Transaction Consistency and the New Finance in Bankruptcy

David A. Skeel Jr.
University of Pennsylvania Carey Law School

Thomas Jackson
University of Rochester

ESSAY

TRANSACTION CONSISTENCY AND THE NEW FINANCE IN BANKRUPTCY

David A. Skeel, Jr. & Thomas H. Jackson***

Neither scholars nor the derivatives industry have fully explored the question of how the treatment of derivatives and repos in bankruptcy would change if their exemption from a number of bankruptcy's core provisions was removed. This Essay tries to fill the gap, and to develop a more general theory about the importance of "transaction consistency"—that is, equivalent treatment of similar transactions—in bankruptcy. The effect of transaction consistency on repos would be limited, because repos would automatically be terminated as of the bankruptcy filing and thus could not be reinstated by the debtor. Derivatives have more at stake, but the nondebtor's right of setoff would reduce many of the adverse effects. The special treatment should not simply be removed, however. Given the distinctive attributes of these contracts, the Essay argues that repo lenders should be able to immediately sell some kinds of collateral, and that the automatic stay should be limited to three days for derivatives. The Essay also explains how transaction consistency can be integrated with the Dodd-Frank Act, and might make Dodd-Frank's resolution rules unnecessary in most cases.

Introduction

One of the few areas of American finance that the financial reforms of 2010 did not dramatically restructure was bankruptcy. Designed for financially troubled firms (and individuals), bankruptcy has a host of provisions for staying individual debt collection,[1] rearranging capital struc-

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* S. Samuel Arsht Professor, University of Pennsylvania Law School.

** University Professor, University of Rochester. We are grateful to Barry Adler, Darrell Duffie, Franklin Edwards, Anna Gelpern, David Hahn, Richard Hynes, Rosa Lastra, Locke McMurray, Charles Mooney, Ed Morrison, Habib Motani, Gideon Parchomovsky, Mark Roe, Ken Scott, James Sprayregen, Kimberly Summe, Oren Sussman, John Taylor, James Thompson, Antony Zacaroli, and participants at a faculty workshop at Bar-Ilan University, at the Insolvency Roundtable at the University of Oxford, at the International Centre for Financial Regulation's "Future of Bank Funding" conference, at the Corporate Law Roundtable at the University of Pennsylvania Law School, and at Richmond and Philadelphia Reserve Banks' Workshops for helpful comments on earlier drafts; to Elizabeth Hendee for excellent research assistance; and to the University of Pennsylvania Law School for generous summer funding.

1. Chief among these are the automatic stay and the executory contract assumption provisions. The automatic stay forbids creditors from seizing or selling collateral, terminating contracts, or engaging in any other "act to obtain possession of property of the estate." 11 U.S.C. § 362 (2006). Similarly, 11 U.S.C. § 365 outlines permissible contract assumption, giving the debtor the ability to assume valuable executory contracts even if the debtor is in default at the time it files for bankruptcy.

tures (and changing the relevant decisionmakers),[2] and otherwise sorting out viable from nonviable businesses.[3] The Dodd-Frank Act borrows a few provisions from bankruptcy for the new resolution rules it established for systemically important financial institutions that fall into financial distress;[4] it gives bank regulators new powers to deal with these institutions' distress;[5] and it calls for several studies of bankruptcy.[6] But the legislation does not amend the bankruptcy laws.

To appreciate just how remarkable the neglect of bankruptcy is, we need only consider the regulatory treatment of the instruments of contemporary finance before and after the 2008 crisis. Prior to the crisis, the financial innovations of the past thirty years—swaps and other derivatives contracts,[7] repurchase agreement (repo) financing,[8] and structured finance[9] in particular—were almost completely unregulated both outside and inside of bankruptcy. Outside of bankruptcy, over-the-counter (OTC) derivatives were treated as private contracts between the two par-

2. This is the consequence of the so-called absolute priority rule, 11 U.S.C. §§ 725, 726, as implemented in Chapter 11's reorganization rules, 11 U.S.C. §§ 1123, 1126, 1129, which require that higher-priority creditors be paid before lower-priority creditors and shareholders unless the higher-priority creditors consent to different treatment.

3. Thomas Jackson, The Logic and Limits of Bankruptcy Law 8–17 (1986) [hereinafter Jackson, Logic and Limits].

4. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 210(a)(11)(a)–(b), 124 Stat. 1376, 1470–71 (2010) (to be codified at 12 U.S.C. § 5390) (incorporating bankruptcy-like fraudulent conveyance and preference provisions).

5. See id. §§ 201–217, 124 Stat. at 1442–1520 (to be codified in scattered sections of 12 U.S.C.) (codifying resolution rules).

6. See id. § 202(e), 124 Stat. at 1448–49 (to be codified at 12 U.S.C. § 5382) (providing for bankruptcy study by Comptroller and Administrative Office of U.S. Courts); id. § 216, 124 Stat. at 1519 (to be codified at 12 U.S.C. § 5394) (providing for study by Federal Reserve and Administrative Office of U.S. Courts).

7. The major forms of swaps include credit default swaps, interest rate swaps, and currency swaps. See 11 U.S.C. § 101(53B) (defining "swap agreement"). A credit default swap functions like insurance, with one party (the protection seller) promising the other party (the protection buyer) a payment in the event that a third party (the reference entity) that is the subject of the contract experiences a "credit event" such as default or bankruptcy. With an interest rate swap, one party agrees to pay one form of interest (such as a fixed interest rate) and the other pays a different rate (such as an interest rate that varies based on the prime rate). With a currency swap, one party agrees to pay a specified amount of one currency (such as dollars) and the other promises a different currency (such as euros). In each case, the obligations are usually netted out at the end of the contract, and one party pays the other the difference.

8. In a repurchase or "repo" transaction, one party sells securities to the other and promises to buy them back at a specified time in the future. See id. § 101(47) (defining "repurchase agreement"). Repos are generally used for financing and are very similar to a secured loan with securities as collateral.

9. In its most common form, structured finance, or "securitization," involves a sale by the issuer of assets such as mortgages or credit card receivables to a new entity. Investors in the new entity receive securities issued by the new entity, and the funds they contribute are used by the entity to purchase its assets. See, e.g., Steven L. Schwarcz, The Future of Securitization, 41 Conn. L. Rev. 1313, 1315–17 (2009) (outlining and explaining securitization).

ties, and 2000 legislation explicitly forbade the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) from regulating them.[10] Inside of bankruptcy, repos and derivatives were insulated from core bankruptcy provisions such as the automatic stay, which prohibits creditors from terminating their contracts or seizing and selling collateral,[11] thanks to a series of legislative amendments creating what are often described as "safe harbors" or "exemptions" for these contracts.

When the 2008 crisis subjected the privileged status of derivatives and repos to a stress test, it was, to put it mildly, found wanting. Derivatives had been touted as reducing risk and as a self-regulating market.[12] Imposing regulation, the reasoning went, would interfere with the market, with potentially catastrophic consequences. Yet the absence of regulation did not cushion the blow of any of the 2008 collapses—Bear Stearns, Lehman Brothers, or AIG. In each case, it hastened the implosion and magnified the risk that their defaults would paralyze the financial system. The absence of regulation was the problem, not a solution, as we have documented in detail elsewhere.[13]

In response to this unintended stress test, the Dodd-Frank Act has created a massive and entirely new regulatory framework for derivatives outside of bankruptcy. If the new rules work as designed, most derivatives (which are defined as "swaps" in the legislation) will be cleared on a clearinghouse that will act as the guarantor of the obligations of both parties.[14] They also must be traded on exchanges (referred to in the Act

10. See Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, app. E, 114 Stat. 2763A-365 (codified as amended in scattered sections of 7 U.S.C.). The Commodity Futures Modernization Act of 2000 excluded a broad range of derivatives transactions from the jurisdiction of both the CFTC and the SEC, leaving them unregulated by the federal government. Noah L. Wynkoop, Note, The Unregulables? The Perilous Confluence of Hedge Funds and Credit Derivatives, 76 Fordham L. Rev. 3095, 3099 (2008).

11. 11 U.S.C. § 362(a).

12. The most famous endorsement came from former Federal Reserve Chairman Alan Greenspan, who credited derivatives with easing the effects of the Enron and WorldCom collapses. Alan Greenspan, Chairman, Fed. Reserve, Remarks to the Federal Reserve Bank of Chicago's Forty-First Annual Conference on Bank Structure: Risk Transfer and Financial Stability (May 5, 2005), available at http://www.federalreserve.gov/Boarddocs/Speeches/2005/20050505/default.htm (on file with the *Columbia Law Review*) (attributing "the remarkable resilience of the banking system, which had [by the time of earlier remarks by Greenspan in 2003] recently shrugged off severe shocks to the economy and the financial system" to derivatives and sophisticated risk management).

13. See infra Part II (analyzing how repos and derivatives would be treated if subject to same core bankruptcy policies as other contracts, and citing other works by each of the authors on these issues).

14. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 723, 124 Stat. 1376, 1675–82 (2010) (to be codified at 7 U.S.C. § 2) (discussing clearing requirement). Technically, the clearinghouse is a principal to both parties, becoming a buyer to every seller and a seller to every buyer. The effect is similar to a guaranty, and this term will be used throughout the Essay.

as "boards of trade"),[15] which will require that they be more transparent and their terms more standardized than in the past. The Dodd-Frank Act does not regulate repos or structured finance nearly as extensively as derivatives. But it imposes important new restrictions on their operation outside of bankruptcy.[16]

The key phrase, once again, is "outside of bankruptcy." Although the Dodd-Frank Act will have important indirect effects on bankruptcy, lawmakers left the bankruptcy treatment of derivatives, repos, and other financial innovations largely untouched.[17] Their special status endures.

This Essay offers a new perspective on the implications of this special treatment. To motivate the analysis, the Essay identifies four different distortions caused by the special rules for repos and swaps.[18] First, the special treatment diminishes counterparties' incentive to screen and monitor the debtor, particularly with the systemically important firms that dominate the derivatives industry and are likely to be bailed out if they fall into financial distress. Second, the special treatment functions as a credit subsidy for the new finance. Debtors favor the new finance over traditional sources of funding, and creditors do not limit their exposure to a potentially vulnerable debtor. Third, insulation from bankruptcy's core policies exacerbates the risk of runs by removing the debtor's ability to temporarily halt them. Finally, the absence of a stay and the prospect of a mass termination of the debtor's derivatives hinder a debtor's ability to effectively resolve its financial distress in bankruptcy. This initial analysis draws on insights we and others have developed in previous work.

The Essay then turns to its principal counterfactual: What would applying the core bankruptcy policies—honoring a principle we will refer to as "transaction consistency"—mean for derivatives and repos?[19] Scholars,

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15. See id. (discussing exchange requirement).

16. Most importantly, bank regulators are authorized to limit the amount of short-term debt that a systemically important financial institution is permitted to have in its capital structure. Id. § 165(g), 124 Stat. at 1429 (to be codified at 12 U.S.C. § 5365). For structured finance, the legislation requires that the originator retain at least 5% of the credit risk of the structured finance entity. Id. § 941, 124 Stat. at 1891–92 (to be codified at 15 U.S.C. § 78o-11).

17. This Essay's particular concern is with repos and derivatives. The current treatment of structured finance is less problematic, as it treats securitization transactions as true sales, and thus, as remote from the issuer's bankruptcy, except in egregious circumstances.

18. Special treatment may prevent other distortions. The Essay considers these benefits when discussing the effect that removing the special treatment would have. See infra text accompanying note 22.

19. To call this principle "transaction consistency" may seem heretical (or unnecessary) to some bankruptcy insiders. It bears an unmistakable family resemblance to the "equality of creditors" principle, a longstanding staple of bankruptcy that says similarly situated creditors should be treated as equivalently wherever possible. Thomas H. Jackson, Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain, 91 Yale L.J. 857, 859–68 (1982) (discussing idea of creditor equality). Despite the familiarity of the "equality of creditors" principle, we prefer "transaction consistency" for several reasons. The first is that the traditional term is so familiar that it has lost much of its content in practice. In

including the two of us, have not previously worked through all of the implications of removing the special protections for repos and derivatives, and treating them more like other contracts. The results are surprising, even stunning. Despite the enormous energy that the Federal Reserve, the U.S. Treasury, and the financial services industry have spent over the past thirty years lobbying to insulate repos from the rules that apply to ordinary contracts in bankruptcy, transaction consistency would have only a limited effect on the treatment of repos. Because repos are financing transactions—a "financial accommodation," in bankruptcy lingo—the debtor cannot "assume" them in bankruptcy, as it can other executory contracts.[20]

With swaps, on the other hand, transaction consistency would mean significant changes in the bankruptcy treatment; although even here, the fears of the derivatives industry are overstated. While transaction consistency would indeed suggest the debtor could assume these contracts, the debtor's ability to pick the good swaps and abandon the bad ones—to "cherry pick," as the industry ominously calls it—would be limited, since bankruptcy would largely honor the master swap agreements that the industry uses to coordinate and net obligations.[21]

Moreover, this Essay does not simply call for a formalistic application of transaction consistency that is blind to the characteristics of repos and swaps that distinguish them from most ordinary contracts. Most importantly, they are highly volatile, with values often changing dramatically over short periods. Many must be fine-tuned constantly, with the parties recalibrating each other's margin or collateral obligations daily.[22] To account for these distinctive attributes, this Essay proposes several adjustments from formal transaction consistency. With repos, it concludes that lawmakers should continue to exempt cash-like collateral such as treasury bills or agency debt from the automatic stay. This would enable counterparties to quickly close out contracts involving securities that are easy to value, are not likely to impose systemic risk on the financial system, and usually will not be essential to an efficient resolution of the debtor's financial distress. The preferred treatment of cash-like collateral would also encourage the parties to use these securities rather than more

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addition, the two terms have different connotations. Equality of creditors connotes fairness, and assuring fairness was its historical objective: In the nineteenth century, sophisticated creditors were often discriminated against, as debtors favored friends and local creditors. Fairness is still an issue, but transaction consistency gives a better sense of the distortions created by deviations, which are the primary concern of this Essay.

20. See 11 U.S.C. § 365(c)(2) (2006) (excepting from power to assume or assign "a contract to make a loan, or extend other debt financing or financial accommodations").

21. The key provision here is 11 U.S.C. § 553, which honors prebankruptcy setoff rights.

22. With many derivatives contracts, the parties are required to post "initial margin"—which is the value corresponding to a portion of any potential obligations under the contract—as well as "variation margin"—additional margin payments to reflect changes in the current value of the contract.

illiquid securities such as the mortgage-backed securities that featured prominently in the 2008 crisis. With swaps, this Essay proposes the stay should be limited to three days, due to the high velocity and volatility of derivatives transactions. Although this Essay argues that master netting agreements should generally be honored in bankruptcy, a counterparty should not be permitted to use the (automatic) termination of a repo as a basis for cancelling all of the obligations in a master agreement that includes swaps and other derivatives.

This Essay proceeds as follows: Part I briefly outlines the rationales that were used to justify the special treatment of derivatives and repos in bankruptcy. It then shows how derivatives and repos fared in the 2008 stress test, culling lessons from the major failures. Part II analyzes the implications of transaction consistency for derivatives and repos, looking at their status as executory contracts, the implications of the automatic stay, the contours of setoff and netting, and the application of bankruptcy's preference and fraudulent conveyance provisions.

Part III considers the implications of the new financial reform legislation for the transaction consistency analysis. Of particular importance are (1) the new requirement that most derivatives be cleared on clearinghouses that will guarantee the performance of both parties to the contracts and will impose suitable collateral requirements; and (2) the newly minted Federal Deposit Insurance Corporation (FDIC) resolution rules for large, systemically important financial institutions. For cleared derivatives, the clearinghouse will become the true party in interest in the event a counterparty fails. This means that the clearinghouse is more than just a middleman in the transaction. A clearinghouse should therefore be subject to the same transaction consistency treatment in bankruptcy as is a counterparty.

The Dodd-Frank Act's new resolution regime has its own temporary stay and other bankruptcy-like rules, which might seem to make the bankruptcy treatment of repos and derivatives redundant. But the resolution regime only applies to the largest institutions, and even these institutions cannot use it unless the U.S. Treasury steps in and invokes the resolution rules. Not only would the bankruptcy adjustments advocated in this Essay apply in most cases, but they could also make the resolution regime far less necessary. Armed with a stay and other bankruptcy protections, the managers of a large troubled institution—the next AIG, for instance—would have an incentive to file for bankruptcy before regulators intervened, in order to control the disposition of the firm's assets.

Recognizing the realities of the reform process,[23] Part IV offers several more limited alternative proposals for reform. Rather than moving to

23. This recognition comes in part from our own experience. Both of us were involved in numerous discussions with Congressional staff of both parties, and in other ways, during the legislative debates that led to the Dodd-Frank Act. While we would like to think that we made a tiny contribution to the removal of a dedicated $50 billion fund from the original version of the Dodd (Senate) bill, see Restoring American Financial Stability

complete transaction consistency, Congress could constrain many of the problematic effects of the current rules with a few very limited adjustments. The most minimalist approach would simply reinstate the bankruptcy rules that prevent contract termination by invalidating so-called "ipso facto" clauses.[24] A slightly more expansive strategy would also reintroduce a limited stay for swaps, without altering the treatment of repos. Although neither reform promises the full benefits of transaction consistency, either would correct the worst distortions of the current framework.

The Conclusion briefly summarizes the analysis and the implications of the transaction consistency principle advocated in this Essay.

I. What Happened? The 2008–2009 Stress Test

Bankruptcy's heart and soul lie in two provisions: the automatic stay and the trustee's power to avoid preferential transfers.[25] The automatic stay, which prohibits creditors from taking steps to collect what they are owed once a debtor has filed its bankruptcy petition, is the key to bankruptcy's collective proceeding. From the moment a debtor files for bankruptcy, the stay halts the "race of diligence" by creditors that might otherwise lead to piecemeal liquidation of the debtor's assets, setting the stage instead for a coordinated resolution of the debtor's financial distress. The preference provision reinforces this collective solution to financial distress by empowering the trustee to retrieve payments or other transfers made to a creditor within ninety days of bankruptcy.[26] The preference power aims to assure that some creditors are not treated more favorably than others, and is designed to encourage creditors to trigger the collective proceeding rather than seeking payments from a troubled debtor outside of bankruptcy.[27]

Since 1978, when the current bankruptcy laws were enacted, Congress has created and steadily expanded exemptions for derivatives, repos, and other financial contracts from these and related bankruptcy

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Act of 2010, S. 3217, 111th Cong. (2010) (as introduced in Senate, Apr. 15, 2010), our own influence on the final legislation was essentially nil. With this Essay, we are going back to the drawing board.

24. An ipso facto clause is a provision that defines the debtor's bankruptcy or insolvency as an event of default and thus as grounds for terminating the contact. The rules that invalidate so-called ipso facto clauses for ordinary contracts can be found in 11 U.S.C. §§ 365(e), 541(c). Derivatives and repos are exempted from these rules. Id. §§ 559, 560, 561 (exempting repos, swaps, and netting agreements, respectively).

25. Id. §§ 362(a), 547 (outlining automatic stay and preference provisions, respectively).

26. Id. § 547(b)(4). The reach back is extended to one year if the recipient of the transfer is an insider. Id.; see also id. § 101(31) (defining "insider").

27. See, e.g., Jackson, Logic and Limits, supra note 3, at 125 (explaining normative underpinnings of preference law).

provisions.[28] As of 2006, on the eve of the financial crisis, Congress had exempted these contracts from the stay and preference provisions, as well as the bankruptcy anti-ipso facto clause rules, the trustee's power to avoid fraudulent conveyances, and the limitations on a nondebtor's ability to setoff or net obligations that the nondebtor owes to the debtor against obligations the debtor owes the nondebtor.[29]

This Part considers how the rationales that were used to justify the special treatment fared under the severe stress of the 2008 financial crisis. Two conclusions emerge: 1) The special treatment creates major distortions in global finance; and 2) remarkably little attention was given (or has been given since) to the precise implications that ordinary bankruptcy treatment would have for these contracts.

A. *The Rationales for Exclusion*

Proponents of the special treatment—which included both regulators like the Federal Reserve and U.S. Treasury and the principal industry groups—have offered four primary rationales for excluding derivatives and other financial contracts from the policies that lie at the heart of the bankruptcy framework.

In the earliest debates, which predated the massive expansion of the derivatives markets in the late 1980s and 1990s, the case for exclusion focused on the status of securities professionals as middlemen rather than true parties in interest in securities transactions. Suppose, for example, that Buyer arranged with Broker to purchase a share of stock from Seller for $100, and Buyer filed for bankruptcy after paying $100 to Broker. In theory, the trustee in Buyer's bankruptcy might sue Broker, alleging that Broker had received a $100 preference, even if Broker had simply transferred the funds to Seller.[30] Proponents of an exclusion argued that Broker, in a scenario such as this one, is a conduit and is not really the recipient of a preferential transfer.[31] This rationale for exclusion is sensible and is easily reconciled with the transaction consistency objective.

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28. For the chronology and other details, see Edward R. Morrison & Joerg Riegel, Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges, 13 Am. Bankr. Inst. L. Rev. 641, 644–45 (2005) (describing progression of congressional protections available to counterparties).

29. Id.

30. If Buyer did not pay for the stock immediately or bought it on credit, the payment could be construed as a payment "on account of an antecedent debt," which would thus be subject to challenge as a preference. 11 U.S.C. § 547(b)(2). As the initial transferee of the payment, Broker theoretically could be asked to turn over $100, even if Broker was really just a conduit. See, e.g., 11 U.S.C. § 550(a)(1) (authorizing trustee to recover from "initial transferee," even if this transferee is not "entity for whose benefit the payment is made").

31. "If a firm or a clearing organization had to return margin payments received from a debtor when he had already transmitted those funds to others in the clearing chain," a witness testified in 1981, "its finances would be seriously undermined to the point where it also might be driven into bankruptcy." Bankruptcy of Commodity and Securities Brokers: Hearings before the Subcomm. on Monopolies & Commercial Law of the H. Comm. on the Judiciary, 97th Cong. 165 (1981) (statement of Edmund R. Schroeder, Attorney,

The second rationale for special treatment is that securities and derivatives markets are too complex to be treated the same way as other contracts. The complexity rationale sometimes merged with the middleman rationale. In a 1981 hearing, a lawyer representing the New York Cocoa Clearing Association and the New York Sugar Clearing Association warned: "[I]t should be borne in mind that when these moneys flow through the clearing chain, they are disbursed in many different directions, and there really is no way of tracing where they have gone."[32] If the trustee of a bankrupt broker "tried to go out into the system to recover money paid as margin," another witness stated, "then the whole system would become paralyzed because nobody would know who was entitled to what."[33]

With the final two rationales, which came to dominate the debate—discussion really, since contrary views were rarely presented—the focus shifted squarely to the financial instruments themselves. Repos and derivatives need to be insulated from the ordinary bankruptcy process, according to the third rationale for special treatment, because subjecting them to the stay and the trustee's preference powers would magnify volatility and retard the growth of the market.[34] With repos, the bête noir was *Lombard-Wall*, a 1982 bankruptcy court decision holding that a repo buyer should be treated as a secured creditor in a bankruptcy of the repo seller and subject to the automatic stay.[35] Congressman Walter Fauntroy, one of

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Barrett Smith Schapiro Simon & Armstrong, New York, N.Y., appearing for New York Cocoa Clearing Association and New York Sugar Clearing Association).

32. Id.

33. Id. at 167 (statement of Stephen F. Selig, Esquire, Baer, Marks, & Upham, New York, N.Y., appearing for Comex Clearing Association, Commodity Exchange, Inc., Kansas City Board of Trade, Bache, Bear Stearns, Dean Witter Reynolds, and Merrill Lynch Commodities). Securities and Exchange Commission Commissioner Bevis Longstreth sounded this theme in the same hearing, opining that the application of ordinary preference law to securities transactions "creates uncertainty which is incompatible with the efficient working of the national clearance and settlement system." Id. at 240 (statement of Bevis Longstreth, Comm'r, Sec. & Exch. Comm'n).

34. A slightly wider range of views emerged in the early discussion of repos than with derivatives. The Department of the Treasury opined in the early 1980s that it might not be necessary to exempt repos from the automatic stay. Letter from Paul A. Volcker, Chairman of the Fed. Reserve, to Senator Robert J. Dole, Chairman, Subcomm. on Courts, Comm. on the Judiciary (Sept. 29, 1983). Although the Federal Reserve disagreed, they initially were willing to consider minor limitations on the special treatment. In 1984, Representative Peter Rodino stated that then-Federal Reserve Chair Paul Volcker had "stated in written correspondence to this committee that amendments that limit protection to repo transactions of $1 million or more" would be sufficient, and would "'avoid major exceptions to existing bankruptcy law.'" Bankruptcy Law and Repurchase Agreements: Hearing on H.R. 2852 and H.R. 3418 Before the Subcomm. of Monopolies & Commercial Law of the H. Comm. on the Judiciary, 98th Cong. 61 (1984) [hereinafter 1984 House Hearing] (statement of Rep. Peter W. Rodino, Jr., Chairman, H. Comm. on the Judiciary).

35. Lombard-Wall Inc. v. Bankers Trust Co. (In re Lombard-Wall, Inc.), 23 B.R. 165 (Bankr. S.D.N.Y. 1982). Lombard-Wall was a securities firm that dealt with government securities. Shortly after Lombard-Wall filed for bankruptcy in August 1982, the bankruptcy court held that its repos would be treated as secured loans rather than sales and that they

the sponsors of legislation creating the initial repo exclusion, reported that *Lombard-Wall* alarmed market participants, magnifying their uncertainty and slowing the growth of repos.[36] The decision "cast a cloud over the future health of the repo market" and "create[d] a risk of market 'grid-lock,'" according to an industry witness.[37]

This rationale resonated particularly strongly with repos, because the Federal Reserve uses repos itself in its efforts to adjust the nation's money supply and protect the stability of the financial system. If repos could get caught up in a repo participant's bankruptcy, the reasoning went, this could interfere with the Federal Reserve's handling of monetary supply.[38]

With swaps, industry representatives warned about the ill effects of "cherry picking."[39] If a debtor could assume the contracts that were "in the money" while rejecting its bad contracts and relegating the counterparty's claim for damages to general unsecured status, these rep-

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would be subject to the automatic stay. The court issued a temporary restraining order forbidding the repo buyers from selling the collateral absent court approval and subsequently confirmed its ruling despite protests that the repo buyers' inability to sell their collateral would reduce the liquidity of the repo market. Id. at 166 (requiring repo buyers to turn over securities to estate and holding that "[u]nless Lombard is able to obtain and use the Securities immediately . . . Lombard will be forced to stop its operations, leaving the estate and its creditors facing financial disaster"). For a good discussion of the Lombard-Wall default and the push for bankruptcy protection, see Kenneth D. Garbade, The Evolution of Repo Contracting Conventions in the 1980s, 12 Fed. Res. Bank N.Y. Econ. Pol'y Rev. 27, 35–36 (2006). Lombard-Wall's failure came three months after the collapse of another securities dealer, Drysdale Government Securities, had rattled the government securities markets. Id. at 32–34 (discussing Drysdale failure and shift to recognition of accrued interest that followed).

36. See 1984 House Hearing, supra note 34, at 19 (statement of Del. Walter Fauntroy).

37. Id. at 83 (statement of Robert Brown, Chairman of the Board of Directors of the Public Securities Association). Witnesses predicted that the market would flourish, on the other hand, if repo protections were expanded. Even years later, this reasoning for expansive repo protections was solidly in place. According to Seth Grosshandler of Cleary, Gottlieb, Steen & Hamilton, testifying in 1999: "Market participants could . . . enter into . . . [repo] transactions with greater confidence that they will be easily enforceable, improving the liquidity and cost of financing for the underlying instruments . . . ." Bankruptcy Reform Act of 1999 (Part III): Hearing on H.R. 833 Before the Subcomm. on Commercial & Admin. Law of the H. Comm. on the Judiciary, 106th Cong. 388 (1999) [hereinafter 1999 House Hearing] (statement of Seth Grosshandler, Esquire, Partner, Cleary, Gottlieb, Steen & Hamilton LLP).

38. Commenting on market concerns about the *Lombard-Wall* decision, Federal Reserve Chairman Paul Volcker told Congress: "[I]f the repo market were to become less attractive, its usefulness as an instrument of monetary policy would decline." 1984 House Hearing, supra note 34, at 71 (quoting Letter from Paul A. Volcker, Chairman, Fed. Reserve, to Senator Robert J. Dole, Chairman, Subcomm. on Courts, Comm. on the Judiciary (Jan. 20, 1983)). For a lengthy exegesis on the importance of repo financing to the nation's financial markets and Federal Reserve policymaking activities, see In the Matter of Bevill, Bresler & Schulman Asset Mgmt. Corp., 67 B.R. 557, 566–71 (D.N.J. 1986).

39. See, e.g., John C. Dugan, Derivatives: Netting, Insolvency, and End Users, 112 Banking L.J. 638, 640 (1995) (emphasizing "cherry-picking" concern).

resentatives warned, the debtor's bankruptcy could destabilize the swaps market.[40]

The final rationale—which tended to silence any lingering objections (but looks more than a little ironic from a post-2008 vantage point)—was the need to keep systemic risk in check. If derivatives and repos were subject to the automatic stay, the argument went, a debtor's failure could have a domino effect, taking other participants in the derivatives market down with it.[41] A counterparty that had entered into a large derivatives contract with the debtor to hedge its business risks might find itself unhedged if it could not cancel its contract and enter into a new hedging contract with someone else. The counterparty might also face rising losses as contract values continued to change. Any delay in the counterparty's ability to terminate its derivative with the debtor could therefore have a crippling effect and might even undermine confidence in the market more generally. If counterparties could quickly exit their contracts, on the other hand, the derivatives markets would adjust and quickly restore their equilibrium.

Prior to the 2008 crisis, these rationales (especially the last one) were viewed as dispositive.[42] The special treatment for derivatives and repos in bankruptcy was steadily expanded, and there was no serious initiative to rein it in.

B. *Evidence from the Crisis*

Just as the 2008 crisis called the self-regulating derivatives and repo markets into severe question outside of bankruptcy, it also refuted the arguments for their insulation from the core provisions of bankruptcy. The discussion that follows briefly highlights the lessons of the three most prominent collapses, with a particular emphasis on details that will inform the analysis in Part II.

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40. For criticism of this argument, see Stephen J. Lubben, Derivatives and Bankruptcy: The Flawed Case for Special Treatment, 12 U. Pa. J. Bus. L. 61, 68–73 (2009) ("The Bankruptcy Code does not change [the calculations of an insolvent company], as the power to reject under section 365 is precisely the same as the power to breach when insolvent. The 'cherry picking' argument then loses much of its force.").

41. See 1999 House Hearing, supra note 37, at 352 (prepared statement of Oliver Ireland, Associate General Counsel, Board of Governors of the Federal Reserve System) ("The right to terminate or close-out protects [financial institutions] . . . on an individual basis, and by protecting both supervised and unsupervised market participants, protects the markets from systemic problems of 'domino failures.'").

42. See, e.g., Michael H. Krimminger, Adjusting the Rules: What Bankruptcy Reform Will Mean for Financial Market Contracts, FYI: An Update on Emerging Issues in Banking, FDIC (Oct. 11, 2005), http://www.fdic.gov/bank/analytical/fyi/2005/101105fyi.html (on file with the *Columbia Law Review*) (noting "[i]f [a counter-party] . . . is placed into bankruptcy or receivership, the normal stays on termination of contracts and liquidation of collateral could create escalating losses" and "as a result, the ability to terminate the contract and net exposures quickly can be crucial to limit the losses to the non-defaulting party").

1. *Bear Stearns.* — As Bear Stearns bled cash in early March 2008, it consulted a team of bankruptcy lawyers about the possibility of a bankruptcy filing.[43] If the bankruptcy exclusions were an effective mechanism for dampening a run, allowing a Bear Stearns bankruptcy should have been a live option. In reality, Bear Stearns's repo counterparties ran even before the bankruptcy decision was made, and Treasury Secretary Henry Paulson and then-New York Federal Reserve President Timothy Geithner rejected bankruptcy as unthinkable.[44] Not only did regulators have little confidence that bankruptcy's special repo and derivatives provisions would dampen the risk of a run, they worried that a mass sale of repo collateral could drive down the values of mortgage-related securities and further destabilize the markets.[45] This calculus suggests that the very exclusions that were justified as reducing systemic risk—allowing counterparties to terminate (and sell collateral) notwithstanding the automatic stay—can actually exacerbate it through the very sale of that collateral when the troubled institution is a large player in the relevant markets, as Bear Stearns was.

The concerns that the special exclusions would not stop a run, and that they might even trigger one, are issues that arose once Bear Stearns had become financially distressed—that is, they are ex post concerns. The exclusions may have had pernicious ex ante effects as well. Because repos and derivatives are insulated from the stay and the trustee's avoidance powers, they are privileged as compared to other methods of financing.[46] Bear Stearns may have relied more on repos, and less on equity or traditional secured finance, for its funding because of the special status repos enjoyed. Mark Roe has pointed out, for instance, that the percentage of Bear Stearns's repo financing climbed from 7% of its liabilities and twice its equity in 1990, to 25% and eight times its equity in 2008.[47] It is important not to overstate this effect. As demonstrated in the next part, transaction consistency in bankruptcy would have a much smaller impact on the treatment of repos in bankruptcy than it would on derivatives. But even a

43. William D. Cohan, House of Cards: A Tale of Hubris and Wretched Excess on Wall Street 66–67 (2010) (describing consultation of Bear Stearns top executives).

44. See, e.g., Kate Kelly, Fear, Rumors Touched Off Fatal Run on Bear Stearns, Wall St. J., May 28, 2008, at A1 (noting discussion among Geithner, Paulson, and Bernanke concerning likely fallout from allowing Bear Stearns to collapse).

45. David Wessel, In Fed We Trust: Ben Bernanke's War on the Great Panic 166–68 (2009) ("The Fed pushed for the Treasury to promise to 'indemnify' the Fed if mortgage-linked securities ultimately weren't worth the $30 billion.").

46. The possibility that the special treatment in bankruptcy could subsidize use of derivatives as compared to other forms of financing was first identified by Franklin Edwards and Ed Morrison. See Franklin R. Edwards & Edward R. Morrison, Derivatives and the Bankruptcy Code: Why the Special Treatment?, 22 Yale J. on Reg. 91, 121 (2005) [hereinafter Edwards & Morrison, Derivatives and the Bankruptcy Code] (noting "the Code may unintentionally alter the debt structure of firms towards a greater reliance on derivatives by favoring derivatives counterparties over other creditors").

47. See Mark J. Roe, The Derivatives Market's Payment Priorities as Financial Crisis Accelerator, 63 Stan. L. Rev. 539, 552 (2011).

small advantage for repos over ordinary secured credit may have distorted Bear Stearns's financing decisions.

2. *Lehman Brothers.* — A seldom noticed fact about the fateful days before Lehman Brothers filed for bankruptcy in September 2008 was that the credit default swap (CDS) market was—at least based on CDS prices—almost the last to know about Lehman's travails. The spreads on CDS contracts insuring Lehman debt showed little evidence of impending default until immediately before Lehman's collapse on the weekend of September 12–14, 2008.[48] Until the spike in spreads finally began a few days earlier, the CDS market showed few signs that anything was amiss. This remarkable pricing pattern does not testify to the market participants' obliviousness, as might seem to be the case at first glance. More likely, it demonstrates the CDS protection sellers' confidence that they would be bailed out if Lehman collapsed.

The special protections for derivatives compounded this distortion and may have magnified the losses Lehman's unexpected collapse caused in two respects. The first concerns the now-infamous Repo 105 transactions that Lehman employed at the end of each quarter to disguise the amount of its leverage. For accounting purposes, repo transactions are ordinarily characterized as financing, rather than a sale. But Lehman interpreted the accounting rules to allow a repo seller to treat a repo as a sale if the underlying securities are worth at least 105% of the cash paid by the repo buyer. As recounted by the examiner appointed in Lehman's bankruptcy, through this interpretation, Lehman characterized the repos as sales rather than financing—i.e., debt—to buff up its balance sheet in late 2007 and 2008.[49] This recharacterization of repos as sales shaved $38.6 billion from Lehman's debt in the fourth quarter of 2007, and $49.1 billion and $50.38 billion in the first and second quarters of 2008 respectively.[50]

Bankruptcy's special treatment of repos subtly but centrally invited this accounting manipulation. If the bankruptcy laws treated repos as the secured transactions that they clearly are,[51] the accounting loophole

48. See David Skeel, The New Financial Deal: Understanding the Dodd-Frank Act and Its (Unintended) Consequences 28–29 fig.2.3 (2010) [hereinafter Skeel, New Financial Deal].

49. Report of Anton R. Valukas, Examiner at 732, In re Lehman Bros. Holdings Inc., Bankr. No. 08-13555 (JMP), 2011 WL 4071995 (Bankr. S.D.N.Y. Sept. 14, 2011) [hereinafter Valukas Report], available at http://lehmanreport.jenner.com/ (on file with the *Columbia Law Review*) (concluding repos were used to "create materially misleading picture of the firm's financial condition"). Spurred by the Examiner's report, the New York Attorney General has sued Lehman's accountants, Ernst & Young, alleging that they were aware of Lehman's manipulations and failed to disclose them. See Complaint, Cuomo v. Ernst & Young LLP, No. 0451586 (N.Y. Sup. Ct. filed Dec. 21, 2010), available at http://www.ag.ny.gov/media_center/2010/dec/ErnstYoungComplaint.pdf (on file with the *Columbia Law Review*).

50. Valukas Report, supra note 49, at 739.

51. For a discussion of the question of whether repos are lending transactions or sales, see infra Parts II.B.1–2.

might never have emerged. Repo 105 is in this sense a legacy of the quest to exempt repos from bankruptcy in the wake of the *Lombard-Wall* decision.[52] The pretense that these financing transactions were sales delayed recognition of Lehman's true financial condition and almost certainly magnified the costs of its failure.

The second contribution of the derivatives exclusions to Lehman's losses is exemplified by J.P. Morgan's ability to seize and sell Lehman's assets immediately before it collapsed. Owed roughly $20 billion by Lehman, J.P. Morgan froze $17 billion in securities and cash and demanded a $5 billion payment.[53] Because of the special treatment of derivatives, Lehman could not prevent J.P. Morgan from selling the assets by filing for bankruptcy, had little choice but to make the payment, and could not expect to retrieve the payment in a subsequent bankruptcy.[54]

The effect of the special provisions once Lehman did in fact file for bankruptcy was somewhat ambiguous. Lehman was able to sell its investment banking operations to Barclays even without the stay, and over 700,000 derivatives contracts were terminated and netted without causing Lehman's counterparties to fail.[55] But the absence of the automatic stay sowed considerable confusion and contributed to a large loss of value at the outset of the case. "Lacking the full benefit of a 'breathing space' within the contours of the bankruptcy code," Harvey Miller, the lead attorney in the Lehman bankruptcy, told Congress a year later, the beginning of the case was "a period of perpetual crisis."[56]

3. *AIG.* — With AIG, the derivatives exclusions played an unambiguously problematic role. AIG's fortunes went into a freefall after it was forced to begin posting collateral for its large portfolio of CDSs (which were written on pools of mortgage-related securities) due to a ratings downgrade.[57] AIG's counterparties repeatedly ratcheted up their collat-

52. See supra notes 35–38 and accompanying text (discussing *Lombard-Wall* case).

53. See, e.g., Darrell Duffie, The Failure Mechanics of Dealer Banks, 24 J. Econ. Persp. 51, 67–68 (2010) [hereinafter Duffie, Failure Mechanics] (describing J.P. Morgan interventions).

54. See, e.g., Susanne Craig & Robin Sidel, Crisis on Wall Street: J.P. Morgan Made Dual Cash Demands, Wall St. J., Oct. 8, 2008, at C2 (recounting pressures J.P. Morgan put on Lehman).

55. See, e.g., Debtor's Motion for Entry of an Order Pursuant to Sections 105 and 365 of the Bankruptcy Code to Establish Procedures for the Settlement or Assumption and Assignment of Prepetition Derivative Contracts at 4, In re Lehman Bros. Holdings, Inc., Bankr. No. 08-13555 (JMP) (Bankr. S.D.N.Y. Nov. 13, 2008) ("[T]he Debtors are party to approximately 930,000 Derivative Contract transactions of which approximately 733,000 are purported to have been terminated.").

56. Too Big to Fail: The Role for Bankruptcy and Antitrust Law in Financial Regulation Reform: Hearing Before the Subcomm. on Commercial & Admin. Law of the H. Comm. on the Judiciary, 111th Cong. 9 (2009) (prepared statement of Harvey R. Miller, Weil, Gotshal & Manges, LLP).

57. According to a subsequent report by the Special Investigator General for the Troubled Asset Relief Program (TARP), Federal Reserve and Treasury officials feared a panoply of potential consequences if AIG stopped making payments to counterparties,

eral demands, to the point where compliance threatened to cannibalize the company.[58] If the CDSs had been subject to an automatic stay in the event of bankruptcy, AIG could have just said no to the collateral demands, knowing that bankruptcy would offer a stay and a breathing space for arranging a response to the company's financial distress.[59] In addition, if the CDSs had been subject to bankruptcy's preference provision, last-minute collateral grabs would have been avoidable as preferential transfers.[60] The special exclusions from the stay meant that AIG had no choice but to accede to the collateral demands, and the preference exclusion meant there would have been no way to recover anything from favored creditors like Goldman Sachs, which also received billions of dollars more as a result of the AIG bailout.[61]

The special derivatives provisions also significantly influenced the government's decisions. The potential consequences of mass termination of the CDS contracts—which would be made possible in bankruptcy by the counterparties' ability to invoke ipso facto clauses and their exemption from the stay—were a principal justification for the government's decision to arrange $85 billion (eventually boosted to $182 billion) in rescue funding.[62]

* * *

Distilling the experience of these signature 2008 cases, we can identify five adverse effects of bankruptcy's departure from transaction consistency for repos and derivatives. First, the special treatment dampens

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including "the impact on the American retirement system [because many retirement plans had bought stable value fund contracts from AIG]; the impact of AIG's commercial paper obligations[;] the broader effect on the already frozen credit markets and money market mutual funds; and the considerable systemic risk to the global financial system." Office of the Special Inspector Gen. for the Troubled Asset Relief Program (SIGTARP), SIGTARP-10-003, Factors Affecting Efforts to Limit Payments to AIG Counterparties 9 (2009) [hereinafter SIGTARP Report], available at http://www.sigtarp.gov/reports/audit/2009/Factors_Affecting_Efforts_to_Limit_Payments_to_AIG_Counterparties.pdf (on file with the *Columbia Law Review*).

58. See generally Gretchen Morgenson & Louise Story, Testy Conflict with Goldman Helped Push A.I.G. to Precipice, N.Y. Times, Feb. 7, 2010, at A1 (describing AIG's difficulties retrieving alleged collateral overpayments from Goldman Sachs).

59. Compare 11 U.S.C. § 362(a) (2006) (providing for general stay), with id. § 362(b)(17) (providing exception for swaps).

60. Compare id. § 547(b) (describing transfers, including transfers of collateral, within ninety days of bankruptcy avoidable as preferences), with id. § 546(g) (outlining special treatment of swaps).

61. See, e.g., Carrick Mollenkamp & Serena Ng, Report Rebuts Goldman's Claim on AIG: TARP Audit Suggests AIG Collapse Could Have Resulted in Big Losses, Wall St. J., Nov. 18, 2009, at C1 (questioning Goldman's claim that they were fully protected and thus did not need bailout).

62. See, e.g., SIGTARP Report, supra note 57, at 9 (reciting Federal Reserve Chairman Ben Bernanke's testimony identifying "global banks and investment banks that had $50 billion in exposure to losses on loans, lines of credit and derivatives" as reason for intervention).

counterparties' incentives to screen and monitor. A counterparty that can be confident it will be protected will be less careful about whom it contracts with—that is, it may not screen carefully—and it is less likely to actively monitor the actions of its contractual partners.[63] In our view, in the case of derivatives, the contribution of the special provisions to that outcome is principally indirect, through a close linkage with the prospect of a bailout of the debtor's derivatives counterparties. The dampening of monitoring incentives appears to be most serious with swaps. Because these contracts are particularly likely to be bailed out if the government considers the debtor to be systemically important, swaps creditors are insulated from the consequences of failing to carefully scrutinize the debtor's financial condition. The special treatment of derivatives in bankruptcy magnifies this problem by removing the debtor's ability to halt a run by filing for bankruptcy, which ratchets up the pressure for a bailout.[64]

Second, the special treatment distorts a debtor's financing decisions. The special treatment makes repos and derivatives more attractive sources of financing than alternatives such as traditional secured loans.[65] The bankruptcy protections are not the only reason for investment banks' dramatic increase in use of repo-based financing, but they surely contributed to the trend. Major changes to the bankruptcy laws in 2005 extended the protection of repos to mortgage and mortgage-related collateral, including the mortgage-backed securities that Bear Stearns and Lehman used in their repo transactions right on the cusp of the 2008 crisis.[66] Unlike traditional secured finance, short-term repos can be pulled immediately by refusing to roll over the repo at the first sign of trouble. As a result, financial institutions that depend heavily on repo financing are subject to runs, much as commercial banks were before the

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63. See, e.g., David A. Skeel, Jr., Bankruptcy Boundary Games, 4 Brooklyn J. Corp. Fin. & Com. L. 1, 18, 20 (2009) [hereinafter Skeel, Bankruptcy] (describing monitoring effect); see also Roe, supra note 47, at 556–60 (exploring monitoring issue in detail).

64. James Sprayregen, a leading bankruptcy attorney who was consulted when AIG threatened to collapse, has recalled that bankruptcy was briefly considered as a possible option, but rejected precisely because bankruptcy would not stay the termination of AIG's derivatives. See E-mail from James H.M. Sprayregen, Partner, Kirkland & Ellis LLP, to David Skeel (Jun. 9, 2011, 1:48 PM EST) (on file with the *Columbia Law Review*). Sprayregen further elaborated on this idea in discussions with the authors at the Richmond and Philadelphia Federal Reserve Banks' Workshop: Financial Firm Bankruptcy held on July 26, 2011. The new Dodd-Frank resolution rules counteract this to some extent for the companies to which they apply by providing for a temporary suspension of ipso facto clauses. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 210(C)(10)(B), 124 Stat. 1376, 1491 (2010) (to be codified at 12 U.S.C. § 5390). But derivatives are still likely to be bailed out by regulators in practice. See infra Part III.

65. See, e.g., Edwards & Morrison, Derivatives and the Bankruptcy Code, supra note 46, at 121 (noting substitution effect).

66. See, e.g., Stephen J. Lubben, The Bankruptcy Code Without Safe Harbors, 84 Am. Bankr. L.J. 123, 138 (2010) (suggesting changes to Bankruptcy Code may have encouraged use of mortgage-backed securities as repo collateral).

advent of deposit insurance in the 1930s.[67] By increasing the incentives to use repo financing, the bankruptcy safe harbors exacerbate the fragility of the financial system.

Third, in addition to increasing the risk of runs indirectly, by encouraging the use of short term financing, the special treatment can also directly contribute to runs. This argument is the flipside of the derivatives industry's contention, most plausible for smaller debtors, that special treatment can prevent system-wide problems. If the debtor is the counterparty to a large number of contracts, as AIG was, the absence of a stay seems especially likely to fuel runs, rather than forestalling them.[68] Absent a stay, the debtor faces the difficult choice of meeting escalating collateral demands, even to the point of dismembering itself, or filing for bankruptcy and triggering the simultaneous termination of all of its contracts, which can cause systemic damage by driving down asset prices.[69]

Fourth, and relatedly, the special treatment diminishes managers' incentive to prepare for, and to file for, bankruptcy if the firm falls into financial distress, because bankruptcy does not offer any protection against counterparties' efforts to terminate their derivatives and seize or sell collateral. This means that regulators, who often wait far too long to intervene, will be the ones to decide when to invoke bankruptcy or other insolvency proceedings.

Finally, the special treatment can interfere with efficient ex post resolution of the debtor's financial distress. If the debtor is not able even temporarily to halt its counterparties from terminating their contracts, it may face a crippling loss of value at the outset of the case. This could significantly impair the efficiency of the resolution process.

* * *

Despite these adverse effects, it is still possible that transaction consistency would be worse than the existing protections. To reach firmer conclusions about the regulation of the new finance in financial distress, it is necessary to consider carefully just what effects transaction consistency in bankruptcy would have, as well as the implications of the Dodd-Frank reforms.

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67. This comparison is a central feature of Gary Gorton's recent work. In an article with Andrew Metrick, he argues that "the core problem in the financial crisis was a run on repos," which occurred when nervous repo buyers increased the amount of the "haircut"—that is, the difference between the value of the collateral and the amount the repo buyer pays in the initial sale. Gary Gorton & Andrew Metrick, Regulating the Shadow Banking System, Brookings Papers on Econ. Activity, Fall 2010, at 261, 264, 279, available at http://www.brookings.edu/~/media/Files/Programs/ES/BPEA/2010_fall_bpea_papers/2010fall_gorton.pdf (on file with the *Columbia Law Review*). "An increase in a repo haircut," Gorton and Metrick argue, "is tantamount to a withdrawal from the issuing bank." Id. at 279.

68. See, e.g., Kenneth Ayotte & David A. Skeel, Jr., Bankruptcy or Bailouts?, 35 J. Corp. L. 469, 495 (2009) [hereinafter Ayotte & Skeel, Bailouts] (making this argument).

69. Id.

II. What Would Transaction Consistency Mean for Derivatives and Repos?

This Part asks how repos and derivatives would be treated if transaction consistency were restored in bankruptcy—that is, if repos and derivatives were subject to the same core bankruptcy policies as other contracts.

A. *Bankruptcy's Treatment of Ordinary Contracts*

Bankruptcy, of course, does not treat all contracts the same. Contracts that have been completed by one party or the other are either assets (if completed by the debtor) or liabilities (if completed by the other party). And if the contracts remain materially uncompleted by both parties—and thus have elements of both assets and liabilities—they fall into a third category: executory contracts.[70] Thus, only in the context of executory contracts does it make sense to talk about the debtor's "choice" between assumption (i.e., a belief that the asset value exceeds the liability value) or rejection (i.e., a belief that the asset value is less than the liability value) of the contract. Even then, the Bankruptcy Code sharply limits the ability of the debtor to assume (or assign) one type of executory contract: a contract "to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor."[71]

We make this point because different financial contracts would face different bankruptcy rules based on their underlying attributes. Generally speaking, for present purposes, it is possible to identify three "typical" contracts that, because of their underlying attributes, have somewhat different treatments in bankruptcy. Once we identify those three typical contracts and their bankruptcy treatment, we can "map" various financial contracts to those groupings.[72]

First are loans, as well as contracts to make loans (or extend other financial accommodations), to the debtor. These are all, effectively, "breached" upon the filing of a petition in bankruptcy by the debtor. The value of the breached loan is calculated as of that moment—as is the

70. See Vern Countryman, Executory Contracts in Bankruptcy: Part I, 57 Minn. L. Rev. 439, 460 (1973) (defining executory contract as "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other"); see also Jackson, Logic and Limits, supra note 3, at 105–18 (discussing special nature of executory contracts in bankruptcy).

71. 11 U.S.C. § 365(c)(2) (2006). This prohibition on assumption or assignment also applies to contracts to issue a security of the debtor, id., or where applicable law "excuses a party . . . from accepting performance from or rendering performance to an entity other than the debtor." Id. § 365(c)(1)(A).

72. This Essay focuses on the treatment of these contracts in bankruptcy in terms of (a) their valuation, (b) their ability to be assumed and/or assigned, and (c) their protection (in the case of contracts backed by security interests). This Essay later addresses other issues involving such contracts, such as the application of preference law to payments received within ninety days of bankruptcy. See infra Part II.E (explaining that preference and fraudulent rules are waived off for repos, derivatives, and other financial contracts).

value of any collateral that may be securing the loan. The claimant without security (or other rights, such as recoupment or setoff) holds an unsecured claim, valued at that point (and without interest or such—unless all unsecured claims are going to be paid in full).[73] The secured creditor's claim, if undersecured, is bifurcated into a secured claim and an unsecured claim.[74] The value of the collateral is likewise determined and "fixed" as of the date of the filing of the petition. Thereafter, the secured creditor's rights to the value of the collateral are given "adequate protection,"[75] which effectively means that while the secured creditor does not realize any increases in the value of the collateral (assuming the automatic stay precludes taking the collateral), the secured creditor is also given protection—apart from the time value of delay—against any diminution in the value of the collateral during the bankruptcy proceeding.

If the loan contract was not yet funded, the debtor would not be able to assume or assign the loan, which means that both parties would be off the hook with respect to the loan.[76] To the extent that the nondebtor party could show damages resulting from this effective rejection of the executory contract, that party would have a claim for those damages valued as of the date of the filing of the petition. For simplicity's sake, these contracts will be called "loan contracts."

Second are what can be described as standard executory contracts, with unfulfilled obligations on both sides. While there is a complication—and, hence, a third category—that will be discussed next, the prototype we are thinking about here is a standard commercial contract, such as a contract to buy and sell widgets, with delivery and payment both occurring in the future. Under Bankruptcy Code section 365, the debtor is given two kinds of choices with respect to such contracts. First, the debtor may either "assume" or "reject" the contract,[77] and may do so at any time during the bankruptcy case unless, on motion, the court orders the decision to be made at an earlier point.[78] If the debtor rejects the contract, it is presumably because the debtor views the contract as burdensome—i.e., in the example above, because the debtor believes that the widgets are not as valuable as the amount the debtor had contracted

73. See 11 U.S.C. § 726(a)(5) (noting, in such circumstances all unsecured claimants will receive "interest at the legal rate from the date of the filing of the petition").

74. Id. § 506(a).

75. See id. §§ 361, 362(d)(1) (stating what constitutes "adequate protection" and when it is required).

76. Id. § 365(c)(2).

77. Id. § 365(a). If the debtor wishes to assume a contract or lease, it must "cure[ ], or provide[ ] adequate assurance that [it] will promptly cure" any default, compensate the other party for any losses, and "provide[ ] adequate assurance of future performance." Id. § 365(b).

78. Id. § 365(d)(1). As the discussion in the text suggests, the debtor generally has considerable discretion when it makes its decision whether to assume or reject a contract or lease. One of the few exceptions is nonresidential leases, which are subject to a 120-day limit. Id. § 365(d)(4).

to pay for them. If the debtor assumes the contract, it is presumably because the debtor views the contract as valuable—i.e., in the example above, the widgets to be delivered are more valuable than the payment obligation for them—and the contract is treated as if it is one made by the debtor-in-possession (an "expense of administration"). In the case of assumption, the debtor has a second choice. If the debtor does not have a need for the completed contract, but nonetheless views it as valuable, the debtor may "assign" the contract to another party; upon assignment, the other party, and not the debtor, is on the hook with respect to performance.[79] Both assumption and assignment can be accomplished despite any contractual provision that is considered to be an ipso facto clause; that is, a clause providing that the contract is breached (or terminated) because of "the insolvency or financial condition of the debtor at any time before the closing of the case" or "the commencement of a case under this title."[80] These provisions may not be perfect. They seem to, for example, give the debtor a one-way option during the bankruptcy proceeding to see if the contract turns out to be valuable. The other party to the contract may be faced during this interregnum with a decision whether to continue to work on the contract at some expense to that party.[81] But our point is more basic: For this kind of contract, these rules, whether entirely "fair" or not, are clear and apply across the board.[82] These contracts will be called "classic executory contracts."

There is a third category—a variation on the second—that is exemplified by classic insurance contracts as well as real estate leases. In these contracts, even if the debtor does not ultimately assume the contract, the debtor receives a "use" benefit during the period between the commencement of the bankruptcy case and a decision to assume or reject the contract. A debtor that uses real property during a bankruptcy proceeding should be required to pay for that use, irrespective of any ultimate decision to assume or reject.[83] Similarly, a debtor whose building is insured should be required to pay for that insurance coverage during a bankruptcy proceeding, again irrespective of any ultimate decision to assume or reject.

The Bankruptcy Code is fully consistent with this intuition. In the case of nonresidential real property leases, the debtor is required to

79. Id. § 365(f)(2) (requiring debtor or trustee to satisfy requirements for assumption and provide "adequate assurance of future performance by the assignee" as prerequisites to assignment).

80. Id. § 365(e)(1)(A)–(B). The assignee, however, would otherwise need to comply with the terms of the contract.

81. See Douglas G. Baird & Thomas H. Jackson, Cases, Problems, and Materials on Bankruptcy 278 (2d ed. 1990) (describing parties' incentives during this period).

82. In the situations we just noted, the other party's major remedy is to seek a court order requiring the debtor to assume or reject the contract. 11 U.S.C. § 365(d)(2).

83. See, e.g., Thompson v. IFG Leasing Co. (In re Thompson), 788 F.2d 560, 563 (9th Cir. 1986) (holding when debtor used property prior to rejection, the "fair and reasonable value" of property is an administrative expense).

"timely perform all [of its] obligations . . . until such lease is assumed or rejected."[84] In other cases, such as the case of insurance coverage, the debtor's "use" of the coverage prior to a decision to assume or reject would give rise to an administrative expense claim at market value.[85] Apart from this issue of paying for the "use" of property (or coverage) during the period prior to the decision to assume or reject, these contracts are treated in parallel with what we are calling classic executory contracts. For want of a better term, they will be called "insurance-like executory contracts."

We can now "map" derivatives, repos, and other financial contracts to these categories. As we do so, it will become apparent that not all financial contracts have the same kinds of underlying attributes. This analysis highlights the treatment that each would receive in bankruptcy, which forms the foundation for an examination as to whether and why that treatment is insufficient.

For bankruptcy purposes, repos and swaps, the principal financial contracts, have very different characteristics. Repos are in essence secured loans. Under the analysis above, they would accordingly belong in the category of classic loans. A second, conceptually quite different, type of contract is epitomized by swaps and various other forms of derivatives. At their core, they ordinarily are hedges—analytically indistinguishable from a contract to purchase widgets on June 1st at a certain price[86]—and comfortably fit within the category of classic executory contracts.[87] As executory contracts, they could (were they treated similarly to other contracts in bankruptcy) be assumed and assigned irrespective of ipso facto clauses. Those that function like an insurance policy would be given the additional protection of payments for the use of the "insurance" during the pendency of the bankruptcy case.

The following section unpacks the basic treatment of repos and swaps under a transaction consistency norm in more detail, before turning to the other two core bankruptcy policies that are elided with these contracts: setoff and the trustee's avoidance powers.

84. 11 U.S.C. § 365(d)(3).

85. We have to assume the debtor is in fact using the coverage, as indeed would be the case prior to a rejection. If the building is insured, and there is no fire, the debtor would, at the end of the coverage period, reject the contract; if, however, there was a fire, the debtor would, at that point, assume the contract. Given that, it is clear that, in reality, the debtor is "using" the coverage during that interregnum.

86. This tension was revealed with the question of whether a natural gas distributor's supply contracts with its customers should be characterized as swaps for purposes of bankruptcy's special rules. Hutson v. Smithfield Packing Co. (In re Nat'l Gas Distribs. LLC), 369 B.R. 884, 900 (Bankr. E.D.N.C. 2007), rev'd sub nom., Hutson v. E.I. du Pont de Nemours & Co. (In re Nat'l Gas Distribs. LLC), 556 F.3d 247 (4th Cir. 2009). Analytically, it is *both* a standard commodities contract *and* a hedge, and it would be strange to have this characterization turn on the "primary purpose" or some such thing.

87. As we discuss in more detail below, in the event that a swap is embedded in, or used as, a loan, it should be treated as a financial accommodation. See infra notes 123–125 and accompanying text (discussing loan-like swaps).

B. *How Would (and Should) Repos be Treated?*

1. *Repos as Secured Loans.* — When Lehman's examiner released his lengthy report on Lehman's fall, press coverage immediately centered on a hitherto unknown pattern of transactions that Lehman employees dubbed "Repo 105."[88] These transactions provide a useful context for more carefully exploring the treatment of repos.

As discussed earlier, Lehman arranged a series of repos shortly before the close of each quarter.[89] The repos consisted of sales by Lehman of securities that Lehman would repurchase at a specified price after the end of the quarter. The 105 in "Repo 105" is a shorthand reference to Lehman's interpretation of the underlying accounting rule. So long as the securities used in the repo were worth at least 105% of the cash paid by the repo buyer, Lehman interpreted the relevant accounting rule to permit the transaction to be booked as a sale rather than a loan.[90] Treating the Repo 105s as sales rather than as secured loans enabled Lehman to remove them from its balance sheet debt and thereby to reduce its apparent leverage ratio, with the result of making Lehman look less risky than it actually was.[91]

As the examiner pointed out, Repo 105 treatment was entirely artificial. Regardless whether the securities were worth more or less than 105% of the cash received, repos were functionally identical to an ordinary loan, with the securities as collateral. Under ordinary principles of secured transactions, the repos would be characterized as secured transactions.[92] This conclusion can be stated with confidence because American

88. See Valukas Report, supra note 49, at 732–1053. As noted earlier, Ernst & Young has been charged with having known about the Repo 105 transactions and having acquiesced in them. See supra note 49. Press coverage was immediate. See, e.g., Jacob Goldstein, Repo 105: Lehman's 'Accounting Gimmick' Explained, NPR (Mar. 12, 2010, 11:55 AM), http://www.npr.org/blogs/money/2010/03/repo_105_lehmans_accounting_gi.html (on file with the *Columbia Law Review*).

89. See supra text accompanying notes 49–50 (describing use of repos to reduce Lehman's reported debt).

90. See Valukas Report, supra note 49, at 754–57 (discussing Lehman's use of Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 140 ("SFAS 140") to characterize Repo 105 transactions as sales). Repos are ordinarily treated as loans for accounting purposes. But SFAS 140 allows the repo seller to characterize a report as a sale if specified criteria are met. See Fin. Accounting Standards Bd., Statement of Financial Accounting Standards No. 140: Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities ¶ 98 (2000). Lehman's interpretation of this was that a sale characterization would be appropriate if the securities conveyed to the buyer were worth at least 105% of the cash paid by the buyer.

91. According to the Lehman examiner, Lehman used $38.6 billion in Repo 105s in fourth quarter 2007, $49.1 billion in first quarter 2008, and $50.38 billion in second quarter 2008. The transactions reduced its reported leverage from an actual ratio of 17.8 dollars of debt for every dollar of equity to a reported debt-to-equity ratio of 16.1; 17.3 to 15.4; and 13.9 to 12.1 in these three quarters. Valukas Report, supra note 49, at 748.

92. For a nice analysis of this point from early in the evolution of the repo market, see Gary Walters, Note, Repurchase Agreements and the Bankruptcy Code: The Need for Legislative Action, 52 Fordham L. Rev. 828, 838–40 (1984) (noting repo transactions are

commercial law—principally as reflected in the Uniform Commercial Code (U.C.C.)—has a deeply entrenched commitment to piercing through formal labels and defining transactions in terms of their actual form. A key gatekeeping provision of Article 9 explicitly states, for instance, that "a transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract" will be treated as a secured transaction.[93]

To be sure, it is not always obvious whether a transaction that takes on some of the attributes of a loan should be characterized as a secured transaction. In some cases, the drafters of the U.C.C. have simplified the analysis by explicitly defining a transaction that takes the form of a sale as a secured transaction; in other cases, the termination has been left to judicial discretion. Sales of accounts under a "factoring" arrangement are the best known example of the first strategy;[94] and the case law addressing whether a debtor's sale of identified assets (such as credit card receivables or mortgages) as part of a securitization transaction should be deemed a true sale is the most important example of the second.[95]

The "true sale" cases put our analysis of repos into stark relief. The originators' objective in a securitization transaction is to ensure that the sale of assets will be treated as a true sale rather than a secured transaction, and thus is "bankruptcy remote" if the debtor later files for bankruptcy. To achieve this result, the debtor is required to relinquish any

like loans in that buyers generally pay less than securities' market value and sellers usually receive securities' interest or other distributions). The leading article in this area takes the opposite view. See Jeanne L. Schroeder, Repo Madness: The Characterization of Repurchase Agreements Under the Bankruptcy Code and the U.C.C., 46 Syracuse L. Rev. 999, 1018 (1996) [hereinafter Schroeder, Repo Madness] (arguing repos do not qualify as secured transactions since they lack tangible "res"). It may be worth noting, however, that the author, a top commercial law scholar, starts from the premise that the "repo market is simply too enormous and important" to run the risk that repos might be recharacterized as loans, and sets out to find a strong argument for this conclusion. Id. at 1014.

93. U.C.C. § 9-109(a) (2011). In a much discussed recent case, a bankruptcy judge determined that the characterization of repos should turn on the parties' "objective intent," and that this created an issue of material fact, in part because the repo buyer was required to "transfer the same, not merely equivalent, securities." In re Criimi Mae, Inc., 251 B.R. 796, 800–05 (Bankr. D. Md. 2000).

94. Sales of accounts are defined as secured transactions and brought within Article 9 by U.C.C. § 9-109(a)(3).

95. In a securitization, a firm sells accounts receivable or other assets to a new entity created for the purposes of the transaction, often as a means of generating financing for the firm's business. If the transaction is not a "true sale," it could be recharacterized as a secured loan and the assets treated as part of the bankruptcy case if the firm later files for bankruptcy. So long as it is a true sale, on the other hand, the transaction will be "bankruptcy remote." See Kenneth C. Kettering, Securitization and Its Discontents: The Dynamics of Financial Product Development, 29 Cardozo L. Rev. 1553, 1564 (2008) (discussing bankruptcy remote, securitization, and some of the controversy securitization has engendered); see also Edward J. Janger, The Costs of Liquidity Enhancement: Transparency Cost, Risk Alteration and Coordination Problems, 4 Brooklyn J. Corp. Fin. & Com. L. 39, 44 (2010) ("[C]ertainty that the assets have been subject to a true sale has been hard to come by.").

interest in the assets that are sold. Repos, by contrast, have precisely the opposite intent. The parties fully contemplate that the debtor will reacquire the securities used in the repo transaction by tendering the specified price—which is functionally indistinguishable from a loan repayment.[96]

Leases and sale-leaseback arrangements complicate the analysis, but only a little. Although structured as a lease, or as a sale followed by a lease from the buyer back to the seller, these transactions often function like loan transactions. Article 2A of the U.C.C. provides extensive rules for leasing arrangements, but largely leaves the determination of whether the transaction is a "true" lease or a disguised secured loan to judicial decision.[97] Courts have tended to focus on factors such as whether the lessee/debtor is required to make more than a nominal payment if it wishes to purchase the assets at the end of the lease.[98]

Repos are far more like a secured loan than either a securitization or a sale-leaseback transaction. The repo seller is, for instance, fully expected to pay the specified amount and to reacquire the securities that are the subject matter of the transaction. The "haircut"—that is, the difference between the current value of the securities and the amount of credit extended to the debtor—is functionally equivalent to negotiations between a debtor and its lender over the amount of collateral collateralizing a loan. Moreover, if the repo seller fails to perform, and the repo buyer sells the securities, the repo buyer ordinarily must return any excess over the intended repurchase price to the repo seller.[99]

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96. Many of the standard terms of repo contracts underscore this intention. The repo seller, rather than the buyer, is typically entitled to any interest payments or other proceeds of the securities during the pendency of the contract. See, e.g., Jeanne L. Schroeder, A Repo Opera: How *Criimi Mae* Got Repos Backwards, 76 Am. Bankr. L.J. 565, 571 (2002) [hereinafter Schroeder, A Repo Opera] ("[R]epos typically provide that the repo seller is the owner of all interest and other distributions made on the underlying security pending the repurchase."); see also Bond Mkt. Ass'n & Int'l Capital Mkt. Ass'n, Global Master Repurchase Agreement (2000) [hereinafter Global Master Repurchase Agreement], available at http://www.icmagroup.org/ICMAGroup/files/25/25561a36-72bc-439d-8538-039a3a979b03.pdf (on file with the *Columbia Law Review*) (providing standard master agreement for repo transactions based on English law).

97. See, e.g., U.C.C. § 2A-103(1)(j) (defining "lease" as "a transfer of the right to possession and use of goods for a term in return for consideration," but excluding without defining "a sale, including a sale on approval or a sale or return, or retention or creation of a security interest").

98. A nominal repurchase price suggests that the transaction really is a loan. For a survey of cases that had arisen under Article 2A as of the early 1990s, see generally Robert D. Strauss et al., Leases, 47 Bus. Law. 1545 (1992).

99. Repo sellers like Lehman recognize that their repo transactions are loans and regularly treat them as such for accounting purposes. The Lehman examiner highlighted this fact in his criticism of Lehman's Repo 105 transactions. "Like other large investment banks," he reported, "Lehman engaged, on a daily basis, in tens of billions of dollars of repo transactions in its normal course of business for financing purposes." Valukas Report, supra note 49, at 751. In contrast with its Repo 105s, "Lehman accounted for these ordinary repo transactions as financing transactions." Id.

The one feature of many repos that might seem to call the conclusion that they function as secured transactions into question is the repo buyer's option under many repo contracts to return either the original securities or equivalent substitute securities.[100] This makes the ostensible collateral of the transaction more nebulous than with a traditional secured loan.[101] The fungibility concern only applies to repos that do not require return of the original collateral.[102] While the possibility that the repo buyer will return different (though comparable) collateral raises questions about the parties' respective entitlements that we consider in our discussion of rehypothecation below, it does not alter their status as loans rather than sales.

This reasoning reveals a striking irony in Lehman's interpretation of the accounting rule that spawned its Repo 105 transactions. Although repos of all kinds are essentially secured loans, a repo involving securities worth more than 105% of the amount of credit extended looks *even more* like a secured transaction than a sale. This is because the debtor has an even stronger incentive to reacquire the securities if they are much more valuable than the cash advance than if they are worth less. The repo buyer in such a transaction is like a heavily overcollateralized secured creditor. From this perspective, using the requirements of Repo 105 to determine whether a repo is a sale gets things precisely backwards.

2. *Transaction Consistency for Repos.* — If repos were construed as loans by a bankruptcy court and they were subject to the same core bankruptcy rules that apply to other secured transactions, how would they be treated in bankruptcy? The short answer, as will become evident, is that their treatment would change only in limited respects.

The first thing to note, as mentioned earlier, is that repos would be automatically "breached" as of the filing of the petition in bankruptcy, and the claim and the value of the collateral would be determined as of that moment.[103] From that point forward, the debtor would have no fur-

100. See, e.g., Global Master Repurchase Agreement, supra note 96, ¶ 3(f) (requiring return of "equivalent securities" on repurchase date); see also Schroeder, A Repo Opera, supra note 96, at 571 ("[T]he repo buyer . . . is *typically* entitled to deal with the security and is only required to sell back an *equivalent* security.").

101. The absence of clearly identifiable collateral is the central plank in Jeanne Schroeder's argument that repos are best treated as sales rather than secured loans. See Schroeder, Repo Madness, supra note; see also supra note 92 (discussing Schroeder's argument and counterarguments).

102. See, e.g., In re Criimi Mae, Inc., 251 B.R. 796, 803–04 (Bankr. D. Md. 2000) (finding ambiguity as to whether repo at issue was sale or secured transaction, and emphasizing requirement that specific collateral be returned weighed in favor of treating it as secured transaction).

103. Kimberly Summe has argued that repos and derivatives would present insoluble valuation issues. Kimberly Anne Summe, Lessons Learned from the Lehman Bankruptcy, *in* Ending Government Bailouts as We Know Them 59, 94 (Kenneth E. Scott, George P. Shultz & John B. Taylor eds., 2010) ("Complex derivatives such as credit default swaps on asset-backed securities or collateralized debt obligations presented a major challenge for valuation when markets began to fall apart."). This, however, is a necessary part of *any*

ther obligation to post collateral, but would need to provide adequate protection for the collateral's value as of the filing of the petition.[104] The counterparty could exercise recoupment rights, and would have rights of setoff, although it would need relief from the automatic stay in order to exercise the statutorily recognized setoff right.[105]

With the possible exception of requiring the counterparty to gain court permission before exercising its setoff rights, we find this treatment unexceptional. To the extent the collateral was insufficient, the counterparty would be unsecured and would need to stand in line with other unsecured creditors. The essential point is that the counterparty knows its situation as of the moment of bankruptcy and can proceed accordingly.

We do think that, to the extent the repo buyer (or its agent) is in possession of collateral, it should be able to quickly realize on this collateral. In most cases, the collateral is either cash or cash-like, highly liquid, assets.[106] In those cases, there are few, if any, reasons for delay. Valuation disputes are minimal to nonexistent when the collateral is cash or cash-like, and there is nothing "firm-specific" about the collateral, meaning that the ordinary justification for the automatic stay as applied to secured creditors simply does not exist.[107] Indeed, if done as a matter of recoup-

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termination; Summe suggests it is a reason to reconsider whether complex derivatives are suitable for a mark-to-market model. Id.

104. See 11 U.S.C. §§ 361, 362(d)(1) (2006) (stating what constitutes adequate protection and when it is required).

105. See id. § 362(a)(7) (providing that filing of petition operates as stay of "the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor"). The right of setoff is expressly recognized and is generally treated as the equivalent of a secured claim that existed at the time of the filing of the bankruptcy petition. Id. § 553. If the off-set arises out of the same transaction, it has been considered a "recoupment," not a "setoff," and is thus not subject to § 553 or § 362(a)(7). See In re Holyoke Nursing Home, Inc., 372 F.3d 1, 4 (1st Cir. 2004) (holding transaction was recoupment rather than setoff and "[a]s such, it was neither a voidable preference nor a violation of the automatic stay").

106. This is particularly so in the wake of the 2008 crisis, which has prompted a shift back to cash-like collateral for derivatives and sharply diminished repos based on mortgage-backed securities and other less liquidate collateral. See, e.g., Adam Copeland, Antoine Martin & Michael Walker, The Tri-Party Repo Market Before the 2010 Reforms 46 (Fed. Reserve Bank of N.Y. Staff Reports, Staff Report No. 477, Nov. 2010), available at http://www.ny.frb.org/research/staff_reports/sr477.pdf (on file with the *Columbia Law Review*) ("The composition of assets used as collateral has changed somewhat, with more liquid collateral being substituted for less liquid collateral. The amount of Non Fed-eligible collateral more than halved between July 2008 and July 2009, falling from $600 billion to less than $300 billion . . . .").

107. The debtor's need for liquidity, particularly acute for a financial institution that hopes to reorganize, does not undermine this conclusion. This is so because liquidity needs do not make cash or cash-like collateral "firm-specific." Rather, liquidity needs should be addressed through debtor-in-possession financing. While not the subject of this Essay, both authors are participants in (and Jackson is principal drafter for) a Hoover Institution working group that has formed a proposal for the bankruptcies of the largest financial institutions. Included in that proposal are various modifications to bankruptcy's

ment—that is, closing out on a single repo contract itself—the Bankruptcy Code would allow the counterparty to proceed without first going to court.[108] For repo creditors that do not have a right of recoupment, an exception could be created for such contracts from first needing court permission to sell cash and cash-like collateral in its possession or there could be a presumption of a quick determination upon a motion being made. In either case, the "exceptions," if such they are, to current bankruptcy rules are, at most, minor.[109]

If this analysis is correct, it suggests that the pernicious effects of the Bankruptcy Code's special treatment of repos are subtler than many suggest. The special treatment did not radically alter a repo lender's incentive to monitor the debtor, for instance.[110] In the Bear Stearns and Lehman debacles, repo lenders (unlike swaps counterparties, as shown above) monitored aggressively and indeed took advantage of their special status.

But the special treatment did encourage excessive use of repos, rather than more traditional forms of secured finance, in several ways. First, the special treatment of repos eliminated delays in exiting the corresponding contract, thus enhancing the attractiveness of repos for fi-

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standard rules and procedures for debtor-in-possession financing for such institutions. See Thomas H. Jackson et al., Resolution of Failed Financial Institutions: Orderly Liquidation Authority and a New Chapter 14 (April 25, 2011) [hereinafter Jackson, et. al., Chapter 14 Proposal] (unpublished manuscript), available at http://media.hoover.org/sites/default/files/documents/Resolution-Project-Booklet-4-11.pdf (on file with the *Columbia Law Review*). Requiring a counterparty in possession of cash or cash-like collateral to turn it over to the debtor is, as a matter of both principle and existing procedures, extremely dubious as a source of liquidity. A hearing would be necessary prior to transfer under § 542(e) and/or before the collateral could be used by the debtor per § 363(a) and (c)(2). 11 U.S.C. §§ 363(a), 363(c)(2), 542(e). Moreover, upon turn-over, the counterparty would have to be given adequate protection, id. § 361, which effectively is the requirement for senior-most debtor-in-possession financing. Id. § 364(d). In every other situation, such financing can only be used if "the trustee is unable to obtain such credit otherwise." Id. § 364(d)(1)(A). For these reasons, liquidity needs of financial institutions are not a reason to deviate from the idea that cash and cash-like collateral in the possession of a counterparty should not be subject to the automatic stay.

108. For a discussion on recoupment doctrine and its implications for repos and derivatives below, see infra notes 150–154 and accompanying text.

109. For a discussion of the application of preference law and other trustee avoidance powers, see infra Part II.E. It is worth noting that the prices even of cash-like collateral may be volatile under extraordinary market conditions, as with some Treasury bonds in 2008. See, e.g., Stan Luxenberg, After a Rollercoaster Year, Are TIPS Attractive?, Registered Rep. (Apr. 5, 2010, 3:31 PM), http://registeredrep.com/investing/fixedincome/tips_little_inlation_yet0403/ (on file with the *Columbia Law Review*) (describing volatility of Treasury Inflation-Protected Securities). This still would not call for a stay, however, because the value at any given time still is less likely to be subject to uncertainty than with more opaque or firm-specific collateral.

110. We thus part ways with the analysis of Mark Roe, whose fine article we are otherwise in full accord with, on this point. See Roe, supra note 47, at 541 (arguing special treatment reduced incentive of repo lender to monitor debtor).

nancing as compared to less volatile sources of funding.[111] Second, the special treatment in bankruptcy may have invited the characterization of repos as sales for purposes such as Lehman's Repo 105 transactions.[112] Third, although not directly linked to their special status in bankruptcy, repos enjoy automatic perfection, which removes the transaction costs of perfecting an ordinary secured loan.[113]

Reversing the special treatment of repos would reduce these distortions without dramatically changing the practical status of repos in bankruptcy.[114] To be sure, even a small change may have costs.[115] For example, the marginal reductions in benefits could induce repo lenders to insist on larger haircuts. Moreover, even a tiny difference in a repo lender's ability to exercise its rights and sell its collateral in bankruptcy could increase the risk of runs on a financially precarious repo debtor prior to bankruptcy.[116]

In our view, each of these costs would be well addressed by our proposal to exempt repos that are collateralized by cash or cash-like securities from the automatic stay. Allowing the lender to assert immediate control over cash collateral would protect the most important class of repos without jeopardizing collateral that the debtor needs for the Chapter 11 process. Although repos collateralized by other, more opaque, forms of collateral, and thus subject to a stay, could become more costly, and some current lenders might be less able to participate in these transactions,[117] these effects are altogether appropriate given the risks posed by these repos and the benefits of a stay.[118]

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111. See supra notes 34–38, 41–42 and accompanying text (discussing motives for special treatment, including elimination of delay).

112. See supra notes 48–52 and accompanying text (examining Lehman's 105 transactions).

113. Where a repo is recharacterized as a secured transaction, as we argue it should be, U.C.C. § 9-309(10) provides automatic perfection. See U.C.C. § 9-309(10) (2011).

114. It would not alter the ease of perfecting the security interest, because U.C.C. § 9-309(10) would continue to provide automatic perfection. For an argument that repos should be subject to a filing requirement if their special bankruptcy treatment is retained, see Enrico Perotti, Systemic Liquidity Risk and Bankruptcy Exceptions 4 (Ctr. for Econ. Policy Research, Policy Insight No. 52, 2010), available at www.cepr.org/pubs/policyinsights/policyInsight52.pdf (on file with the *Columbia Law Review*).

115. As our friend and colleague Darrell Duffie has repeatedly reminded us.

116. See supra note 68 and accompanying text (presenting this argument).

117. Money market funds, for instance, are limited to investments that can be liquidated quickly. See generally Adam Copeland, Darrell Duffie, Antoine Martin & Susan McLaughlin, Policy Issues in the Design of Tri-Party Repo Markets 20 (Hoover Inst., Working Paper No. 55, Jul. 2011), available at http://www.darrellduffie.com/uploads/working/CopelandDuffieMartinMcLaughlin_Working_July%2023_2011.pdf (on file with the *Columbia Law Review*) (noting "revisions of Rule 2a7 of the Investment Company Act, designed to lower risks to money market funds, push those funds into shorter-term assets").

118. The proposal outlined in the text could easily be coordinated with Acharya and Oncu's recent proposal to establish a resolution authority for repos that are collateralized by opaque collateral. Viral V. Acharya & T. Sabri Oncu, The Repurchase Agreement

3. *Rehypothecation.* — Rather than simply hold or control the securities it receives in a repo transaction, the repo buyer frequently employs them in additional transactions. This widespread practice—which is the rehypothecation referred to in the last section—adds a further wrinkle to the treatment of repo (and derivatives) transactions in bankruptcy.[119]

One might plausibly conclude that rehypothecation—or even the right of rehypothecation, whether or not it is exercised—transforms a repo from a lending transaction to a sale. In our view, however, jumping to this conclusion misconstrues the nature of the underlying transaction. Even if the securities are rehypothecated, the transaction is still fundamentally a loan. While most secured transactions involve identifiable collateral that does not shift form, not all do. The collateral in an inventory loan is continuously shifting, for instance, and there is no limit on the number of subsequent parties who can take a property interest in the collateral in an ordinary loan.[120]

This last point presents the real issue with rehypothecation. The question is not whether rehypothecated securities cease to be loans. The real issue is the parties' respective entitlements if one or more fails to perform. If the debtor (the repo seller) consents to rehypothecation, it essentially relinquishes any rights against a subsequent buyer or recipient of a security interest in the securities from the lender (repo buyer), but the transaction is no less a loan. The conclusion that the debtor's only recourse is against its lender, the original buyer, under these circumstances is in fact entirely consistent with the current rules in Articles 8 and 9.[121] It is confusing only because of the multiple departures from transaction consistency in the characterization and treatment of repos.

C. *How Would (and Should) Swaps and Other Derivatives Be Treated?*

Because of the range of functions they serve, the treatment of swaps under core bankruptcy principles would be more variegated than with repos. While most swaps would be characterized as ordinary executory

(Repo) Market, *in* Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance 319, 345–46 (Viral V. Acharya, Thomas F. Cooley, Matthew P. Richardson & Ingo Walter eds., 2010). Under their proposal, a new authority would make initial payments to a debtor's repo counterparties and would subsequently liquidate the collateral. Id. A stay on seizing or selling the collateral would facilitate this process.

119. For an in-depth description of rehypothecation as well as an account of the historical context and an analysis of current patterns, see generally Kenneth C. Kettering, Repledge Deconstructed, 61 U. Pitt. L. Rev. 45 (1999).

120. See, e.g., Schroeder, Repo Madness, supra note 92, at 1023 (using security interest in grain in which secured creditor is not required to give back grain as example of inventory loan). A standard repo contract with fungible securities—such as treasury bonds—is quite similar.

121. See U.C.C. §§ 8-502, 8-510(a) (2011); see also Christian A. Johnson, Derivatives and Rehypothecation Failure: It's 3:00 PM, Do You Know Where Your Collateral Is?, 39 Ariz. L. Rev. 949, 980 (1997) (concluding any party that expressly permits rehypothecation "has in substance subordinated its rights in the posted collateral to the third party").

contracts, swaps are also used for financing and different kinds of insurance purposes (in the latter case they would be insurance-like executory contracts in our typology).

Start with the use of swaps for financing, which is the least intuitive, least common, and most easily dealt with function of swaps. Although swaps are not ordinarily envisioned as financing instruments, they have this purpose in some transactions. Consider an unlikely swaps borrower: Italy. To spruce up its balance sheet as it prepared to join the European Union, Italy entered into a massive swap transaction with J.P. Morgan Chase.[122] In form, the contract was a standard swap based on the relationship between the value of the lira and the London Interbank Offered Rate (LIBOR).[123] By undervaluing the lira by 44%, however, the parties transformed it into a loan that Italy would be required to pay at the end of the contract term.[124]

While the size and purpose of the transaction were extraordinary, lenders also sometimes use swaps for more ordinary purposes. Contracts taking this form would be construed as "financial accommodations" in bankruptcy, and thus would be subject to the same treatment as repos.[125] Like repos and other loans, they would be automatically terminated when the debtor filed for bankruptcy, and the debtor would not be permitted to assume the contract. Our proposed amendment to this treatment also would stand for loan-like swaps. The automatic stay should apply to most collateral, but it should not interfere with sales of cash or cash-like collateral by the debtor's counterparty.

Most swaps would fall into the second category. Because they entail ongoing obligations by both sides, even the most exotic swap is simply an ordinary executory contract for bankruptcy purposes. The most troublesome feature of this result is that, as noted earlier, it may give a debtor time to speculate without consequence (if the hedge turns out to be "in the money," the debtor assumes; if the hedge turns out to be a bad deal, the debtor rejects).[126] As the discussion on netting and setoff below indicates, the risk of strategic assume-or-reject decisions is mitigated consider-

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122. See, e.g., Benn Steil, Op-Ed., Enron and Italy: Parallels Between Rome's Efforts to Qualify for Euro Entry and the Financial Chicanery in Texas, Council on Foreign Relations (Feb. 21, 2002), http://www.cfr.org/italy/enron-italy-parallels-between-romes-efforts-qualify-euro-entry-financial-chicanery-texas/p4455 (on file with the *Columbia Law Review*) (describing transaction and comparing it to transactions used by Enron).

123. The London Interbank Offered Rate is the interest rate at which banks lend to one another.

124. There obviously was no guaranty that the swap would retain its value for J.P. Morgan, given the inevitable fluctuations in the value of the lira and LIBOR. But J.P. Morgan could lock in the value by hedging against the fluctuations if it wished to protect itself.

125. 11 U.S.C. § 365(c)(2) (2006).

126. See supra text accompanying note 21 (noting "debtor's ability to pick the good swaps and abandon the bad ones").

ably if the debtor and its counterparty have a master netting agreement, as they often will. But it does not disappear.[127]

While strategic use of the debtor's executory contract powers is a conceptual concern with *all* classic executory contracts, it may have particular bite in transactions that are themselves designed, explicitly, as hedges rather than as the buying and selling of a good. The Bankruptcy Code is not wholly consistent in how it currently treats this concern with respect to executory contracts in other contexts. For example, much of the undesirable nature of the delay option is mitigated by a requirement of compliance with the terms of the lease prior to assumption or rejection, and § 365(d) sets time limits on the debtor's decision in cases of unexpired leases of nonresidential real property where the debtor is the lessee.[128] But the debtor does have considerable flexibility whether and when to assume or reject. Given the likely reality that the parties to swaps and derivatives are sophisticated players, and particularly with an assumption of court expertise, a short period in which to assume or reject is desirable. Whether it needs to be mandated in the Bankruptcy Code or left to court decisions based on the request of a counterparty—but with a presumption that the period should not be long—is an issue discussed below.

There are arguments that derivatives, unlike repos, have special reasons to be exempted from the automatic stay—in the sense of allowing the counterparty to terminate without waiting for an assumption or rejection decision of the debtor. Thus, in the words of one leading expert:

> The application of an automatic stay, while appearing to preserve the value of the "assets" of the failing entity, may be illusory as it relates to derivatives since derivative transactions and the collateral associated with those transactions are not really assets in the traditional sense, and the preservation of value may rapidly change, particularly in a distressed market. . . . Highly liquid derivative transactions, such as interest rate and foreign exchange derivatives (which constitute 80 percent of the $600 trillion notional value over-the-counter derivative market), were terminated by many of Lehman Brothers' counterparties after the investment bank's failure, allowing those counterparties to reduce potential losses by entering into replacement transactions. The loss of an ability to hedge one's trading book because of the application of a stay would result in significant losses for qualified financial contract counterparties, causing a catastrophic decline in the activities of the financial markets.[129]

These arguments, however, have several weaknesses. First, derivatives certainly *can* have significant value—and hence are "assets"—of the

127. See infra Part II.D.

128. See 11 U.S.C. § 365(d)(4) (setting time limit to 120 days). There are also time limits for such a decision on residential real property or personal property in Chapter 7. Id. § 365(d)(1).

129. Summe, supra note 103, at 82 (footnote omitted).

debtor (precisely the reason behind permitting an assumption or rejection decision in the first place); the fact that their value may change rapidly is a feature, not a reason to distinguish them from "assets in the traditional sense."[130] Second, an argument about the inability of a counterparty to hedge its books during the period before the debtor decides to assume or reject, even if true,[131] would have significant force only if there were systemic concerns, and thus would essentially focus on systemically important debtors, not all debtors. Third, even in these cases, some of these consequences might be mitigated either through the creative entering into of replacement transactions (themselves hedged) or requests for a strict timetable on the assumption or rejection decision.[132] Finally, if the swap is collateralized, the counterparty most likely would be entitled to payments to the extent the collateral declined in value after the bankruptcy petition was filed, as noted earlier.[133]

Still another argument for forgoing a stay centers on the "runability" of swaps. If swap counterparties anticipate being treated less favorably inside than outside of bankruptcy, the reasoning goes, they will run as soon as they detect the prospect of bankruptcy. The counterparty to a swap may not seem to have as great a capacity to run as a bank depositor; a swap counterparty cannot simply cancel its contract and grab whatever it is owed at any time, any more than a bondholder or other creditor can. But the structure of the derivatives market makes it easy for counterparties to achieve the same effect. Suppose, for instance, that Bank of America (BOA) and Goldman Sachs have a currency swap that requires Bank of America to deliver \$1.3 million and Goldman to deliver €1 million in six months. If it catches wind of a possible BOA bankruptcy, Goldman could ask BOA to enter into a second, offsetting swap that calls for BOA to deliver €1 million and Goldman \$1.3 million on the same date as the original contract. Alternatively, and perhaps more likely,

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130. It is the case that interest rate swaps are, in fact, diminished in importance in bankruptcy, since (for the most part) debtors do not make interest payments, on prepetition debt at least, during the bankruptcy case. Ayotte & Skeel, Bailouts, supra note 68, at 496 n.136. Even so, to the extent they have value, because of a hedge that is "in the money," it is an element bargained for by the debtor, and hence, analytically, a proper asset of the estate.

131. Given that the original derivatives contract was a hedge, the probability (or risk) of an assumption or rejection would logically be directly related to the relative values of the currencies, interest rates, or other underlying factor on which the original derivatives contract was based. Because of that direct correlation, it would seem entirely possible to hedge against the possibility of either assumption or rejection (or both).

132. The counterparty can minimize risk by "limiting its exposure to any given debtor, . . . and . . . sell[ing] a duplicative hedge to a third party. Moreover, the uncertainty could be reduced under a rule that required the debtor to make prompt decisions on assumption, much as bank regulators do in a bank insolvency." Skeel, Bankruptcy, supra note 63, at 17–18 n.84.

133. See supra note 75 and accompanying text (describing protection given to secured creditors after bankruptcy filing against any diminution in value of collateral during subsequent bankruptcy proceedings).

Goldman could enter into the second swap with another, healthier counterparty. Either way, the second swap would eliminate its exposure to BOA. Widespread exit could cripple a financial institution that is not in fact insolvent, much as a bank run can cripple an otherwise healthy bank.

As noted earlier, we believe that the risk of runs is indeed the most serious concern with transaction consistency for financial contracts.[134] But here, too, the concerns do not seem great enough to justify complete insulation from core bankruptcy principles. A swap counterparty can protect itself and diminish its subsequent need to run by the expedient of requiring adequate margin or collateral for the transaction, for instance.[135] As discussed below, the percentage of adequately collateralized swaps should rise sharply when the clearinghouse requirements of the new reform legislation are fully implemented.[136] Moreover, for swaps counterparties that are not adequately collateralized, the special treatment may prevent one kind of run—mass exit from contracts before bankruptcy—but increases the risk of other kinds of runs. If large numbers of counterparties demand collateral at the same time, for instance, a debtor's liquidity may quickly dry up, as AIG found when Goldman and other banks ratcheted up their collateral demands. If the debtor did in fact file for bankruptcy, the filing could trigger massive, simultaneous cancellations of contracts and fire sales of the collateral securing the contracts.[137]

While the case for the current, blunderbuss elimination of the stay and other core bankruptcy policies is thus unpersuasive, the distinctive characteristics of swaps and other financial contracts do justify a more truncated automatic stay. The new reform legislation includes a one-plus day halt on termination (which will function similarly to a stay in this context) in resolution proceedings.[138] We believe that a similarly truncated stay—we would propose three business days—should be workable in bankruptcy even in complex cases.[139] Although some might argue that

134. See supra notes 68–69, 116 and accompanying text.

135. Although this would be difficult if there were a long stay, because a counterparty's collateral would need to cover potentially large post-bankruptcy shifts in the values of the contracts, it is less problematic if the stay is short.

136. See infra Part III.A.

137. See, e.g., Ayotte & Skeel, Bailouts, supra note 68, at 494–95 (discussing potential consequences of bankruptcy filing).

138. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 210(c)(10)(B)(i)(I), 124 Stat. 1376, 1491 (2010) (to be codified at 12 U.S.C. § 5390).

139. A proposal drafted by one of us (Jackson) for a working group coordinated by the Hoover Institution calls for a similar three-day stay. See Jackson et al., Chapter 14 Proposal, supra note 107, at 2–27. In addition to its temporary restriction on ipso facto clauses, the Dodd-Frank Act also invalidates "walkaway" clauses that permit a counterparty to cancel a contract without making any payment to the debtor, even if the debtor is in the money. Dodd-Frank Act § 210(c)(8)(F), 124 Stat. at 1488 (to be codified at 12 U.S.C. § 5390). Walkaway clauses should also be invalidated in bankruptcy.

three days is not enough time, it is important to recognize that the managers of a troubled financial institution will not begin thinking about which swaps to assume and which to reject for the first time the day they file for bankruptcy. Knowing that they only have three days to work with, a debtor's managers will have an incentive to plot their executory contract decisions long before they actually file. Moreover, the Dodd-Frank Act's requirement that systemically important financial institutions prepare wind-down plans on a regular basis, even while they are healthy, will aid in the ability to sort out quickly which swaps to assume, as will the increased transparency the new regulation should bring to the derivatives markets.[140]

To summarize, the treatment of swaps under ordinary bankruptcy principles would prove more complex than with repos. Swaps fall into all three categories of bankruptcy contracts, and only the first—swaps that function as loans—would be automatically terminated and accelerated. Counterparties to other swaps would be subject to the automatic stay. The value of their collateral would, however, be protected, and they would be compensated for the value of the insurance provided while the stay was in place.

D. *Setoffs, Recoupment, and Netting*

Thus far, we have treated derivatives and repos as isolated contracts that the debtor is entitled to assume or reject on a contract-by-contract basis. While contracts between a dealer bank and an end user—a business that that uses derivatives for hedging—often take this form, the dealer banks that dominate the derivatives market have numerous transactions with one another.[141] These contracts are generally coordinated under a master agreement based on the standardized International Swaps and Derivatives Association (ISDA) master agreement.[142] Under current practice, which ISDA has successfully persuaded the U.S. and many other nations to enshrine in law, the parties are authorized to close out and net all

140. See Dodd-Frank Act § 165(d), 124 Stat. at 1426–27 (to be codified at 12 U.S.C. § 5365) (requiring wind-down plans). As explored below, Dodd-Frank also pushes towards a regime in which most swaps would be traded on an exchange or "swap execution facility" and cleared on a clearinghouse. See infra notes 168–180 and accompanying text. Such a move would almost certainly permit rapid valuations of swaps, again facilitating the ability to make decisions regarding such swaps within a three-day stay period.

141. See, e.g., Duffie, Failure Mechanics, supra note 53, at 57–58 (noting that both parties to over-the-counter derivatives are frequently dealers).

142. ISDA is the principal trade and lobbying group for the derivatives industry. See ISDA, http://www.isda.org (last visited Oct. 9, 2011). It supplies the standard form contracts that are used (as customized by the parties) in most derivatives transactions. For an example of a master agreement, see ISDA Master Agreement and Schedule Between Comerica Bank and Rackspace US, Inc. dated Sept. 26, 2007, Exhibit 10.32, *in* Rackspace, Inc. Registration Statement (Form S-1) (Apr. 25, 2008), available at http://www.sec.gov/Archives/edgar/data/1107694/000119312508091225/dex1032.htm (on file with the *Columbia Law Review*).

of the contracts, not just an individual contract, in the event of a default.[143]

The derivatives industry has touted netting as a signal benefit of existing practice, dramatically reducing exposure and as a result increasing the potential scope of derivatives trading.[144] Although netting did not figure prominently in the early arguments for special treatment, the industry has increasingly pointed to netting as a reason why the current bankruptcy exclusions need to be protected. The loss of netting rights in the event derivatives were subject to a stay in bankruptcy and the debtor's ability to "cherry pick" among its contracts, the reasoning goes, would radically increase the riskiness of derivatives and force a constriction of the size of the derivatives markets.[145]

Once again, it is important to understand precisely how transaction consistency would and would not affect the treatment of derivatives. Before turning to this analysis, we note in passing that one could question whether continued expansion of the derivatives market, which the industry treats as irrefutably desirable, is necessarily a good thing. In the aftermath of the crisis, evidence has mounted that the financial sector may have grown to too great a portion of the economy during the period of derivatives expansion.[146] Like the advocates of preserving special status for derivatives, however, we agree that a return to transaction consistency would be problematic if it destroyed all of the benefits of netting.

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143. See, e.g., 11 U.S.C. § 101(53B) (2006) (defining "swap agreement" to include a master agreement); id. § 560 (exempting netting under swap agreement); id. § 561 (exempting netting across multiple swap and other financial market contracts and master agreements).

144. Netting is the practice of offsetting cross-cutting obligations. If counterparty owes debtor $50 on one derivative, for instance, while debtor owes counterparty $30 on another derivative, counterparty's "net" obligation to debtor is $20. If netting is not permitted, on the other hand, the parties' combined exposure would be $80. Netting can be seen as significantly reducing overall exposure, and as a result overall risk, in the derivatives markets. ISDA has warned that removing the special provisions protecting netting rights in bankruptcy could have dire effects. See David Mengle, The Importance of Close-Out Netting 6–7 (ISDA Research Notes No. 1, 2010), available at http://www2.isda.org/attachment/MTY4MQ==/Netting-ISDAResearchNotes-1-2010.pdf (on file with the *Columbia Law Review*) (arguing unenforceability of netting will result in increased credit exposure, shortfalls of collateral and capital, increased risk and uncertainty, and inability to hedge). For a more equivocal assessment of the impact of netting, see Robert R. Bliss & George G. Kaufman, Derivatives and Systemic Risk: Netting, Collateral, and Closeout, 2 J. Fin. Stability 55, 56 (2006) ("[I]t is not clear whether the netting and collateral provisions when combined with closeout . . . decreases the potential for economic damage, as is generally claimed in previous work, or indeed increases the risk.").

145. See Mengle, supra note 144, at 3–4 (describing how netting avoids "unwanted exposure to . . . market risk" and noting "trillions of dollars of derivative notional amounts outstanding are largely the result" of netting).

146. See, e.g., Patrick Bolton, Tano Santos & Jose A. Scheinkman, Is the Financial Sector Too Big? 1–2 (Sept. 8, 2010) (unpublished manuscript) (on file with the *Columbia Law Review*) (modeling factors that can produce excessive development of financial sector).

In reality, it would not. The key bankruptcy doctrines here are creditors' rights of setoff and recoupment. Under bankruptcy's setoff provision, a creditor is entitled to offset mutual obligations that it and the debtor owe to one another.[147] Because many, and perhaps all, of the obligations under a master agreement would be treated as mutual obligations, the debtor would not be able to pick and choose which derivatives to assume. The debtor would be required to either assume or reject all of the derivatives in a single master agreement.[148] The cherry picking fear is thus misguided as it relates to a single master agreement.

The principal difference between the current treatment of the contracts in a master agreement, on the one hand, and transaction consistency, on the other, is that a creditor cannot invoke ordinary setoff rights unilaterally, and the creditor would be subject to the debtor's ability to assume all of the contracts if the debtor wishes to keep them in place. Setoff is subject to the automatic stay, and is not permitted until the bankruptcy judge authorizes it.[149] Under our proposed treatment of derivatives, this means that the counterparty's ability to set off the contracts in its master agreement would be delayed for up to three days. In our view, this is a sensible compromise between immediate setoff—or netting, in industry terminology—and the interest in facilitating an effective restructuring.

In some contexts, another key doctrine—recoupment—would enable derivatives counterparties to avoid even this limited delay. Recoupment is similar to a setoff, but a nondebtor with recoupment rights can exercise the rights immediately, without interference from the automatic stay.[150] The key to recoupment is that it is available only when the nondebtor and debtor have claims against one another that arise out of the same transaction. In the classic recoupment case, the nondebtor withholds excess payments that the debtor has previously made under a supply contract, and uses them to offset the debtor's next batch of obliga-

147. See 11 U.S.C. § 553(a).

148. The Dodd-Frank Act's resolution regime takes this principle still further, requiring that the FDIC either assume or reject all of its derivatives with a single counterparty, regardless of whether they are part of a single master agreement. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 210(c)(9), 124 Stat. 1376, 1489–90 (2010) (to be codified at 12 U.S.C. § 5390).

149. 11 U.S.C. § 362(a)(7) (providing that stay applies to setoffs of any debt owing to debtor that arose before commencement of case against any claim against debtor).

150. Recoupment is treated as an "equitable exception" to the automatic stay. See, e.g., Thompson v. Bd. of Trs. of the Fairfax Cnty. Police Officers Ret. Sys. (In re Thompson), 182 B.R. 140, 146 (Bankr. E.D. Va. 1995) (explaining rationale and scope of automatic stay doctrine).

tions under the contract.[151] Because the claims are so closely connected, the nondebtor is entitled to exercise recoupment rights.[152]

Any derivative or repo in which the parties owe cross-cutting obligations to one another would be a candidate for recoupment. If the debtor had made margin payments to the nondebtor under a swap, for instance, and values shifted so that the nondebtor had liability under the swap, recoupment would enable the nondebtor to use the excess margin to offset its obligations to the debtor.[153]

If a master agreement is treated as a single contract, recoupment could even apply to all of the obligations in the agreement. Although one line of cases has defined the mutuality requirement quite restrictively, the transactions in a single master agreement will often be so closely related that they should, in our view, be subject to recoupment rights.[154] This would not give the nondebtor the right to immediately terminate all of the derivatives in a master agreement. However, the nondebtor could use its recoupment rights to offset any claims pressed by the debtor (such as requests for margin payments) during the period before the debtor made its decision whether to assume or reject.

In our view, the existing bankruptcy rules described above need only be adjusted in one significant way. Under the analysis presented thus far, a master agreement that included both derivatives and repos, as many do, would automatically be terminated, because repos could not be assumed. In theory, the parties could solve this problem by separating their derivatives contracts from their repos. But the leading dealers might continue to mix the treatment, either because they do not anticipate bankruptcy or in a deliberate effort to limit the benefits of bankruptcy. To prevent the artificial termination of all of the contracts in a master agreement due to the presence of a repo, we recommend that lawmakers amend the executory contract provision to make clear that termination or acceleration of

151. In Ashland Petroleum Co. v. Appel (In re B&L Oil Co.), 782 F.2d 155 (10th Cir. 1986), a leading recoupment case, B&L Oil executed an oil division order in favor of Ashland Petroleum which granted Ashland the right to purchase oil from B&L. On two occasions Ashland overpaid B&L for the oil. Id. at 156. B&L subsequently filed for Chapter 11 bankruptcy. Id. After filing, Ashland withheld money from payments owed to B&L for subsequent oil deliveries in order to recoup Ashland's pre-petition overpayments. Id. The Tenth Circuit found that recoupment did apply in this instance because the order was a single contract and the overpayments were analogous to advances and overpayments in other cases where application of the doctrine was upheld. Id. at 158–59.

152. Id. at 157 (noting availability of recoupment when debtor and creditor's claims arise from same transaction).

153. For an argument that the nondebtor should have a right of setoff under similar circumstances, see Johnson, supra note 121, at 986 ("[P]ermitting a pledgor to setoff its payment obligation against posted collateral would appear to limit the systemic risk that concerned Congress in the event of the bankruptcy of the secured party.").

154. See, e.g., Tavenner v. United States (In re Vance), 298 B.R. 262, 267–68 (Bankr. E.D. Va. 2003) (describing comparatively capacious "logical relationship" test, and contrasting more restrictive approach requiring that obligations must arise out of "single integrated transaction").

a repo does not preclude assumption by the debtor of other, related contracts.[155]

Overall, then, concerns about the effect of transaction consistency are significantly overstated. With the limited exceptions we have noted, existing bankruptcy rules accommodate the concerns that transaction consistency would undermine the benefits of netting that are available under existing law.

E. *Preference and Fraudulent Conveyance*

In addition to insulation from the automatic stay, the other major protection for derivatives and repos in bankruptcy is that they are excluded from bankruptcy's preference and fraudulent conveyance provisions. With ordinary creditors, if an insolvent debtor makes payments or transfers collateral within ninety days of bankruptcy, the transfer can be avoided (and the creditor required to give the value back) as a preference.[156] Similarly, if an insolvent debtor enters into a transaction for which it does not receive reasonably equivalent value, the transaction can be reversed as a fraudulent conveyance.[157] These rules are waived off for repos, derivatives, and other financial contracts.[158]

Once again, the industry concerns that are used to justify this exclusion are not nearly so serious as is generally assumed.[159] Even the legiti-

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155. One final adjustment: As noted earlier, we also would include language making clear that "walkaway" clauses are not enforceable in bankruptcy, just as they are invalidated in the new Dodd-Frank resolution regime. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 210(c)(8)(F), 124 Stat. 1376, 1488, (2010) (to be codified at 12 U.S.C. § 5390).

156. 11 U.S.C. § 547(b) (2006).

157. Id. § 548(a)(1)(B).

158. Id. § 546(e)–(g).

159. ISDA justifies this exception from preference law as follows:

> This provision enables market participants to continue to trade with weakening parties immediately prior to any bankruptcy filing (subject to prohibitions against intentionally fraudulent transactions), so as to allow those weakening parties continued access to market accommodations that might help them survive. Without these safe harbor protections, market participants would be extremely reluctant to enter transactions with a weakening party in order to avoid receiving payments or taking collateral within the Code's suspect time periods relating to preferences and fraudulent conveyances.

Int'l Swaps & Derivatives Ass'n, Bankruptcy Code Swap Safe Harbor Overview 3 (2010) (on file with the *Columbia Law Review*). This argument, note, does not apply to *new* transactions with "weakening parties" within the preference period (as such new transactions would be for new value). Rather, the argument suggests that, prior to the preference period, such contracts will not be entered into as frequently because of the preference risk. Putting aside that this does not distinguish these transactions from any other transactions (all of which are subject to preference risk), the argument ultimately depends on the assumption that "continued access to market accommodations" of "weakening parties" is a good thing. We believe a strong counterargument—that weakening parties should be resolved and financial players with the greatest expertise and monitoring ability are in the best position to stop inevitable delay—is as or more plausible. In any event, the ISDA argument runs counter to the overarching policy of preference law.

mate worry of derivatives participants about the ongoing adjustments they make to the margin or collateral put up in connection with the contract being caught in a preference snare does not justify the current regime of wholesale exclusion of derivatives from preference law. With the swap described earlier, for instance, in which Bank of America promised to pay $1.3 million in return for €1 million from Goldman Sachs in six months, the parties ordinarily would adjust their margin on a daily basis.[160] If the value of the dollar increased, Bank of America would augment its margin, as would Goldman if the euro went up. If preference law applied and Bank of America filed for bankruptcy, each of the margin payments made or additional collateral posted by Bank of America during the ninety days before bankruptcy might be challenged as preferential. Not only would sorting out the sequence of transfers be mind-numbingly difficult, advocates of special treatment argue, but the payments really are not preferential at all. They are simply ordinary adjustments, rather than special treatment.

If one focuses on these ordinary adjustments and sets to one side predefault grabs like Goldman's demands for collateral as AIG wobbled, this argument is compelling. But the plight of derivatives counterparties is not unique. Other credit arrangements have raised very similar issues in the past and have been addressed in bankruptcy's preference provisions. Most closely analogous is the treatment of lenders who take security interests in inventory or the debtor's accounts receivable. Because inventory is sold and debtors collect accounts receivable, the lender's original collateral disappears, and its security interest attaches to the new inventory the debtor acquires to replenish its stock and to the debtor's new accounts.[161] Prior to the enactment of the 1978 Bankruptcy Code, attachment of the debtor's security interest to the new collateral during the ninety days before bankruptcy could be challenged as preferential, even though it simply replaces the original collateral, because it is a transfer of a property interest to the creditor on the eve of bankruptcy.[162]

Congress addressed this problem by including a special protection for inventory and receivable lenders in the preference provision.[163] Under this provision, commonly known as the "two-point net improvement" provision, collateral transfers can only be avoided to the extent they make the lender better off as of bankruptcy than the lender was ninety days before bankruptcy. If the lender is fully collateralized ninety days before bankruptcy, nothing can be avoided. If the lender is less un-

160. See supra text accompanying note 134 (outlining Bank of America and Goldman swap hypotheticals).

161. This assumes that the lender has an "after acquired" property clause in its security agreement, as inventory and receivable lenders invariably do. See U.C.C. § 9-204 (2011) (authorizing after acquired property clauses).

162. 11 U.S.C. § 96 (1976) (current version at 11 U.S.C. § 547(b) (2006)). The change was explained in Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 93-137, pt. 1, at 209–10 (1973).

163. 11 U.S.C. § 547(c)(5).

dercollateralized at bankruptcy than it was at ninety days before bankruptcy, the difference—the amount by which the lender's position has improved—can be avoided but only that amount.

The same principle should be extended to derivatives and repos. So long as the counterparty's position is not improved during the ninety days before bankruptcy, the trustee would not be permitted to avoid any of the margin and collateral adjustments as preferential. If the counterparty has strengthened its protections on the eve of bankruptcy, on the other hand, it would be required to give back the amount of the improvement. While the parties often will have made numerous adjustments during the ninety-day period, this approach only requires two calculations—one for the beginning of the ninety-day period and one as of bankruptcy. Given that the parties calculate values continuously, determining whether there has been an improvement in position should be quite straightforward.[164]

The approach we propose would require an amendment to the preference provision, and we strongly advocate this amendment. But even in the absence of a formal amendment, courts might be able to achieve a similar result by applying the existing preference provision. If the parties' mutual adjustments were construed as substitutions of collateral, they might be protected, much as courts protected inventory and receivable lenders before the enactment of the current two-point net improvement test.[165]

In addition to collateral and margin adjustments, the other major prebankruptcy maneuvers that could run aground of the preference provision are transactions that are designed to enable a counterparty to close out its relationship with the debtor. Recall from our earlier hypothetical that Goldman Sachs could exit its relationship with Bank of America by proposing to offset their earlier transaction with a new swap, under which it promised to pay Bank of America $1.3 million dollars in return for €1 million. Should this transaction be treated as preferential? If Goldman owes Bank of America under the earlier swap, we believe the offsetting swap does indeed give Goldman an inappropriate benefit at the

164. This stands in notable contrast to the current § 547(c)(5), which can be difficult to apply because of the need to determine the value of the inventory or receivable collateral as of ninety days before bankruptcy, something inherently difficult when it consists of a non-liquid cluster of, say, inventory.

165. The best known case prior to the adoption of 11 U.S.C. § 547(c)(5) in 1976 was Grain Merchants of Ind., Inc. v. Union Bank & Savings Co., 408 F.2d 209 (7th Cir. 1969). In *Grain Merchants*, the court held that the lender had not received preferences when its security interest attached to new inventory and accounts receivable during the preference period, despite the apparent violation, because the new security interest was a replacement for the lender's interest in prior inventory and accounts. Id. at 218. Under the current § 547, courts might treat the adjustments as contemporaneous exchanges of new value, which are protected by § 547(c)(1). The fit is not perfect, however, because the parties are not substituting new for old collateral, as inventory and receivable lenders do. Rather, they are adding or subtracting collateral as the values under the contract change.

expense of Bank of America's other creditors, since the transaction reduces Goldman's (otherwise unsecured) exposure on the eve of bankruptcy.[166] In form, Goldman has not received a standard preference, because the new swap is not simply a payment or other transfer to Goldman. Instead, Goldman has created a setoff, which effectively ensures that its unsecured obligation will be paid in full. This, too, is anticipated by the bankruptcy laws. Under existing law, the creation of a setoff can be avoided to the extent it leaves the debtor's counterparty better off.[167] This logic, which seems altogether appropriate, would only apply if Goldman exited the relationship through an offsetting swap with Bank of America, rather than with a different counterparty.

III. Implications of the Dodd-Frank Act

Although the Dodd-Frank Act borrows a number of bankruptcy provisions, it nonetheless leaves bankruptcy's statutory provisions oddly untouched. But while there are no direct statutory changes to bankruptcy law, there are important ways in which the Dodd-Frank Act affects bankruptcy indirectly. If it functions as intended, the legislation will require that most derivatives be traded on an exchange and be subject to clearing on a recognized clearinghouse. The likelihood that a larger percentage of derivatives will be cleared and exchange-traded enhances the case for transaction consistency with derivatives in bankruptcy. In addition, the new resolution regime for large financial institutions, another major Dodd-Frank innovation, creates a conflict between bankruptcy and resolution treatment of derivatives, sharply increasing the stakes of the decision whether to restore transaction consistency.

A. *The New Clearinghouse and Exchange Requirements*

The Dodd-Frank Act gives the CFTC and SEC the authority to require that every swap be cleared on a clearinghouse unless no clearing organization will accept the swap.[168] Swaps that are cleared must also be traded on an exchange or "swap execution facility," rather than negotiated privately between the two parties.[169] The new requirements dramatically increase the regulatory oversight of derivatives outside of bank-

166. If Goldman owes Bank of America, on the other hand, the new swap is not preferential because it simply has the effect of prepaying an obligation that Goldman would otherwise be required to pay later.

167. If a nondebtor incurs an obligation in order to create a right to set off the obligation against an unsecured claim, and affects the setoff prior to bankruptcy, the trustee is authorized to retrieve the amount by which the nondebtor's position is improved. 11 U.S.C. § 553(b) (allowing trustee to recover reduction in insufficiency on date of setoff compared to amount of insufficiency ninety days before filing of petition in bankruptcy). If the nondebtor does not invoke its setoff right until after the bankruptcy is filed, 11 U.S.C. § 553(a)(3) achieves the same effect.

168. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 723(a), 124 Stat. 1376, 1675–76, 1681 (2010) (to be codified at 7 U.S.C. § 2).

169. Id.

ruptcy, and they have other important indirect implications for bankruptcy.

With swaps that are cleared, the clearinghouse interposes itself between the two counterparties to a swap and stands ready to make good on either side of the contract if one of the counterparties fails.[170] Because the clearinghouse is responsible for both sides' performance, it will require each to post margin or collateral on an ongoing basis and will monitor both sides. If Bank of America and Goldman enter into a swap requiring Bank of America to deliver $1.3 million and Goldman to deliver €1 million, the clearinghouse would serve as guarantor of each side's performance and would require each to meet specified margin requirements.

Closely linked with the clearinghouse innovation is a requirement that swaps be traded on exchanges (or executed on swap execution facilities),[171] rather than negotiated privately in the over-the-counter (OTC) market, unless no exchange will have them. The objective here is transparency: Swaps will need to be standardized if they are traded on exchanges like stocks or bonds, which will make them easier to price and compare.

The initial question posed by this restructuring of the derivatives market is whether it moots the argument for transaction consistency. If Bank of America and Goldman are both fully protected by the presence of a clearinghouse, some might say, there is not much need for an automatic stay. But this misunderstands the intent of the automatic stay. If Bank of America were to file for bankruptcy, the presence of a clearinghouse would protect Goldman and thus diminish the risk that Goldman would be destabilized by Bank of America's default. But an important goal of the stay is to enable Bank of America to arrange an efficient disposition of its assets in bankruptcy. This may depend on, among other things, preserving existing hedging arrangements.[172] The clearinghouse arrangement has no effect on this function (other than to introduce the issue, discussed below, of whether the clearinghouse also should be subject to the stay), and does not eliminate its importance.[173]

170. The guaranty is somewhat qualified. The clearinghouse has the option of paying the defaulting party's obligation or obtaining a substitute contract. If the clearinghouse decides to pay, it determines the appropriate value. We are grateful to Kimberly Summe for pointing this out to us.

171. Dodd-Frank Act § 723(a), 124 Stat. at 1681 (to be codified at 7 U.S.C. § 2).

172. Bank of America could try to replace any hedging transaction that a counterparty terminated, of course, but the costs could be substantial.

173. Under Dodd-Frank's resolution rules, clearinghouses are subject to the standstill, Dodd-Frank Act § 210(c)(10)(B), 124 Stat. at 1491 (to be codified at 12 U.S.C. § 5390), but they are permitted to continue enforcing margin obligations. Id. § 210(c)(8)(G), 124 Stat. at 1489 (to be codified at 12 U.S.C. § 5390). This protection will not have much practical effect because the FDIC will invariably protect all of the institution's derivatives contracts. As noted below, the clearinghouse should not be insulated from the effect of the stay in bankruptcy.

The bottom line for exchange trading is the same. A swap that is exchange traded is more fungible than an OTC swap, which might seem to suggest that it need not be stayed. But exchange-traded swaps are not like cash. The swap may be an important component of a debtor's portfolio of hedges or brokerage operations. Even if it would be simpler to replace than an OTC swap, its immediate termination could undermine a debtor's disposition of its assets.

Any case for exempting cleared, exchange-traded swaps from transaction consistency would therefore need to rest on other grounds. The best, though ultimately unpersuasive, argument for exemption is tied to the distinction between cleared- and exchange-traded and noncleared- and nonexchange-traded swaps under the new legislation. Exempting cleared derivatives, but not noncleared derivatives, would create an incentive for counterparties to favor cleared derivatives.[174] While we too favor efforts to direct swaps toward clearinghouses and exchanges, this objective is not sufficient to justify jettisoning transaction consistency. The stay is essential to reduce the credit subsidy for derivatives and to facilitate the efficient disposition of the assets of the debtor—Bank of America in the hypothetical.

The status of the clearinghouse itself is more delicate. If the clearinghouse were solely a middleman, it would be a simple matter to conclude that the stay and other core bankruptcy policies should not apply. But the clearinghouse is far more than a conduit. It is not like the stockbrokers whose settlement and margin payments were protected by the original 1978 exemptions.[175] As guarantor of both sides' performance (indeed, technically a counterparty to each), and as the principal monitor, the clearinghouse is itself an integral player.

Because the clearinghouse is not simply a middleman, the presumption of transaction consistency should apply unless there are other reasons that would justify protection from the stay and other bankruptcy policies. The most compelling argument would stem from the new centrality of the clearinghouses to the stability of American finance. Prior to the new legislation, large, interconnected institutions like Citigroup or AIG were the major sources of systemic risk. With the new legislation, that risk may be shifted to the clearinghouses. They are the new too-big-to-fail entities, given their obligation to guarantee all cleared derivatives contracts.[176] The financial system cannot afford, some might argue, for clear-

174. The rationale is that cleared derivatives would enjoy slightly superior treatment, because they would not be subject to the automatic stay in the event one of the counterparties later filed for bankruptcy. At the margin, this would encourage parties to use cleared rather than noncleared derivatives.

175. See supra notes 30–31 and accompanying text (describing arguments that brokers were simply conduits and should not be subject to preference and fraudulent conveyance rules).

176. This point is made (sarcastically) in Editorial, Another Dodd-Frank Triumph, Wall St. J., Feb. 16, 2011, at A16 (criticizing clearinghouse provisions of Dodd-Frank Act as creating new sources of systemic risk).

inghouses to be hampered in any way by bankruptcy provisions like the stay and the trustee's avoidance powers.

While we appreciate these concerns, we do not believe that they add up to a rationale for jettisoning transaction consistency. The first thing to note is that the clearinghouse could protect itself by requiring that swaps be adequately collateralized.[177] Moreover, the interference proposed in this Essay is quite limited—a three-day stay and a preference reachback cabined by the two-point net improvement safe harbor.[178] The bite of transaction consistency would thus be very much at the margins, affecting undercollateralized swaps for a brief transition period.

The core difficulty with retaining the more sweeping current exemptions stems from the fact that the clearinghouses will be stepping into the shoes of the major derivatives trading banks. The clearinghouse, rather than the counterparty, will now be a debtor's principal monitor and creditor. The special treatment would, at the margins, diminish the clearinghouse's incentive to monitor the counterparties, and would diminish the debtor's ability to maximize the value of its assets.[179] In short, leaving the exemptions in place for clearinghouses would thus replicate some of the distortions that exacerbated the 2008 crisis.

One last issue deserves comment. What if the clearinghouse itself were to fail? Once again, the stay should apply, although the reasoning differs in some respects. If the debtor is a clearinghouse, considerations such as preserving a viable business (or viable components of a business) loom less large than with other firms. The key concern is limiting the disruption to the derivatives cleared on the exchange.

The importance of a stay may vary depending on how many clearinghouses emerge as a result of Dodd-Frank, and whether the clearinghouse

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177. Adequate collateralization would consist of collateral in the amount of the shortfall from the counterparty that is currently out of the money, plus sufficient collateral to cover possible swings in value during the three-day period of the stay.

178. Somewhat ironically, exempting clearinghouses from the three-day automatic stay would undermine one of the key advantages clearinghouses (and exchanges) provide. The ability to make three-day decisions regarding the assumption or rejection of swaps requires accurate valuation information that is virtually instantaneously available. Swaps cleared on clearinghouses (and therefore traded on exchanges or swap-execution facilities) would have precisely this attribute. If, however, clearinghouses were exempted from the automatic stay, the swaps that would remain subject to the three-day stay proposed here would likely be the ones without accurate and instantaneous pricing information. See supra note 139 and accompanying text (introducing proposed three-business-day truncated stay).

179. While the attention has been on whether clearinghouses should be exempted from bankruptcy's automatic stay, the same reasoning would apply if the issue were whether clearinghouses should be exempted from bankruptcy's preference rules (as adjusted pursuant to the analysis). Although incomplete, preference rules are bankruptcy law's most important effort to address a serious problem that leads bankruptcies to systematically start too late: These rules deny gains from creditors who foresee bankruptcy but avoid, rather than commencing, it. See supra notes 26–27 and accompanying text (introducing concept of preference rules). For that reason, the monitoring argument for counterparties applies equally to their inclusion in the preference rules for swaps.

that falls into distress has a large presence in the market. If a small clearinghouse failed, the derivatives could be moved to other clearinghouses, perhaps even in the absence of a stay. If a clearinghouse of any substantial size failed, by contrast, a stay would be essential in order to provide enough time to determine which derivatives to assume and which to reject.[180] The managers of a clearinghouse could not effectively handle large numbers of derivatives quickly enough to prevent systemic damage in the absence of the stay. The market for clearinghouses is currently quite concentrated, and seems likely to remain concentrated. Moreover, a stay might be beneficial even for a small clearinghouse if its failure comes, as often will be the case, when many counterparties are themselves stressed. It is therefore important that the stay apply to clearinghouse failures, as it does in other contexts.

B. *Resolution Authority*

The new framework for large, systemically important financial institutions gives bank regulators the power to take over troubled-bank holding companies, systemically important nonbank financial institutions, or other companies that are predominantly engaged in financial activities.[181] Although the trigger is more complex—calling for U.S. Treasury initiation with the concurrence of the Federal Reserve and FDIC[182]—the new authority is designed to give the FDIC the same kinds of resolution powers it has with ordinary commercial banks.[183] The FDIC has a nearly unfettered right to sell or transfer assets or liabilities to third parties, as with ordinary banks.[184] With repos and derivatives, the FDIC is given a one-plus-day period during which counterparties cannot terminate or net

180. For an argument that Dodd-Frank's one-day standstill would not be enough time to handle the huge number of derivatives for which a clearinghouse is responsible, see Julia Lees Allen, Note, Derivatives Clearinghouses and Systemic Risk: A Bankruptcy and Dodd-Frank Analysis, 64 Stan. L. Rev. (forthcoming 2012).

181. The resolution rules are set forth in Title II of the Dodd-Frank Act, entitled Orderly Resolution Authority (OLA). See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, tit. II, 124 Stat. 1376, 1442 (2010) (to be codified at 12 U.S.C. § 5381). Interestingly, there is no requirement that a financial institution be designated as systemically important under section 805 (a category that subjects it to extensive new regulation under Title I) prior to being taken over under the resolution rules. Id. § 805, 124 Stat. at 1809 (to be codified at 12 U.S.C. § 5464). Instead, regulators need only find that it is a "covered financial company" because, among other things, its failure might cause systemic damage. Id. § 202, 124 Stat. at 1444–50 (to be codified at 12 U.S.C. § 5382) (outlining requirements for resolution petition).

182. Id. § 203(a), 124 Stat. at 1450–51 (to be codified at 15 U.S.C. § 1583(a)) (requiring recommendation by U.S. Treasury and approval by two-thirds of Federal Reserve Governors and FDIC Board).

183. The analogy between FDIC resolution and the Dodd-Frank resolution rules is criticized at length in Skeel, New Financial Deal, supra note 48, at 117–27 (arguing rationale for FDIC resolution of small- and medium-sized banks does not apply to large financial institutions).

184. Id. at 123–24.

their contracts.[185] During this time, the FDIC is permitted to decide which contracts to transfer, subject to the stricture that the FDIC must transfer either all or none of the contracts with any given counterparty.

The relationship between the resolution framework and our transaction consistency analysis is initially counterintuitive. If one concluded that the stay is most essential for large, systemically important debtors—as is plausible[186]—the resolution framework might appear to make a bankruptcy stay unnecessary. The kinds of institutions that featured in the crisis—the AIGs and Lehmans—are covered by the FDIC's newly expanded powers, and these powers include a temporary stay. To the extent that the key institutions are taken care of, parallel reform of the bankruptcy laws may not seem so urgent.

In our view, transaction consistency should not be limited to large, systemically important financial institutions. Even if one wished to limit its scope to these institutions, the new resolution regime would not obviate the need for bankruptcy changes. The scope of the regime, broad as it is, is not exhaustive. Most financial institutions, even quite large ones, would be subject to the bankruptcy process, not the new resolution regime.[187] More importantly, even those institutions that clearly are covered—Bank of America, for instance—are not precluded from filing for bankruptcy. Only if the U.S. Treasury initiates the new regime prior to a bankruptcy filing, or removes the institution from bankruptcy after it has filed, will the new regime be employed with even the largest institutions.[188]

Indeed, the asymmetry between the Dodd-Frank and bankruptcy treatment of repos and derivatives—with a one-plus-day prohibition on termination in Dodd-Frank resolution but no stay in bankruptcy—makes

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185. Under the new resolution rules, qualified financial contracts (which include repos and derivatives) cannot be terminated until 5 PM of the day after a receiver is appointed. Dodd-Frank Act § 210(c)(10)(B), 124 Stat. at 1491 (to be codified at 12 U.S.C. § 5390).

186. See, e.g., Skeel, Bankruptcy, supra note 63, at 19 (explaining possible benefits of stay only for systemically important institutions).

187. Assistant Treasury Secretary Michael Barr, the Obama Administration's point person for the legislation, assured lawmakers that "bankruptcy proceedings will remain the dominant option for handing the failure of a non-bank financial institution, even very large ones." Too Big to Fail: The Role for Bankruptcy and Antitrust Law in Financial Regulatory Reform (Part I): Hearing Before the Subcomm. on Commercial & Admin. Law of the H. Comm. on the Judiciary, 111th Cong. 23 (2009) (prepared statement of Michael S. Barr, Assistant Treasury Secretary); see also U.S. Dep't of the Treasury, Financial Regulatory Reform: A New Foundation 76–79 (2009), available at http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf (on file with the *Columbia Law Review*) ("Bankruptcy is and will remain the dominant tool for handling the failure of a [bank holding company], unless the special resolution regime is triggered because of concerns about financial stability.").

188. See, e.g., Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 208, 124 Stat. 1376, 1459–60 (2010) (to be codified at 12 U.S.C. § 1588) (authorizing removal of case from bankruptcy to Dodd-Frank resolution).

the need for a stay even greater. If a troubled, systemically important financial institution filed for bankruptcy, its counterparties would be well aware that they would lose their right to terminate if bank regulators were to transfer the case from bankruptcy to resolution. As a result, counterparties would have an even stronger incentive to terminate their contracts immediately than they did prior to the enactment of the new resolution rules. Reintroducing a limited stay in bankruptcy would remove these perverse incentives.

Even the most avid proponents of the regime have characterized its use as a last resort, with bankruptcy preferable except in extreme cases.[189] From this perspective, the resolution regime makes bankruptcy reform more urgent, rather than less. Under the present framework, with the resolution framework superimposed on the bankruptcy laws, there is little incentive for a large troubled financial institution to file for bankruptcy. In the absence of a stay, derivatives counterparties' ability to cancel their contracts en masse would severely complicate the managers' efforts to arrange an efficient resolution.[190] With one of the most important benefits of bankruptcy unavailable, the managers may stall, hoping for regulatory forbearance.[191]

If bankruptcy included a stay and other protections, by contrast, managers would have an incentive to prepare for and file for bankruptcy in the event of financial distress. From the managers' perspective, the prospect of a stay would be superior to resolution because it would give them a meaningful prospect of achieving an effective resolution. The stay would halt a run by the institution's derivatives counterparties long enough to facilitate a sale or other disposition of key assets. If AIG had been able to access a bankruptcy stay, for instance, it could have resisted the collateral calls that hastened its decline by filing for bankruptcy.[192] Under the current regime, AIG had an irresistible incentive to do what it did: plan for a bailout. The prospect that a stay might encourage the managers of a large financial institution to plan for bankruptcy in advance and then use the bankruptcy option strongly reinforces the case for

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189. See supra note 187 and accompanying text (discussing statement of Assistant Treasury Secretary Michael Barr).

190. See supra notes 57–61 and accompanying text (discussing this dilemma with AIG).

191. Moreover, if any large troubled financial institution *did* start in bankruptcy, even with the extraordinarily rapid (and potentially unconstitutional) ability of the government to remove the institution from bankruptcy and place it within the orderly liquidation authority of Title II of Dodd-Frank, Dodd-Frank Act § 202(a), 124 Stat. at 1444–46 (to be codified at 12 U.S.C. § 5382), absent a brief stay on derivative counterparties *in bankruptcy*, the stay provided in the orderly liquidation authority of Dodd-Frank may prove to be illusory. See Skeel, New Financial Deal, supra note 48, at 139 (noting constitutional difficulties with process by which orderly liquidation authority is commenced for entity already in bankruptcy).

192. See supra notes 57–61 and accompanying text (describing crisis at AIG).

transaction consistency with derivatives and other financial instruments in bankruptcy.

IV. Alternative Strategies for Reform

Given the effects of bankruptcy's departures from transaction consistency during the recent crisis, we strongly favor a return to thoroughgoing transaction consistency for repos and other financial instruments. But we also recognize that compromises and incomplete solutions are an inevitable part of the political process. We therefore begin by summarizing our ideal reforms, then introduce several more partial solutions.

Full transaction consistency would mean removing the existing exemptions from core bankruptcy policy for repos, swaps, and other financial contracts, with several important wrinkles discussed earlier. The special provisions exempting these contracts from bankruptcy's anti-ipso facto rules would be deleted, in order to implement bankruptcy's standard limitation on ipso facto clauses.[193] We would reintroduce the automatic stay but limit its duration to three days, due to the volatility and short timeline of derivatives contracts.[194] Bankruptcy's preference and fraudulent conveyance rules also should be reintroduced for derivatives. Because of their similarity to accounts and inventory financing, we would protect collateral transfers that do not improve the counterparty's overall position, as bankruptcy does with accounts and inventory.[195] We would apply these adjustments to clearinghouses as well as ordinary counterparties.[196]

The first alternative would entail simply imposing a three-day delay on the exemptions for repos and derivatives from bankruptcy's anti-ipso facto provisions. This approach, which is the strategy lawmakers have employed for systemically important institutions under the Dodd-Frank Act's resolution rules,[197] is the most minimalist reform that would nudge these financial contracts toward transaction consistency and diminish the per-

193. Compare 11 U.S.C. § 541(c)(1)(B) (2006) (invalidating ipso facto clauses), with id. § 559 (allowing ipso facto clauses in repos), and id. § 560 (allowing ipso facto clauses in swaps).

194. See supra Part II.C (describing proposal for swaps and derivatives).

195. See supra Part II.E (proposing rules for preference and fraudulent conveyance).

196. See supra Part III.A (describing Dodd-Frank clearinghouse requirement). In this ideal world, we would, of course, recommend that there be consistency between our proposals for repos and derivatives in bankruptcy and those in Title II of Dodd-Frank, preferably by having Title II of Dodd-Frank mirror the rules we would place in bankruptcy. This idea—consistency between bankruptcy and Title II of Dodd-Frank in the application of substantive rules—would likewise apply to our alternatives as well. We focus in text on bankruptcy reforms, however, believing that issues concerning reopening Dodd-Frank for amendment raise a whole different level of political issues.

197. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 210(c)(10)(B), 124 Stat. 1376, 1491 (2010) (to be codified at 12 U.S.C. § 5390) (preventing invocation of ipso facto clause until 5 PM the day after resolution petition is filed).

verse incentives created by their special treatment. This most simple of reforms would prevent the kind of mass termination by counterparties that an AIG bankruptcy would have triggered. By preventing immediate exit by the debtor's counterparties, bankruptcy's anti-ipso facto provisions would give the debtor a short window of opportunity to arrange a sale or other disposition of its assets. Our principal concern with reintroducing bankruptcy's ipso facto provisions for three days, rather than providing a true stay, is the risk of circumvention. Derivatives professionals could attempt to contract around the proscription by, for instance, introducing a contractual provision that authorizes a counterparty to seize and sell collateral without formally terminating the contract.[198] The anti-ipso facto clause strategy would thus require vigilant judicial oversight, with bankruptcy courts construing the anti-ipso facto provisions broadly enough to foreclose circumventions.[199]

A second alternative to full transaction consistency would couple the minimalist strategy of temporarily reinstating the anti-ipso facto rules with an automatic stay that would cover only swap transactions.[200] Because swaps are a large percentage of the overall derivatives market, imposing a stay on these derivatives but not on other financial contacts would substantially increase transaction consistency. Repos, the other major component of the new finance, would retain their special status in bankruptcy. As this Essay has demonstrated, this status differs only in limited respects from the treatment repos would receive under true transaction consistency.[201] As financial accommodations, repos would be automatically terminated when the debtor filed for bankruptcy. Imposing a stay on repos is thus less crucial to restoring transaction consistency. A stay on swaps, by contrast, would remove an important distortion in existing finance, limit the risk of mass terminations and collateral sales, and facilitate an orderly disposition of assets.

Each of the alternatives to full transaction consistency could be adopted either by itself or together with our proposed reforms to the preference provision; the preference reforms are, in a sense, another distinct module. Lawmakers might choose to forgo the preference reform initially, in order to focus first on the largest source of distortion and to

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198. If a stay were in place, these steps would be prohibited. But they would not be prevented if Congress reinstated bankruptcy's anti-ipso facto provisions while leaving counterparties' exemption from the stay in place.

199. The bankruptcy judge's handling of the Lehman case gives some comfort in this regard. The judge ruled, for instance, that Lehman's counterparties who did not promptly exercise their right to terminate were deemed to have waived this right. Order to Compel Performance of Contract and to Enforce the Automatic Stay at *1, In re Lehman Bros. Holdings, No. 08-13555 (JMP), 2009 WL 6057286 (Bankr. S.D.N.Y. Sept. 17, 2009).

200. In addition to repealing 11 U.S.C. §§ 559, 560 and related provisions, this reform would entail modifications to 11 U.S.C. § 362(b)(7) and 11 U.S.C. § 362(b)(17) reintroducing a three-day stay.

201. See supra Part II.B.1 (discussing characteristics making repos similar to secured loans).

avoid the potential complexity of assessing a debtor's prebankruptcy transactions.

We should reiterate that moving to full transaction consistency is much preferable to any of the more partial alternatives, but each step in this direction will remedy the distortions caused by the special treatment that derivatives currently receive.

Conclusion

The new finance that has emerged in the past thirty years has often seemed so innovative and different that it could not possibly be subject to the rules that applied to old-fashioned lending arrangements. The market appeared to be sui generis—both distinct and self-regulating.

This Essay has sought to show that the instruments of contemporary finance are not quite so radically different as is conventionally thought. Analysis through the lens of the concept we call transaction consistency shows that derivatives and repos should not simply be insulated from core bankruptcy rules such as the automatic stay and the prohibition of eve-of-bankruptcy preferences. Subjecting derivatives and repos to transaction consistency would have a less radical effect than is commonly thought, and the effect would be beneficial overall. If it has persuaded a few readers that derivatives and repos can be analyzed under the same framework that applies to other contracts, this Essay will have been a success.[202]

We do not claim that a currency swap is no different than a traditional equipment loan, and that a credit default swap is simply an insurance contract. Derivatives and repos do have distinctive qualities, such as the volatility of their value. But these are differences of degree, not differences in kind. Under the framework proposed in this Essay, the stay would be limited to three days, and repos secured by cash-like securities would not be subject to the stay. These adjustments are arrived at by simply applying the concepts that underlie bankruptcy's treatment of ordinary contracts.

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202. The issues are of far more than academic interest alone. The Dodd-Frank Act calls for two different reports on the efficacy of bankruptcy for handling financial institution failures. Dodd-Frank Act § 202(e), 124 Stat. at 1448–49 (to be codified at 12 U.S.C. § 5382) (providing for study by Administrative Office and Comptroller); id. § 216, 124 Stat. at 1519 (to be codified at 12 U.S.C. § 5394) (providing for study by Federal Reserve and Administrative Office). The report by the Board of Governors of the Federal Reserve System was issued in July 2011. Bd. of Governors of the Fed. Reserve Sys., Study on the Resolution of Financial Companies Under the Bankruptcy Code (2011), available at http://www.federalreserve.gov/publications/other-reports/files/bankruptcy-financial-study-201107.pdf (on file with the *Columbia Law Review*) (laying out various alternatives, including ones close to those proposed by this Essay, without committing to any one outcome). The treatment of repos and derivatives in bankruptcy will be central to the analysis of these studies. See, e.g., Dodd-Frank Act § 216(a)(2)(D), 124 Stat. at 1519 (to be codified at 12 U.S.C. § 5394) (calling for analysis of whether special treatment of qualified financial contracts—that is, derivatives—in bankruptcy should be amended).

Our goals for this analysis are two: First, we hope that lawmakers will consider making the simple adjustments in the treatment of derivatives and repos that we have proposed—or, alternatively, the more limited adjustments we have identified as providing most of the benefits of full transaction consistency. Second, we hope that lawmakers will keep the transaction consistency principle in mind when the next wave of financial innovations arrives in the future, as it surely will.[203]

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203. Although our particular concern in this Essay has been repos and derivatives, deviations from transaction consistency have created problems in other contexts as well. The most obvious is the special treatment of consumer mortgages. Unlike most other loans, which can be written down to the value of the collateral if the collateral is worth less than the debtor owes, mortgages on primary residences cannot be altered by debtors under Chapter 13. See 11 U.S.C. § 1322(b)(2) (2006) (noting Chapter 13 plan may "modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence"). The special treatment of mortgages may have contributed to the distortions in the mortgage market during the real estate bubble, and many commentators (including one of us) believe that removing the special treatment might have hastened homeowners' recovery from the recent economic crisis. See, e.g., David A. Skeel, Jr., Bankruptcy Phobia, 82 Temp. L. Rev. 333, 334–35, 340 (2010) (describing defeat of proposals for reform).