions were sold effectively and well, along product lines. Barclays assumed Lehman's Chicago Mercantile Exchange energy derivatives portfolio, Goldman Sachs assumed its equity derivatives portfolio, and DRW Trading assumed its foreign exchange, interest rate, and agricultural derivatives portfolios.¹¹⁶ The clearinghouse could break up and transfer Lehman's portfolio along product lines because it was the single counterparty on all of these Lehman trades. This result speaks well for exchange and clearinghouse resolution.¹¹⁷ The good result, however, depended on an institutional capacity to move the derivatives portfolio along product market lines—a capacity that bankruptcy needs to obtain.

As more trading moves into clearinghouses, the capacity to reposition a failed firm's derivatives book along product lines increases so long as termination-oriented clearinghouses do not acquire the bulk of the business.¹¹⁸ This is a positive aspect of the clearinghouse development.¹¹⁹ Rough estimates indicate that clearinghouses will in time account for three-quarters of relevant trades, three times as much as they have accounted for recently.¹²⁰ But even if that level is reached, there will still be large portfolios

115. A derivatives clearinghouse operates in this way: Two parties make a currency trade. Each is obligated to pay the other based on the actual value of the currencies at a future date. To clear the trade, they turn their obligations over to the clearinghouse, which becomes the obligor to each party, neither of which remains obligated to the other but is only obligated to the clearinghouse. The clearinghouse protects itself by requiring parties to post collateral if their contracts move out-of-the-money, but the clearinghouse itself is obligated to make good on the underlying contracts.

116. See Valukas, *supra* note 57, at 1841-1855; Scott, *supra* note 27.

117. See Will Acworth, *The Lessons of Lehman: Reassessing Customer Protections*, FUTURES INDUSTRY ASS'N (Jan. 22, 2009), http://www.futuresindustry.org/files/2009_jan_feb_mag_pdfs/08_Jan_Feb_Lehman.pdf (“[V]irtually all customer futures positions on dozens of futures exchanges around the world were safely transferred out of Lehman accounts within five days of the bankruptcy announcement on Sept. 15.”); Natasha de Teran, *How the World's Largest Default was Unraveled*, FIN. NEWS, Oct. 13, 2008, <http://www.efinancialnews.com/story/2008-10-13/how-the-largest-default-was-unravelled?ea9c8a2de0ee111045601ab04d673622>.

118. Some major clearinghouses bar transfers, requiring the termination and portfolio liquidation we argue should be avoided. See Summe, *U.S. Regulatory Response*, *supra* note 97, at 78-79.

119. Whether clearinghouses are major bulwarks against systemic risk overall, or just primarily move the risk from visible places to less visible places is analyzed in Mark J. Roe, *Clearinghouse Over-Confidence*, 101 CAL. L. REV. 1641 (2013).

120. John Hull, *The Changing Landscape for Derivatives* (Rotman Sch. of Mgmt., Working Paper No. 2428983, 2014), <http://ssrn.com/abstract=2428983>; *Size and Uses of the Non-Cleared Derivatives Market*, INT'L SWAPS & DERIVATIVES ASS'N 3 (Apr. 2014), http://www2.isda.org/attachment/NjQ0MA==/FINAL-Size_and_Uses_of_the_Non-Cleared_Derivatives_Market.pdf (reporting that one-third of the interest rate derivatives remained uncleared at the end of 2013 and that “a meaningful portion of the derivatives market will remain uncleared”); *How Central Counterparties Strengthen the Safety and Integrity of Financial Markets*, EUREX CLEARING & DEUTSCH BÖRSE GROUP 7 (July 2014), <http://www.clearstream.com/blob/67340/37fbfb2a577d8e43d52d19223b49c63/eurexccpwhitepaper-pdf-data.pdf> (estimating that \$170 trillion of derivatives will remain uncleared). A back-of-the-envelope calculation using that \$170 trillion estimate puts the biggest dealers' uncleared

from systemically important institutions that are not cleared: Lehman was smaller than half the size of the current largest derivative players and its failure still triggered systemic shocks. The derivatives trade association estimates at least \$80 trillion in interest rate derivatives alone will not be cleared.¹²¹ One expert reports that “[t]he derivatives books of the largest dealers today are considerably larger than Lehman’s.”¹²²

Moreover, it remains unclear whether clearinghouses will be captured by their owners and dominated by the current large derivatives players.¹²³ As more systemic risk for derivatives trading comes to reside in clearinghouses, bankruptcy may need authority to restructure a failed clearinghouse effectively. Authorization for sales along product-line is a place to start. If clearinghouses are selling coherent portfolios (as happened in Lehman), there would be good reason to exempt them from any reintroduced stay, since they would be effectuating the transaction that the stay would be intended to facilitate. If they are closing out and liquidating positions, as some now require, they should be subject to the same limits as other counterparties, so that the portfolio can be coherently sold, if that is possible.

Like Dodd-Frank’s Title II, clearinghouses provide an incomplete but potentially useful alternative resolution mechanism for derivatives portfolios. As we have already stated, financial engineers, like structural engineers, should build in redundancy and resiliency in stabilizing complex systems. We currently lack sufficient redundancy and resiliency, and bankruptcy is an obvious place to seek the advantages of greater institutional resiliency.

D. The Moving Target Can Continue Moving

These post-Lehman clearinghouse and resolution structure changes also may make bankruptcy more important. For example, the move to clear more plain-vanilla derivatives will leave the more opaque, more difficult to value, more difficult to sell derivatives contracts inside the failed financial institution.¹²⁴ This result would make the need for a stay and a considered sale more important. And when we speak of clearinghouses, we should not

portfolio at about the size of Lehman’s. The biggest dealers account for 90% of the market, which would give each an average of \$38 trillion, somewhat more than the \$35 trillion size portfolio estimated for Lehman. See Summe, *Misconceptions*, *supra* note 67, and accompanying text.

121. INT’L SWAPS & DERIVATIVES ASS’N, *supra* note 88.

122. Peter Eavis, *Fight Brews on Changes That Affect Derivatives*, N.Y. TIMES DEALBOOK (Aug. 14, 2014, 8:52 PM), <http://dealbook.nytimes.com/2014/08/14/fight-brews-on-changes-that-affect-derivatives> (reporting conclusion of a PricewaterhouseCoopers partner).

123. See Sean J. Griffith, *Clearinghouse Hope or Hype?: Why Mandatory Clearing May Fail to Contain Systemic Risk*, 3 HARV. BUS. L. REV. ONLINE 160 (2013), <http://www.hblr.org/?p=3261>; Sean J. Griffith, *Governing Systemic Risk: Towards a Governance Structure for Derivatives Clearinghouses*, 61 EMORY L.J. 1153, 1189–226 (2012).

124. See Tracy Alloway & Michael Mackenzie, *Investors Dine on Fresh Menu of Credit Derivatives*, FIN. TIMES, Aug. 19, 2014 (describing proliferation of complex credit derivatives since financial crisis encouraged by lack of clearing requirement as yet).

underestimate the financial industry's capacity to move the target to their own advantage: if clearinghouses impede their profits, then they might impede the full move to clearinghouses. Some of this has happened.

Similarly, regulatory effort can change over time. The past few years have had regulators on high alert. As the economy recovers, the financial industry has begun lobbying for rolling back or halting safety measures. In December 2014, for example, Congress repealed the Dodd-Frank measure that would keep derivatives trading out of government-insured banks.¹²⁵ While banks are not subject to the Bankruptcy Code, the repeal signals pressures to ease bank safety regulation. The repeal will likely lead to larger derivatives portfolio being embedded in the country's largest insured banks. That kind of change should prompt banking regulators to consider a product-line bankruptcy resolution plan such as the one we have outlined.

Lastly, post-crisis regulatory intensity over time can be seen as a crisis-drive sine curve, as is well known.¹²⁶ When we are on the downward sloping side of that curve, the economy would benefit from having already built a viable bankruptcy system to restructure and break up a large derivatives portfolio in a large but failed financial firm.

Conclusion

We have shown in this Article how bankruptcy's safe harbors destroy the debtor's portfolio value, make sensible restructuring of a failed and bankrupt financial firm impossible, and exacerbate systemic costs.

Bankruptcy law does not now provide a viable means to reposition a failed financial firm's financial portfolio. Instead, it allows a debtor's counterparties to rapidly and irreversibly close out and dismember a debtor's financial contracts. If the bankrupt dealer is big enough and the economy already precarious enough, the process can disrupt the financial markets, as was the case when Lehman went bankrupt. While the safe harbors promote certainty of payment when a single counterparty closes out with a failed financial firm, when a large firm suffers mass close outs inducing prices to plunge and worldwide financial markets to suffer, then the safe harbors here can undermine instead of support certainty of payment.

However, reverting to baseline bankruptcy rules would not reverse the disruption. We have shown that proposals to reverse the safe harbors would simply change who wins and who loses from the value destruction, without preventing value destruction itself. The safe harbors pin the initial losses on the firm's unsecured creditors while the baseline rules pin the initial losses on the

125. Peter Eavis, *Wall St. Wins a Round in a Dodd-Frank Fight*, N.Y. TIMES DEALBOOK (Dec. 12, 2014, 8:24 PM), <http://dealbook.nytimes.com/2014/12/12/wall-st-wins-a-round-in-a-dodd-frank-fight>.

126. See, e.g., Eric J. Pan, *Understanding Financial Regulation* (Cardozo Legal Stud. Res. Paper No. 329, 2011), www.ssrn.com/abstract=1805018.

firm's derivatives counterparties. The losses and systemic costs persist, regardless. While some of the portfolio value destruction considerations are simple transfers that determine who the winners and losers are, many destroy overall economic value. We saw this destruction during the 2008–2009 financial crisis, after the failure of Lehman and the near-collapse of AIG.

We have also shown how derivatives portfolios are built and then undone in bankruptcy, via reversals of diversification and counterparty closeout at the expensive end of the bid-ask spread for the debtor. Some costs are simple transfers from the debtor and its general creditors to its derivatives counterparties; some are deadweight costs that are not recovered. Coasean critiques highlight the problem: the players' transaction costs—which the bid-ask spread measures—are raised by both the safe harbors and the baseline rules. We can do better than we do now by facilitating sensible section 363 sales of product lines.

Because the derivatives market is highly concentrated in five very large institutions, it is imperative that bankruptcy laws have authority to reposition parts of a failed financial firm's derivatives portfolio. Were it to fail, Citigroup would have no buyer for its derivatives portfolio other than perhaps JPMorgan Chase. We want a mechanism not just to resolve the local portfolio problem but also to breakup concentrated financial portfolios if a major firm fails.

While the section 363 sale mechanism has done well in restructuring industrial firms, it cannot now function for financial firms. First, the Code does not allow bankruptcy any time for the bankrupt debtor to sell off its financial contracts. Bankruptcy also falls short because a money-losing portfolio is unsalable intact. To sell it in part, the portfolio would have to be broken up along product lines, but current bankruptcy law and Dodd-Frank's resolution mechanism do not permit that kind of breakup, which is permitted for industrial firm failures.

Financial regulators say they want failing financial firms to enter into bankruptcy. At the same time, regulators also believe that bankruptcy destroys value and triggers deleterious effects on the broader economy. A good fraction of this value loss comes from portfolio value destruction. We can do more to prevent this destructive financial event from happening again.

Appendix: Suggested Revisions to the Bankruptcy Code

Section 362(b)(17) [Automatic Stay and Rights in Section 560]

The filing of a petition under sections 301, 302, or 303 of this title, or of an application under section 5(a)(3) of the Securities Investor Protection Act of 1970, does not operate as a stay . . . under subsection (a) of this section, of the exercise by a swap participant or financial participant of any contractual right (as defined in section 560) under any security agreement or arrangement or other credit enhancement forming a part of or related to any swap agreement, or of any contractual right (as defined in section 560) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such agreements, including any master agreement for such agreements; *provided, however, that any such exemption from the automatic stay hereunder shall be subject to stay provided in section 563.*

Section 362(b)(27) [Automatic Stay and Master Netting Agreements]

The filing of a petition under sections 301, 302, or 303 of this title, or of an application under section 5(a)(3) of the Securities Investor Protection Act of 1970, does not operate as a stay . . . under subsection (a) of this section, of the exercise by a master netting agreement participant of any contractual right (as defined in section 555, 556, 559, or 560) under any security agreement or arrangement or other credit enhancement forming a part of or related to any master netting agreement, or of any contractual right (as defined in section 555, 556, 559, or 560) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such master netting agreements to the extent that such participant is eligible to exercise such rights under paragraph (6), (7), or (17) for each individual contract covered by the master netting agreement in issue; *provided, however, that any such exemption from the automatic stay hereunder shall be subject to stay provided in section 563.*

Section 560 [Right to Terminate a Swap Agreement]

The exercise of any contractual right of any swap participant or financial participant to cause the liquidation, termination, or acceleration of one or more swap agreements because of a condition of the kind specified in section 365(e)(1) of this title or to offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of one or more swap agreements shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a

court or administrative agency in any proceeding under this title; *provided, however, that any such exercise shall be limited by the stay and sale provisions provided for in section 563.*

As used in this section, the term “contractual right” includes a right set forth in a rule or bylaw of a derivatives clearing organization (as defined in the Commodity Exchange Act), a multilateral clearing organization (as defined in the Federal Deposit Insurance Corporation Improvement Act of 1991), a national securities exchange, a national securities association, a securities clearing agency, a contract market designated under the Commodity Exchange Act, a derivatives transaction execution facility registered under the Commodity Exchange Act, or a board of trade (as defined in the Commodity Exchange Act) or in a resolution of the governing board thereof and a right, whether or not evidenced in writing, arising under common law, under law merchant, or by reason of normal business practice.

Section 561 [Right to Terminate a Master Netting Agreement and Across Contracts]

(a) Subject to subsection (b), the exercise of any contractual right, because of a condition of the kind specified in section 365(e)(1), to cause the termination, liquidation, or acceleration of or to offset or net termination values, payment amounts, or other transfer obligations arising under or in connection with one or more (or the termination, liquidation, or acceleration of one or more)—

- (1) securities contracts, as defined in section 741 (7);
- (2) commodity contracts, as defined in section 761 (4);
- (3) forward contracts;
- (4) repurchase agreements;
- (5) swap agreements; or
- (6) master netting agreements,

shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by any order of a court or administrative agency in any proceeding under this title; *provided, however, that any such exercise shall be limited by the stay and sale provisions provided for in section 563.*

(b)(1) A party may exercise a contractual right described in subsection (a) to terminate, liquidate, or accelerate only to the extent that such party could exercise such a right under section 555, 556, 559, or 560 for each individual contract covered by the master netting agreement in issue;

(2) If a debtor is a commodity broker subject to subchapter IV of chapter 7—

- (A) a party may not net or offset an obligation to the debtor arising under, or in connection with, a commodity contract traded on or subject to the rules of a contract market designated under the Commodity Exchange

Act or a derivatives transaction execution facility registered under the Commodity Exchange Act against any claim arising under, or in connection with, other instruments, contracts, or agreements listed in subsection (a) except to the extent that the party has positive net equity in the commodity accounts at the debtor, as calculated under such subchapter; and

(B) another commodity broker may not net or offset an obligation to the debtor arising under, or in connection with, a commodity contract entered into or held on behalf of a customer of the debtor and traded on or subject to the rules of a contract market designated under the Commodity Exchange Act or a derivatives transaction execution facility registered under the Commodity Exchange Act against any claim arising under, or in connection with, other instruments, contracts, or agreements listed in subsection (a).

(3) No provision of subparagraph (A) or (B) of paragraph (2) shall prohibit the offset of claims and obligations that arise under—

(A) a cross-margining agreement or similar arrangement that has been approved by the Commodity Futures Trading Commission or submitted to the Commodity Futures Trading Commission under paragraph (1) or (2) of section 5c(c) of the Commodity Exchange Act and has not been abrogated or rendered ineffective by the Commodity Futures Trading Commission; or

(B) any other netting agreement between a clearing organization (as defined in section 761) and another entity that has been approved by the Commodity Futures Trading Commission;

provided, however, that all such rights and limitations provided for in this section (b) shall be limited by the stay and sale provisions provided for in section 563.

(c) As used in this section, the term “contractual right” includes a right set forth in a rule or bylaw of a derivatives clearing organization (as defined in the Commodity Exchange Act), a multilateral clearing organization (as defined in the Federal Deposit Insurance Corporation Improvement Act of 1991), a national securities exchange, a national securities association, a securities clearing agency, a contract market designated under the Commodity Exchange Act, a derivatives transaction execution facility registered under the Commodity Exchange Act, or a board of trade (as defined in the Commodity Exchange Act) or in a resolution of the governing board thereof, and a right, whether or not evidenced in writing, arising under common law, under law merchant, or by reason of normal business practice.

(d) Any provisions of this title relating to securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements, or master netting agreements shall apply in a case under chapter 15, so that enforcement of contractual provisions of such contracts and agreements in

accordance with their terms will not be stayed or otherwise limited by operation of any provision of this title or by order of a court in any case under this title, and to limit avoidance powers to the same extent as in a proceeding under chapter 7 or 11 of this title (such enforcement not to be limited based on the presence or absence of assets of the debtor in the United States), *other than the stay and sale provisions provided for in section 563.*

[New] Section 563 [Limited Stay and Sale Provisions]

(a) In the case of contractual rights, including without limitation master netting agreements, and other obligations exempted from the automatic stay of section 362 by paragraphs (b)(17) and (b)(27) thereof, such rights and obligations shall be subject to the stay and sale provisions provided for in this section 563 in the case of a proceeding involving a financial institution or an affiliate of a financial institution. For such otherwise exempt rights and obligations, there shall automatically be a temporary stay, on the same terms and conditions of the automatic stay provided for in section 362 and such stay shall continue in place for 10 days after the filing of the petition by a financial institution or an affiliate of one under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970. The court may extend this temporary stay for up to another 10 business days if it finds that an orderly wind-down or transfer of a substantial portion of such contractual rights and obligations is likely to be completed within that additional 10 business days. The standards for relief from the stay, provided for in section 362(d), shall apply to this temporary stay.

(b) However, notwithstanding subsection (a) hereof, if the Financial Stability Oversight Council has determined under 12 U.S.C. § 5323 that the debtor is a nonbank financial company and material financial distress at the debtor, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the debtor, could pose a threat to the financial stability of the United States and if the Secretary of the United States Department of Treasury determines that the continuation of the stay is likely to cause significant risk to the United States financial system and the American economy, the court may not approve the extension under subsection (a), and must terminate the temporary stay forthwith.

(c) During the period of such a temporary stay, or its extension, the trustee or any party, including a financial institution's primary regulator, may propose a sale of such contractual rights and obligations. Notwithstanding any master netting agreement as defined in section 101(38A) of this title, the court may sell packages of such contractual rights and obligations under section 363 grouped by product lines (as generally recognized in the financial industry). After notice and a hearing appropriate for the circumstances, such sale shall be consummated pursuant to section 363. Such sale or sales may include some

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or all of the debtor's contracts and obligations handled under this section 563, grouped by product line, but does not require that all such contracts and obligations be sold.

Conforming changes would be needed to other safe harbor provisions, including sections 555, 556, and 559, as well as the safe harbor from section 547 preferences.

